UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-K/A

(Amendment No. 1)

FOR ANNUAL AND TRANSITION REPORTS

PURSUANT TO SECTIONS 13 OR 15(d) OF THE

SECURITIES EXCHANGE ACT OF 1934

(Mark One)

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

For the fiscal year ended December 31, 2004

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 333-115587

NORTH ATLANTIC HOLDING COMPANY, INC.

(Exact name of registrant as specified in its charter)

Delaware **(State or other jurisdiction of incorporation or organization)**	**20-0709285** **(I.R.S. Employer Identification No.)**

257 PARK AVENUE SOUTH, NEW YORK, NEW YORK 10010-7304

(Address of principal executive offices) (Zip Code)

Registrant s telephone number, including area code: (212) 253-8185

Securities registered pursuant to Section 12(b) of the Act: None

Securities registered pursuant to Section 12(g) of the Act: None

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 x No ¨.

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy materials or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. x

Indicate by check mark whether the registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2). Yes ¨ No x.

As of March 29, 2005, the only class of voting or non-voting common equity issued and outstanding was the Registrant s Voting Common Stock, par value $.01 per share. There is no trading market for the Voting Common Stock.

As of March 29, 2005, 588,578 shares of the Registrant s Voting Common Stock, par value $.01 per share were outstanding.

EXPLANATORY NOTE

This amendment is being filed to include the signature of PricewaterhouseCoopers LLP, independent registered public accounting firm, in its report included in Part II, Item 8, which signature was inadvertently omitted in the original filing, and to make certain changes to such report and to the Notes to the Company s Consolidated Financial Statements included in Part II, Item 8. The entirety of Part II, Item 8, as amended, is included in this Form 10-K/A, as are new Exhibits 31.1, 31.2, 32.1 and 32.2, dated the date of the filing of this Form 10-K/A.

PART II

Item 8. Financial Statements and Supplementary Data

The Company s Consolidated Financial Statements and Notes to Consolidated Financial Statements, and the report of PricewaterhouseCoopers LLP, independent registered public accounting firm, with respect thereto, referred to in the Index to Financial Statements of the Company contained in Item 15(a), appear on pages F-1 through F-43 of this Form 10-K and are incorporated herein by reference thereto. Information required by schedules called for under Regulation S-X is either not applicable or is included in the Consolidated Financial Statements or Notes thereto.

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.

Date: April 1, 2005

NORTH ATLANTIC HOLDING COMPANY, INC.

By: /s/ Thomas F. Helms, Jr.

Thomas F. Helms, Jr.
Chairman, Chief Executive Officer and President

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Report of Independent Registered Public Accounting Firm

To the Board of Directors

North Atlantic Holding Company, Inc.

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of operations, comprehensive income (loss), cash flows, and changes in stockholders deficit present fairly, in all material respects, the financial position of North Atlantic Holding Company, Inc. and its subsidiaries at December 31, 2004 and 2003, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2004 in conformity with accounting principles generally accepted in the United States of America. 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 of these statements 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. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in note 2 to the financial statements, it is probable that, absent obtaining additional capital investment, a waiver or a refinancing, a subsidiary of the Company will fail to meet a financial covenant requirement for its revolving debt agreement due to its financial performance. Not meeting this requirement would permit the lenders to demand immediate repayment in full, which would then permit holders of the Company s Senior Discount Notes and North Atlantic Trading Company, Inc. s New Senior Notes to also demand immediate repayment. This matter raises substantial doubt about the Company s ability to continue as a going concern. Management s plans as to these matters are also described in the notes to the financial statements. The financial statements do not include any adjustments that might result from the outcome of the uncertainty.

/s/ PricewaterhouseCoopers LLP

Louisville, Kentucky

March 31, 2005

North Atlantic Holding Company, Inc. and Subsidiaries

Consolidated Balance Sheets

December 31, 2004 and 2003

(dollars in thousands except share data)

	2004	2003
ASSETS		
Current assets:		
Cash	$ 2,347	$ 304
Accounts receivable, net of allowances of $284 and $367 in 2004 and 2003, respectively	7,839	10,384
Inventories	37,959	42,257
Income taxes receivable		910
Other current assets	5,861	3,594
Total current assets	54,006	57,449
Property, plant and equipment, net	10,771	8,310
Deferred income taxes		22,549
Deferred financing costs, net	13,105	5,163
Goodwill	128,697	128,659
Other intangible assets, net	10,293	10,851
Other assets	15,526	10,663
Total assets	$ 232,398	$ 243,644
LIABILITIES AND STOCKHOLDERS DEFICIT		
Current liabilities:		
Accounts payable	$ 7,005	$ 5,275
Accrued expenses	4,642	6,039
Accrued interest expense	6,274	757
Deferred income taxes		4,654
Revolving credit facility	14,500	6,300
Total current liabilities	32,421	23,025
Notes payable and long-term debt	266,622	185,686
Deferred income taxes		1,141
Postretirement benefits	6,061	9,333
Pension benefits and other long-term liabilities	4,013	5,946
Total liabilities	309,117	225,131
Commitments and contingencies		
Preferred stock, mandatory redemption value of $0 and $65,080 in 2004 and 2003, respectively, issued and outstanding shares, 2,941,513.08 in 2003		65,080
Stockholders deficit:		
Common stock, voting, $.01 par value; 2004; authorized, issued and outstanding shares, 10; $01 par value; 2003; authorized shares, 750,000; issued and outstanding shares, 528,241	6	5
Common stock, nonvoting, $01 par value; authorized shares, 750,000; issued and outstanding shares, -0-		
Additional paid-in capital	5,291	9,663

Loans to stockholders for stock purchases	(99)	(168)
Accumulated other comprehensive loss	(1,351)	(1,229)
Accumulated deficit	(80,566)	(54,838)
Total stockholders deficit	(76,719)	(46,567)
Total liabilities and stockholders deficit	$ 232,398	$ 243,644

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

North Atlantic Holding Company, Inc. and Subsidiaries

Consolidated Statements of Operations

for the years ended December 31, 2004, 2003 and 2002

(dollars in thousands except share data)

	2004	2003	2002
Net sales	$ 115,320	$ 101,593	$ 94,425
Cost of Sales	58,617	48,616	40,973
Gross profit	56,703	52,977	53,452
Selling, general and administrative expenses	37,031	32,589	24,065
Amortization expense	462	67	
Operating income	19,210	20,321	29,387
Interest expense and financing costs	31,283	19,122	18,744
Other expense (income)	(4,361)	11,129	1,944
Income (loss) before income taxes	(7,712)	(9,930)	8,699
Income tax expense (benefit)	17,404	(3,689)	3,214
Net income (loss)	(25,116)	(6,241)	5,485
Preferred stock dividends	(1,613)	(7,275)	(6,976)
Net gain on restructuring of preferred stock			5,395
Net income (loss) applicable to common shares	$ (26,729)	$ (13,516)	$ 3,904

	2004	2003	2002
Basic earnings per common share:			
Net income (loss)	$ (43.47)	$ (11.82)	$ 10.38
Preferred stock dividends	(2.79)	(13.77)	(13.20)
Net gain on restructuring of preferred stock			10.21
Net income (loss) applicable to common shares	$ (46.26)	$ (25.59)	$ 7.39
Diluted earnings per common share:			
Net income (loss)	$ (43.47)	$ (11.82)	$ 8.25
Preferred stock dividends	(2.79)	(13.77)	(10.49)
Net gain on restructuring of preferred stock			8.11
Net income (loss) applicable to common shares	$ (46.26)	$ (25.59)	$ 5.87
Common stock dividends	$ (4,884)	$	$
Basic and Diluted earnings per common share			

Common stock dividends	$ (8.45)	$	$
Weighted average common shares outstanding:			
Basic	577,795	528,241	528,241
Diluted	577,795	528,241	664,939

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

North Atlantic Holding Company, Inc. and Subsidiaries

Consolidated Statements of Comprehensive Income (Loss)

for the years ended December 31, 2004, 2003 and 2002

(dollars in thousands except share data)

Consolidated Statements of Comprehensive Income (Loss)

(in thousands)

	2004	2003	2002
Net Income (loss)	$ (25,116)	$ (6,241)	$ 5,485
Other comprehensive income, net of tax benefit:			
Minimum pension liability, net of tax	(122)	(104)	(909)
Comprehensive income (loss)	$ (25,238)	$ (6,345)	$ 4,576

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

North Atlantic Holding Company, Inc. and Subsidiaries

Consolidated Statements of Cash Flows

for the years ended December 31, 2004, 2003 and 2002

(dollars in thousands)

	2004	2003	2002
Cash flows from operating activities:			
Net income (loss)	$ (25,116)	$ (6,241)	$ 5,485
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:			
Depreciation	816	589	700
Amortization expense	462	67	
Amortization of deferred financing costs	1,949	1,386	1,386
Amortization of interest on senior discount notes	6,612		
Deferred income taxes	16,754	(3,689)	2,738
Stock compensation expense	832	417	576
Stock issued for non-cash services	681		
Changes in operating assets and liabilities:			
Accounts receivable	2,545	(1,827)	(1,979)
Inventories	4,298	1,964	3,149
Income tax receivable	910	(23)	(654)
Other current assets	(2,267)	752	(1,755)
Other assets	(4,766)	(1,309)	(985)
Accounts payable	1,730	1,848	150
Accrued pension liabilities	(1,933)	366	495
Accrued postretirement liabilities	(3,272)	(1,509)	558
Accrued expenses and other	3,998	2,351	(1,479)
Net cash provided by (used in) operating activities	4,233	(4,858)	8,385
Cash flows from investing activities:			
Capital expenditures	(3,277)	(1,561)	(625)
Purchase of Stoker, Inc. (net of cash acquired $1,672 see Note 4)	(38)	(21,650)	
Net cash provided by (used in) investing activities	(3,315)	(23,211)	(625)
Cash flows from financing activities:			
Proceeds from revolving credit facility, net	8,200	800	5,500
Proceeds from issuance of new senior notes	200,000		
Proceeds from issuance of new senior discount notes	60,010		
Payment of old senior notes	(155,000)		
Payment of financing costs	(9,891)		
Payments on notes payable	(30,686)		
Payments on senior term loans			(12,500)
Deferred financing costs incurred		(3,907)	
Redemption of preferred stock	(65,080)		
Preferred stock cash dividends	(1,613)		
Common stock dividends	(4,884)		
Principal from long-term borrowings		42,000	
Principal payments on long-term borrowings		(11,314)	
Consent solicitation expenses			(1,219)

Net loans to stockholders for stock purchases	69	(11)	30
Net cash provided by (used in) financing activities	1,125	27,568	(8,189)
Net increase (decrease) in cash	2,043	(501)	(429)
Cash, beginning of period	304	805	1,234
Cash, end of period	$ 2,347	$ 304	$ 805
Supplemental disclosures of cash flow information:			
Cash paid during the period for interest	$ 16,245	$ 17,911	$ 17,560
Cash paid during the period for income taxes	$ 1,297	$	$ 283

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

North Atlantic Holding Company, Inc. and Subsidiaries

Changes in Stockholders Deficit

for the years ended December 31, 2004, 2003 and 2002

(dollars in thousands)

	Common Stock, Voting	Additional Paid-In Capital	Loans to Stockholders for Stock Purchases	Accumulated Other Comprehensive Loss	Accumulated Deficit	Total
Beginning balance, January 1, 2002	$ 5	$ 9,144	$ (187)	$ (216)	$ (45,226)	$ (36,480)
Stock compensation expense		102				102
Net loans to stockholders for stock purchases			30			30
Amount related to minimum pension liability, net of tax of $344				(909)		(909)
Preferred stock dividend					(6,976)	(6,976)
Net gain on restructuring of preferred stock					5,395	5,395
Net income					5,485	5,485
Ending balance, December 31, 2002	5	9,246	(157)	(1,125)	(41,322)	(33,353)
Stock compensation expense		417				417
Net loans to stockholders for stock purchases			(11)			(11)
Amount related to minimum pension liability, net of tax of $64				(104)		(104)
Preferred stock dividend					(7,275)	(7,275)
Net loss					(6,241)	(6,241)
Ending balance, December 31, 2003	5	9,663	(168)	(1,229)	(54,838)	(46,567)
Elimination of equity in NATC		(5,885)			5,885	
Stock compensation expense		832				832
Issuance of common stock	1	681				682
Net loans to stockholders for stock purchases			69			69
Amount related to minimum pension liability net of tax of $74				(122)		(122)
Common stock dividend					(4,884)	(4,884)
Preferred stock dividend					(1,613)	(1,613)
Net loss					(25,116)	(25,116)
Ending balance, December 31, 2004	$ 6	$ 5,291	$ (99)	$ (1,351)	$ (80,566)	$ (76,719)

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

North Atlantic Holding Company, Inc. and Subsidiaries

Notes to Consolidated Financial Statements

for the years ended December 31, 2004, 2003 and 2002

(dollars in thousands)

1. Organization:

North Atlantic Holding Company, Inc. (the Company) is a holding company which owns North Atlantic Trading Company, Inc. (NATC) and its subsidiaries. Except where the context otherwise requires, references to the Company include the Company and its subsidiaries. The Company manufactures and distributes tobacco and related products through its smokeless tobacco, make-your-own, and premium manufactured cigarettes operating segments. The smokeless tobacco segment manufactures and distributes smokeless tobacco products under the ***Beech-Nut***, ***Durango***, ***Trophy***, ***Havana Blossom***, ***Stoker***, ***Our Pride*** and other brand names. The make-your-own segment imports and distributes premium cigarette papers and related products, and manufactures smoking tobaccos under the ***Zig-Zag***, ***Stoker No. 2***, ***Old Hillside*** and other brand names. The premium cigarette segment contract manufactures and distributes premium manufactured cigarettes through wholesale distributors in selected areas of the United States.

National Tobacco Company, L.P., a limited partnership, was formed and acquired the smokeless tobacco division of Lorillard, Inc. in 1988. On April 14, 1992, the general partner and majority owner and certain limited partners sold their partnership interest to a new general partner. Accordingly, the April 1992 transaction was accounted for as the formation of a new entity, National Tobacco Company, L.P. (the Partnership). Certain members of management of the Partnership formed NTC Holding, LLC (the Holding Company), a limited liability company with a finite life expiring December 31, 2100, and caused the Holding Company to form National Tobacco Finance Corporation (the Finance Corporation), a wholly-owned subsidiary of the Holding Company.

On May 17, 1996, the Partnership was recapitalized and the Holding Company acquired a 99% limited partnership interest in the Partnership and the Finance Corporation became the sole general partner and owner of the remaining 1% interest of the Partnership. Accordingly, this transaction was accounted for as the formation of a new entity under the purchase method of accounting.

On May 19, 1997, certain members of management and holders of membership interests in the Holding Company formed NATC. On June 25, 1997, NATC acquired the membership interests in the Holding Company and the Holding Company transferred all of its assets to NATC, including its limited partnership interest in the Partnership, all of the capital stock of the Finance Corporation, and its rights to acquire NATC Holdings USA, Inc. which owned exclusive rights to market and distribute Zig-Zag premium cigarette papers in the United States and Canada and also owned outright the trademarks for tobacco products bearing the Zig-Zag name. NATC then formed North Atlantic Operating Company, Inc. (NAOC), a Delaware corporation and wholly-owned subsidiary of the Corporation. NAOC then exercised its rights to acquire all of the outstanding capital stock of NATC Holdings, USA, Inc. NATC Holdings, USA, Inc. and its wholly-owned subsidiary were then merged into NAOC.

On April 10, 2003, North Atlantic Cigarette Company, Inc. (NACC) was formed to contract manufacture and distribute premium manufactured cigarettes.

On November 17, 2003, NATC purchased all of the common stock of Stoker, Inc. (Stoker). See Note 4, Acquisition of Business . Stoker is the parent of the wholly-owned subsidiaries, Fred Stoker & Sons, Inc. and RBJ Sales, Inc.

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

North Atlantic Holding Company, Inc. and Subsidiaries

Notes to Consolidated Financial Statements

for the years ended December 31, 2004, 2003 and 2002

(dollars in thousands)

1. Organization: Continued

On February 9, 2004, NATC consummated a holding company reorganization whereby the Company became the parent company of NATC. The holding company reorganization was effected pursuant to an Agreement and Plan of Merger (the Merger Agreement), dated February 9, 2004, among NATC, the Company and NATC Merger Sub, Inc., a Delaware corporation and a direct wholly-owned subsidiary of the Company (Merger Sub).

Pursuant to the Merger Agreement, (i) Merger Sub was merged with and into NATC (the Merger), with NATC as the surviving corporation; (ii) NATC became a wholly-owned subsidiary of the Company; (iii) each of the 539,235 issued and outstanding shares of voting common stock of NATC, par value $0.01 per share, was converted into the right to receive one share of common stock of the Company, par value $0.01 per share (Company Common Stock); (iv) each issued and outstanding share of common stock of Merger Sub was converted into one issued and outstanding share of common stock of NATC, and (v) all of the issued and outstanding shares of Company Common Stock held by NATC were cancelled.

Immediately after the Merger, (i) 539,235 shares of Company Common Stock were issued and outstanding; and (ii) ten (10) shares of NATC Common Stock were issued and outstanding.

Subsequently, the Company issued 49,523 shares of Common Stock upon the exercise of certain warrants pursuant to a Warrant Agreement (the Warrant Agreement), dated June 25, 1997, between the Company (as assignee to NATC s rights and obligations under the Warrant Agreement) and The Bank of New York, as warrant agent (as successor to the United States Trust Company of New York). As of December 31, 2004, (i) 588,758 shares of Company Common Stock were issued and outstanding; and (ii) ten (10) shares of NATC Common Stock were issued and outstanding.

On February 17, 2004, NATC consummated the refinancing of its existing debt and preferred stock and the Company issued senior discount notes in conjunction with the refinancing. The refinancing consisted principally of (1) the offering and sale of $200.0 million principal amount of 9¼% senior notes due 2012 by NATC (the New Senior Notes), (2) NATC entering into an amended and restated loan agreement that provides a $50.0 million senior secured revolving credit facility to NATC (the New Credit Agreement) and (3) the concurrent offering and sale of $97.0 million aggregate principal amount at maturity of 12¼% senior discount notes due 2014 of the Company (the Senior Discount Notes). Both the New Senior Notes and the Senior Discount Notes were offered pursuant to Rule l44A and Regulation S under the Securities Act of 1933, as amended.

Concurrently with the closing of the refinancing, NATC also called for the redemption all of its outstanding 11% senior notes due 2004 (the Old Senior Notes), in accordance with the terms of the indenture governing such notes, at the applicable redemption price of 100.0% of the principal amount thereof, plus interest accrued to the redemption date of April 2, 2004. At December 31, 2003, NATC had outstanding $155.0 million aggregate principal amount of its 11% senior notes due 2004.

The proceeds from the offering of the New Senior Notes, along with borrowings under the New Credit Agreement (see Note 11) and the proceeds from the concurrent offering of the Senior Discount Notes were used to (1) repay $36.6 million in outstanding borrowings under

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

North Atlantic Holding Company, Inc. and Subsidiaries

Notes to Consolidated Financial Statements

for the years ended December 31, 2004, 2003 and 2002

(dollars in thousands)

1. Organization: Continued

the existing senior credit facility (the Old Senior Credit Facility), including borrowings used to finance the cash purchase price for the acquisition of Stoker, Inc. (see Note 4), (2) redeem the Old Senior Notes, (3) redeem NATC s existing 12% senior exchange payment-in-kind preferred stock on March 18, 2004, (4) pay a $5.0 million pro rata distribution to stockholders of the Company and make a distribution to certain holders of warrants of the Company, (5) make $2.1 million in incentive payments to certain key employees and outside directors, and (6) pay fees and expenses of $12.8 million incurred in connection with the offerings.

2. Liquidity:

As discussed in the Notes Payable and Long-Term Debt footnote, NATC s New Credit Agreement requires NATC to meet certain financial tests, including a minimum fixed charge coverage ratio. Management s forecasts for 2005 indicate that it is likely that NATC will fail to meet the minimum fixed charge coverage ratio covenant at June 30, 2005 without obtaining an additional capital investment, a waiver from its lenders, or a refinancing of such debt. Not meeting this requirement would permit the lenders to demand immediate repayment in full, which would then permit holders of NATC s New Senior Notes and the Company s Senior Discount Notes to also demand immediate repayment.

Although there can be no assurance, the Company believes that it will be able to successfully negotiate new senior secured financing on reasonably acceptable terms, refinance out the existing lenders, and avoid a default under NATC s New Credit Agreement. Further, management has begun a process to review its core operations and identify and implement opportunities to significantly improve operational and financial performance and its internal cash generating capability.

3. Summary of Significant Accounting Policies:

Basis of Presentation: The financial statements of the Company include the results of operations, cash flows and changes in shareholders equity of the Company, its NATC subsidiary and all other subsidiaries for all periods presented.

Consolidation: The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. All significant intercompany transactions have been eliminated.

Revenue Recognition: The Company recognizes revenues and the related costs upon transfer of title and risk of loss to the customer. The Company classifies customer rebates as sales deductions in accordance with the requirements of Emerging Issues Task Force Issue No. 01-09 and classifies shipping costs incurred as a component of cost of goods sold in accordance with the requirements of Emerging Issues Task Force Issue No. 00-10.

Shipping Costs: The Company records shipping costs incurred as a component of selling, general and administrative expenses. Shipping costs incurred were $3,419, $2,790, and $2,583 in 2004, 2003, and 2002, respectively.

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

North Atlantic Holding Company, Inc. and Subsidiaries

Notes to Consolidated Financial Statements

for the years ended December 31, 2004, 2003 and 2002

(dollars in thousands)

3. Summary of Significant Accounting Policies: Continued

Research and Development Costs: Research and development costs are expensed as incurred. These expenses, classified as selling and administrative expenses, were $521 in 2004, $577 in 2003, and $539 in 2002.

Cash and Cash Equivalents: The Company considers any highly liquid investments with a maturity of three months or less from the date of purchase to be cash equivalents.

Inventories: Inventories are stated at the lower of cost or market. Cost is determined using the last-in, first-out (LIFO) method for approximately 96% of the inventories. Leaf tobacco is presented in current assets in accordance with standard industry practice, notwithstanding the fact that such tobaccos are carried longer than one year for the purpose of curing.

Fixed Assets: Fixed assets are stated at cost less accumulated depreciation. Depreciation is provided using the straight-line method over the estimated useful lives of the related assets (4 to 7 years for machinery, equipment and furniture, and 25 years for buildings). Expenditures for repairs and maintenance are charged to expense as incurred. The costs of major renewals and improvements are capitalized and depreciated over their estimated useful lives. Upon disposition of fixed assets, the costs and related accumulated depreciation amounts are relieved and any resulting gain or loss is reflected in operations during the period of disposition.

Goodwill and other intangible assets: The Company has adopted Statement of Financial Accounting Standards No. 142, Goodwill and Other Intangible Assets (SFAS No. 142).

Under SFAS No. 142, goodwill is no longer to be amortized but reviewed for impairment annually or more frequently if certain indicators arise, using a two-step approach. The net goodwill balances attributable to each of the Company s reporting units are tested for impairment by comparing the fair value of each reporting unit to its carrying value as of December 31 each year. Fair value was determined by using the valuation technique of calculating the present value of estimated expected future cash flows (using a discount rate commensurate with the risks involved) with consideration given to multiples of operating results. The Company has reported that no impairment of goodwill has been incurred as of December 31, 2004.

Deferred Financing Costs: Deferred financing costs are amortized over the terms of the related debt obligations using the effective interest method.

Income Taxes: The Company records the effects of income taxes under the liability method in which deferred income tax assets and liabilities are recognized based on the difference between the financial and tax basis of assets and liabilities using the enacted tax rates in effect for the years in which the differences are expected to reverse.

Advertising and Promotion: Advertising and promotion costs, including point of sale materials, are expensed as incurred and amounted to $3,147, $2,658, and $911 for the years ending December 31, 2004, 2003 and 2002, respectively.

Financial Instruments: The Company has adopted Statement of Financial Accounting Standards No. 133 (SFAS 133), Accounting for Derivative Instruments and Hedging Activities . Forward contracts that qualify as hedges are adjusted to their fair value through other

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

North Atlantic Holding Company, Inc. and Subsidiaries

Notes to Consolidated Financial Statements

for the years ended December 31, 2004, 2003 and 2002

(dollars in thousands)

3. Summary of Significant Accounting Policies: Continued

comprehensive income as determined by market prices on the measurement date. Gains and losses on these contracts are transferred from other comprehensive income into net income as the related inventories are sold. No forward contracts were utilized in 2004.

Stock-Based Compensation: The Company measures stock compensation costs related to the stock options described in Note 16 on the fair value based method which is the preferred method under the provisions of Statement of Financial Accounting Standards (SFAS) No. 123, Accounting for Stock-Based Compensation. The fair value based method requires compensation cost for stock options to be recognized based on the fair value of stock options granted.

Computation of Earnings Per Common Share: Basic earnings per common share is computed by dividing the net income (loss) applicable to common shares by the weighted average number of common shares outstanding during the period.

Diluted earnings per share is computed by dividing the net income (loss) applicable to common shares by the weighted average number of common and common equivalent shares (warrants and stock options), where dilutive, outstanding during the period.

Risks and Uncertainties: Manufacturers and sellers of tobacco products are subject to regulation at the federal, state and local levels. Such regulations include, among others, labeling requirements, limitations on advertising, and prohibition of sales to minors. The trend in recent years has been toward increased regulation of the tobacco industry. There can be no assurance as to the ultimate content, timing or effect of any regulation of tobacco products by any federal, state or local legislative or regulatory body, nor can there be any assurance that any such legislation or regulation would not have a material adverse effect on the Company s financial position, results of operations or cash flows.

The tobacco industry has experienced and is experiencing significant product liability litigation. Most tobacco liability lawsuits have been brought against manufacturers and sellers of cigarettes for injuries allegedly caused by smoking or by exposure to smoke. However, several lawsuits have been brought against manufacturers and sellers of smokeless tobacco for injuries to health allegedly caused by use of smokeless tobacco. Typically, such claims assert that use of smokeless tobacco is addictive and causes oral cancer. As discussed in Note 20, the Company was named as a defendant in such a lawsuit. There can be no assurance that the Company will not sustain losses in connection with such lawsuits and that such losses will not have a material adverse effect on the Company s financial position, results of operations or cash flows or that additional lawsuits will not be brought against the Company.

Forty-six states, certain U.S. territories and the District of Columbia are parties to the Master Settlement Agreement (MSA) and the Smokeless Tobacco Master Settlement Agreement (STMSA). To the Company s knowledge, the signatories to the MSA include 49 cigarette manufacturers and/or distributors and the only other signatory to the STMSA is US Smokeless Tobacco Company. In the Company s opinion, the fundamental basis for each agreement is the states consents to withdraw all claims for monetary, equitable and injunctive relief against certain tobacco products manufacturers and others and, in return, the signatories have agreed to certain marketing restrictions and regulations as well as certain payment obligations.

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

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3. Summary of Significant Accounting Policies: Continued

Pursuant to the MSA and subsequent states statutes, a cigarette manufacturer (which is defined to also include make-your-own cigarette tobacco) has the option of either becoming a signatory to the MSA or opening, funding and maintaining an escrow account, with sub-accounts on behalf of each settling state. The STMSA has no similar provisions. The MSA escrow accounts are governed by states statutes that expressly give the manufacturers the option of opening, funding and maintaining an escrow account in lieu of becoming a signatory to the MSA. The statutes require companies, who are not signatories to the MSA, to deposit, on an annual basis, into qualified banks escrow funds based on the number of cigarettes or cigarette equivalents, i.e., the pounds of MYO tobacco, sold. The purpose of these statutes is expressly stated to be to eliminate the cost disadvantage the settling manufacturers have as a result of entering into the MSA. Such companies are entitled to direct the investment of the escrowed funds and withdraw any appreciation, but cannot withdraw the principal for twenty-five years from the year of each annual deposit, except to withdraw funds deposited pursuant to an individual state s escrow statute to pay a final judgment to that state s plaintiffs in the event of such a final judgment against the Company. Either option becoming a MSA signatory or establishing an escrow account is permissible.

The Company has chosen to open and fund an MSA escrow account as its means of compliance. It is management s opinion, due to the possibility of future federal or state regulations, though none have to date been enacted, that entering into one or both of the settlement agreements or establishing and maintaining an escrow account would not necessarily prevent future regulations from having a material adverse effect on the results of operations, financial position and cash flows of the Company.

Various states have enacted or proposed complementary legislation intended to curb the activity of certain manufacturers and importers of cigarettes that are selling into MSA states without signing the MSA or who have failed to properly establish and fund a qualifying escrow account. To the best of the Company s knowledge, no such statute has been enacted which could inadvertently and negatively impact the Company, which has been and is currently fully compliant with all applicable laws, regulations and statutes, but there can be no assurance that the enactment of any such complementary legislation in the future will not have a material adverse effect on the results of operations, financial position or cash flows of the Company.

Pursuant to the MSA escrow account statutes, in order to be compliant with the MSA escrow requirements, the Company is required to deposit such funds for each calendar year into a qualifying escrow account by April 15 of the following year. As of December 31, 2004, the Company has recorded approximately $13,171 in Other assets. This amount is comprised of approximately $9,428 which represents amounts on deposit plus approximately $21 interest earned thereon and approximately $3,721 pertaining to amounts to be deposited by April 15, 2005 relating to 2004 sales. During 2004, approximately $4,228 was deposited into a qualifying escrow account. The Company is entitled to direct the investment of the escrow funds and is allowed to withdraw any appreciation, but cannot withdraw the principal for twenty-five years from the year of each annual deposit, except to withdraw funds deposited pursuant to an individual state s escrow statute to pay a final judgment to that state s plaintiffs in the event of such a judgment against the Company.

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3. Summary of Significant Accounting Policies: Continued

Use of Estimates: The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities as of the dates of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates. The Company s significant estimates include those affecting the valuation and useful lives of property, plant and equipment and goodwill and other intangible assets, assumptions used in determining pension and postretirement benefit obligations, accrued and deferred income taxes and litigation contingencies.

Concentration of Credit Risk: At December 31, 2004 and 2003, the Company had bank deposits, including MSA escrows, in excess of federally insured limits of approximately $11.9 million and $8.7 million, respectively.

The Company sells its products to distributors and retail establishments throughout the United States. A single customer accounted for 16.5%, 19.9% and 13.1% of the Company s revenues in 2004, 2003 and 2002, respectively. The Company performs periodic credit evaluations of its customers and generally does not require collateral on trade receivables. As of December 31, 2004, Cod Company, Inc., the Company s largest customer, accounted for 12.7% of the outstanding accounts receivable balances. Historically, the Company has not experienced significant credit losses.

Accounts Receivable: Accounts receivables are recognized at their net realizable value. All accounts receivable are trade related and are recorded at the invoiced amount and do not bear interest. The Company maintains allowances for doubtful accounts receivable for estimated uncollectible invoices resulting from the customer s inability to pay (bankruptcy, out of business, etc., i.e. bad debts which result in write-offs). The activity of allowance for doubtful accounts during 2004 and 2003 is as follows (in thousands):

	2004	2003
Balance at beginning of period	$ 367	$ 448
Provision (reduction) for doubtful accounts	(67)	121
Charge offs, net	(16)	(202)
Balance at end of period	$ 284	$ 367

Other Expense (Income): Other Income of $4.4 million in 2004 represents principally $4.5 million associated with the reduction in the judgment rendered against the Company in connection with the litigation with Republic Tobacco, Inc. as described in Note 20, Contingency under Kentucky and Illinois Complaints. Other expense of $11.1 million in 2003 represents $7.4 million associated with the judgment rendered against the Company in connection with the litigation with Republic Tobacco, Inc. and $3.3 million associated with the termination of the Star Cigarette Asset Purchase Agreement, as described in Note 23, Terminated Asset Purchase Agreement . Other expense of $1.9 million in 2002 consists primarily of legal, investigative and related expenses with respect to the infringement activities involving Zig-Zag premium cigarette papers.

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

North Atlantic Holding Company, Inc. and Subsidiaries

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4. Acquisition of Business:

On November 17, 2003, the Company acquired the common stock of Stoker. Stoker, headquartered in Dresden, Tennessee, manufactures and markets smokeless tobacco and make-your-own (MYO) tobacco and related products under various brand names. This acquisition was expected to significantly increase net sales and cash flows. The Company also believed that gross margins would improve as a result of the increased net sales coupled with the elimination of certain costs related to Stoker s historical operations and the consolidation of facilities and functions.

The purchase price of $22.5 million in cash was financed with borrowings under the credit facility in existence at that time. The acquisition has been accounted for under the purchase method, and the results of Stoker have been included in the Company s consolidated results from the date of acquisition.

The aggregate purchase price consists of (in thousands):

Cash	$ 22,500
Transaction costs	822
Total aggregate purchase price	$ 23,322

The following summarizes the final purchase price of the assets acquired and liabilities assumed at the date of acquisition (in thousands):

Cash	$ 1,672
Accounts receivable	906
Inventories	3,403
Property, plant and equipment	2,180
Other intangible assets	9,922
Other assets and restricted escrow funds	6,514
Accounts payable	(559)
Pension plan liability	(750)
Accrued expenses	(2,012)
Income taxes payable	(1,845)
Deferred income taxes	(1,249)
	18,182
Goodwill	5,140
Aggregate purchase price	$ 23,322

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

North Atlantic Holding Company, Inc. and Subsidiaries

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4. Acquisition of Business: Continued

In connection with the other intangible assets relating to the Stoker acquisition, see Note 8.

The unaudited pro forma combined historical results, as if Stoker had been acquired at the beginning of fiscal 2003 and 2002, respectively, are estimated to be:

	2003	2002
Net sales	$ 126,162	$ 121,407
Net income (loss)	$ (4,186)	$ 7,795
Earnings per share -		
Basic	$ (7.92)	$ 14.76
Assuming dilution	$ (7.92)	$ 11.72

The pro forma results are not necessarily indicative of what actually would have occurred if the acquisition had been completed as of the beginning of each fiscal period presented, nor are they necessarily indicative of future consolidated results.

As part of an employment agreement between the Company and the former President of Stoker, the Company agreed to pay $300 per annum for a period of three years relating to employee non-competition.

On November 17, 2003, Stoker terminated its employee defined benefit plan. As part of the stock purchase agreement, the shareholders of Stoker agreed to fund $750 in a restricted escrow account to fund future payments to current and retired Stoker employees.

5. Fair Value of Financial Instruments:

The following disclosure of the estimated fair value of financial instruments is made in accordance with the requirements of SFAS No. 107, Disclosure About Fair Value of Financial Instruments, as amended by SFAS No. 126. The estimated fair value amounts have been determined by the Company using the methods and assumptions described below. However, considerable judgment is required to interpret market data to develop estimates of fair value. Accordingly, the estimates presented herein are not necessarily indicative of the amounts the Company could realize in a current market exchange. The use of different market assumptions and/or estimation methodologies may have a material effect on the estimated fair value amounts.

Cash and Cash Equivalents: Cash and cash equivalents are by definition short-term and the carrying amount is a reasonable estimate of fair value.

Accounts Receivable: The fair value of accounts receivable approximates their carrying value.

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

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5. Fair Value of Financial Instruments: Continued

Long-Term Debt: The fair value of the Company s long-term debt is estimated based on the quoted market prices for the same or similar issues or on the current rates offered to the Company for debt of the same remaining maturities. As of December 31, 2004 and 2003, the fair market value of the Company s debt was $208.8 million and $155.0 million, respectively.

6. Inventories:

The components of inventories at December 31 are as follows (in thousands):

	2004	2003
Raw materials and work in process	$ 4,246	$ 5,996
Leaf tobacco	7,878	8,274
Finished goods loose leaf tobacco	3,069	6,018
Finished goods MYO products	8,539	6,323
Other	2,163	1,350
	25,895	27,961
LIFO reserve	12,064	14,296
	$ 37,959	$ 42,257

During 2004 and 2003, inventory quantities were reduced. This reduction resulted in a liquidation of LIFO inventory quantities carried at lower costs prevailing in prior years as compared with the cost of 2004 and 2003 purchases, the effect of which increased cost of goods sold and decreased net income by approximately $1.7 million and $1.9 million, respectively.

The LIFO inventory value is in excess of its current estimated replacement cost by the amount of the LIFO reserve.

The Company recorded an inventory valuation allowance of $218 as of December 31, 2003.

7. Property, Plant and Equipment:

Property, plant and equipment at December 31 consists of (in thousands):

	2004	2003
Land	$ 654	$ 654
Buildings and improvements	4,282	4,363
Machinery and equipment	12,194	9,250
Furniture and fixtures	3,920	3,164
	21,050	17,431
Accumulated depreciation	(10,279)	(9,121)
	$ 10,771	$ 8,310

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

North Atlantic Holding Company, Inc. and Subsidiaries

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8. Goodwill and Other Intangible Assets:

Goodwill at December 31 consists of (in thousands):

	2004	2003
NTC goodwill, net of accumulated amortization of $4,500 at December 31, 2004 and 2003	$ 27,450	$ 27,450
NAOC goodwill, net of accumulated amortization of $21,175 at December 31, 2004 and 2003	96,107	96,107
Stoker goodwill (see Note 4)	5,140	5,102
	$ 128,697	$ 128,659

	Smokeless	MYO	Premium Manufact-ured Cigarettes	Total
Balance as of January 1, 2004	$ 30,674	$ 97,985	$	$ 128,659
Goodwill addition	1	37		38
Balance as of December 31, 2004	$ 30,675	$ 98,022	$	$ 128,697

The following table summarizes information about the Company s allocation of other intangible assets. Other intangibles, all of which relate to the purchase of Stoker, consist of (in thousands):

	As of December 31, 2004	
	Gross Carrying Amount	Accumulated Amortization
Unamortized indefinite life intangible assets		
Trade names	$ 8,500	$
Formulas	51	
Total	$ 8,551	$

Amortized intangible assets:		
Customer list (useful life of 10 years)	$ 1,400	$ 157
Non-compete agreement (useful life of 3 years)	900	401
Total	$ 2,300	$ 558

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

North Atlantic Holding Company, Inc. and Subsidiaries

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8. Goodwill and Other Intangible Assets, continued:

The Company amortizes the non-competition agreement over its life of 3 years. Amortization expense for other intangibles was approximately $462 for the year ending December 31, 2004. Estimated future amortization expense is $440 for the year ending December 31, 2005, $390 for the year ending December 31, 2006, and $140 for the years ending December 31, 2007, 2008 and 2009.

9. Other Assets:

Other assets at December 31, 2004 and 2003 includes loans and accrued interest to the principal shareholder of $1,487 and $1,559, respectively, amounts related to the MSA escrow account of $13,171 and $8,282, respectively, and other miscellaneous deposits of $868 and $822, respectively.

10. Deferred Financing Costs:

Deferred financing costs at December 31 consist of (in thousands):

	2004	2003
Deferred financing costs, net of accumulated amortization of $1,566 and $8,917 at December 31, 2004 and 2003, respectively	$ 13,105	$ 5,163

During 2004, the Company recorded a write-off of deferred financing cost of approximately $1.6 million relating to the extinguishment of the Senior Notes.

11. Notes Payable and Long-Term Debt:

Notes payable and long-term debt at December 31 consists of (in thousands):

2004	2003

Senior Discount Notes	$ 66,622	$
New Senior Notes	200,000	
Old Senior Notes		155,000
Notes payable		30,686
	$ 266,622	$ 185,686

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

North Atlantic Holding Company, Inc. and Subsidiaries

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11. Notes Payable and Long-Term Debt: continued

On June 25, 1997, NATC issued $155.0 million aggregate principal amount of 11% Senior Notes due 2004 (the Notes) which were called for redemption on April 2, 2004 in connection with the refinancing. The Notes are unsecured senior obligations of NATC which were scheduled to mature on June 15, 2004. The Notes bear interest at 11% per annum, payable semiannually on June 15 and December 15, to holders of record at the close of business on the June 1 or December 1 immediately preceding the interest payment date.

At December 31, 2003, NATC was operating under a Loan Agreement (the Loan Agreement), dated December 31, 2000, with Bank One, Kentucky, NA. as Agent (the Agent), and the banks named therein, which provided for a $25.0 million term loan and a $10.0 million revolving credit facility. The Term Loan was payable in eight (8) quarterly installments of $3,125 million each plus accrued interest, which commenced on March 31, 2001. Both the term loan and the revolving credit facility matured on December 31, 2002, at which time the term loan was paid in full. On December 31, 2002, NATC entered into an Amended Loan Agreement (the Amended Loan Agreement) with Bank One in which the revolving credit facility was increased to $20 million and extended to December 31, 2003. During 2003, the Amended Loan Agreement was amended to reduce the revolving credit facility to $15.0 million and to extend the maturity to March 31, 2004. The unused portion of revolving credit facility at December 31, 2003 amounted to $8.7 million. NATC paid a commitment fee of 0.50% per annum on a quarterly basis on the unused balance of the revolving credit facility. The outstanding amount relating to the revolving credit facility as of December 31, 2003 has been classified as a current liability in the Consolidated Balance Sheet. All terms of the original Loan Agreement remained in place except for the replacement of a Fixed Charge Coverage Covenant with an Interest Coverage Covenant. NATC s obligations under the Loan Agreement were guaranteed by National Tobacco, NAOC and NTFC. In addition, NATC s obligations were collateralized by all of NATC s assets and NATC s equity in its subsidiaries. The interest rate on borrowings under the Amended Loan Agreement was based, at NATC s option, on either LIBOR or the prime rate as announced by the Agent from time to time. At December 31, 2003, the Notes Payable outstanding under the Tranche B term loan portion consisted of $7.7 million incurred to finance the posting of a $7.7 million judgment bond (including accrued interest and fees) in connection with the litigation with Republic Tobacco (See Note 20, Contingencies) and $23.0 million to finance the acquisition of Stoker (See Note 4, Acquisition of Business). As of December 31, 2003, the interest rate on borrowings under the Amended Loan Agreement was 5.15%.

The Loan Agreement and the Notes included cross default provisions and limited the incurrence of additional indebtedness, dividends, transactions with affiliates, asset sales, acquisitions, mergers, prepayments of indebtedness, liens and encumbrances, and other matters. At December 31, 2003, NATC was in compliance with all provisions of the Amended Loan Agreement and Notes.

At December 31, 2003, the Notes and Notes Payable were reclassified as noncurrent liabilities in the Consolidated Balance Sheet, reflecting NATC s intention and ability to refinance the Amended Loan Agreement and Senior Notes, as described above.

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

North Atlantic Holding Company, Inc. and Subsidiaries

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11. Notes Payable and Long-Term Debt: continued

On February 17, 2004, NATC consummated the refinancing of its existing debt and preferred stock. The refinancing consisted principally of (1) the offering and sale of $200.0 million principal amount of senior notes (the New Senior Notes) by NATC, (2) the entering into of an amended and restated loan agreement that provides a $50.0 million senior secured revolving credit facility to NATC and (3) the concurrent sale of $97.0 million aggregate principal amount at maturity of senior discount notes of the Company.

The New Senior Notes are senior unsecured obligations of NATC, mature on March 1, 2012 and are guaranteed on a senior unsecured basis by all of NATC s existing and certain of its future subsidiaries. The New Senior Notes bear interest at the rate of 9 1/4% per annum from the date of issuance, or from the most recent date to which interest has been paid or provided for, and is payable semiannually on March 1 and September 1 of each year. NATC is not required to make mandatory redemptions or sinking fund payments prior to the maturity of the Notes. NATC or the Company may from time to time seek to retire all or a portion of the New Senior Notes through cash purchases and/or exchanges for other securities in open market purchases, privately negotiated transactions or otherwise.

On and after March 1, 2008, the Notes will be redeemable, at NATC s option, in whole at any time or in part from time to time, upon not less than 30 nor more than 60 days prior notice at the following redemption prices (expressed in percentages of principal amount), if redeemed during the 12-month period commencing March 1 of the years set forth below, plus accrued and unpaid interest to the redemption date (subject to the right of holders of record on the relevant record date to receive interest due on the relevant interest payment date):

Year	**Redemption Price**
2008	104.625%
2009	102.313%
2010 and thereafter	100.000%

In addition, prior to March 1, 2008, NATC may redeem the Notes, at its option, in whole at any time or in part from time to time, upon not less than 30 nor more than 60 days prior notice at a redemption price equal to 100% of the principal amount of the Notes redeemed plus a make-whole premium based on U.S. Treasury rates as of, and accrued and unpaid interest to, the applicable redemption date.

In addition, at any time prior to March 1, 2007, NATC may, at its option, redeem up to 35% of the aggregate principal amount of the Notes with the net cash proceeds of one or more equity offerings by the Company or NATC, subject to certain conditions, at a redemption price equal to 109.250% of the principal amount thereof, plus accrued and unpaid interest thereon, if any, to the date of redemption.

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

North Atlantic Holding Company, Inc. and Subsidiaries

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11. Notes Payable and Long-Term Debt: continued

The New Senior Notes limit the incurrence of additional indebtedness, the payment of dividends, entering transactions with affiliates, asset sales, or other encumbrances on our assets, and other matters. At December 31, 2004, NATC was in compliance with all provisions of the New Senior Notes.

In connection with the refinancing, NATC also amended and restated the existing credit facility, resulting in a new $50.0 million (reducing to $40.0 million in August 2005) senior revolving credit facility with Bank One, N.A. as agent (the Agent Bank) and La Salle Bank, National Association. The credit agreement (the New Credit Agreement) governing the new senior revolving credit facility includes a letter of credit sublimit of $25.0 million and terminates three years from the closing date. The Company will use the new senior revolving credit facility for working capital and general corporate purposes. On January 19, 2005, the New Credit Agreement was amended to reduce the revolving credit facility to $35.0 million.

Indebtedness under the New Credit Agreement is guaranteed by each of NATC s current and future direct and indirect subsidiaries, and is secured by a first perfected lien on substantially all of NATC s and NATC s direct and indirect subsidiaries current and future assets and property. The collateral includes a pledge by the Company of its equity interest in NATC and a first priority lien on all equity interest and intercompany notes held by NATC and its subsidiaries.

Each advance under the New Credit Agreement will bear interest at variable rates based, at NATC s option, on either the prime rate plus 1% or LIBOR plus 3%. At December 31, 2004, the interest rate on borrowings under the New Credit Agreement was 5.18%. The New Credit Agreement provides for voluntary prepayment, subject to certain exceptions, of loans. In addition, without the prior written consent of the Agent Bank, NATC will not allow a Change in Control (as defined in the New Credit Agreement), the sale of any material part of its assets and the assets of its subsidiaries on a consolidated basis or, subject to certain exceptions, the issuance of equity or debt.

Under the New Credit Agreement, NATC is required to pay the lenders a closing fee equal to 1.25% of the aggregate commitments, payable on the closing date, and an annual commitment fee in variable amounts ranging from 0.50% to 0.65% of the difference between the commitment amount and the average usage of the facility, payable on a quarterly basis. NATC is also required to pay to the lenders, letter of credit fees equal to 3.00% per annum multiplied by the maximum amount available from time to time to be drawn under such letter of credit issued under the New Credit Agreement and to the lender issuing a letter of credit a fronting fee of 0.125% per annum multiplied by the aggregate face amount of letters of credit outstanding during a fiscal quarter plus other customary administrative, amendment, payment and negotiation charges in connection with such letters of credit.

The New Credit Agreement requires NATC and its subsidiaries to meet certain financial tests, including a minimum fixed charge coverage ratio, and a minimum consolidated adjusted EBITDA. The New Credit Agreement also contains covenants, which among other things, limit the incurrence of additional indebtedness, dividends, transactions with affiliates, asset sales, acquisitions, mergers, prepayments of other indebtedness, liens and encumbrances and other

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

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11. Notes Payable and Long-Term Debt: continued

matters customarily restricted in such agreements. In addition, the New Credit Agreement requires that certain members of Executive Management remain active in the day-to-day operation and management of NATC and its subsidiaries during the term of the facility.

The New Credit Agreement contains customary events of default, including payment defaults, breach of representations and warranties, covenant defaults, cross-acceleration, cross-defaults to certain other indebtedness, certain events of bankruptcy and insolvency, the occurrence of a Change in Control and judgment defaults.

As of December 31, 2004 NATC would have failed to meet its original required minimum fixed charge coverage ratio for the period then ended due to its operating results in 2004. This would have represented an event of default under the terms of NATC s New Credit Agreement. This covenant, however, was eliminated pursuant to the March 30, 2005 amendment to NATC s New Credit Agreement.

On March 30, 2005, the New Credit Agreement was amended. This amendment modifies the fixed charge coverage ratio covenant, which now only applies to quarters ending June 30, 2005 and thereafter, and the minimum consolidated adjusted EBITDA covenant, which now only applies to quarters ending from June 30, 2004 through March 31, 2005. The fixed charge coverage ratio definition was also amended to include any future cash equity contributions to NATC. In addition, the amendment changes the New Credit Agreement maturity date from February 28, 2007 to January 31, 2006.

Concurrently with the offering of the New Senior Notes, the Company issued $97.0 million aggregate principal amount at maturity ($60.0 million in gross proceeds) of its senior unsecured discount notes due 2014 (the Senior Discount Notes). Proceeds of approximately $53.8 million from this issuance was used to make a capital contribution to NATC. The accreted value of these notes is $66.6 million at December 31, 2004. The Senior Discount Notes are the Company s senior obligations and are unsecured, ranking equally in right of payment to all of the Company s future unsubordinated obligations and senior in right of payment to any obligations that are by their terms subordinated to the Senior Discount Notes, and will be effectively subordinated to any secured obligations of the Company to the extent of the assets securing those obligations. The Senior Discount Notes are not guaranteed by NATC or any of its subsidiaries and are structurally subordinated to all of NATC s and its subsidiaries obligations, including the New Senior Notes. The Company or NATC may from time to time seek to retire all or a portion of the Senior Discount Notes through cash purchases and/or exchange for other securities in open market purchases, privately negotiated transactions, or otherwise.

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11. Notes Payable and Long-Term Debt: continued

On and after March 1, 2009, the Senior Discount Notes will be redeemable, at the Company s option, in whole at any time or in part from time to time, upon not less than 30 nor more than 60 days prior notice at the following redemption prices (expressed in percentages of principal amount at maturity), if redeemed during the 12-month period commencing March 1 of the years set forth below, plus accrued and unpaid interest to the redemption date (subject to the right of holders of record on the relevant record date to receive interest due on the relevant interest payment date):

Year	Redemption Price
2009	106.125%
2010	104.083%
2011	102.042%
2012 and thereafter	100.000%

In addition, prior to March 1, 2009, the Company may redeem the Senior Discount Notes, at its option, in whole at any time or in part from time to time, upon not less than 30 nor more than 60 days prior notice at a redemption price equal to 100% of the accreted value of the Senior Discount Notes redeemed plus a make-whole premium based on U.S. Treasury rates as of, and accrued and unpaid interest to, the applicable redemption date.

Further, at any time prior to March 1, 2007, the Company may, at its option, redeem up to 35% of the aggregate principal amount at maturity of the Senior Discount Notes with the net cash proceeds of one or more equity offerings by the Company, subject to certain conditions, at a redemption price equal to 112.250% of the accreted value thereof, plus accrued and unpaid interest thereon, if any, to the date of redemption.

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

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11. Notes Payable and Long-Term Debt: continued

The Senior Discount Notes limit the incurrence of additional indebtedness, the payment of dividends, entering into transactions with affiliates, asset sales, engaging in mergers or acquisitions, creating liens and other encumbrances on assets, and other matters.

The Company is dependent on NATC s cash flows to service its debt. The amount of cash interest to be paid during the next five years is as follows: $0 in each of 2004, 2005, 2006, 2007 and March 1, 2008; $5,941 payable on September 1, 2008 and $5,941 payable on each of March 1 and September 1 thereafter until maturity.

Looking forward, due to the lower than anticipated operating performance of the Company s core business and increased net expenses resulting from the Company s developmental activities relating to Zig-Zag Premium Cigarettes, the Company currently anticipates that NATC will not likely meet the fixed charge coverage ratio test contained in the New Credit Agreement for the rolling four quarter periods ending June 30, 2005 and thereafter without the contribution of additional equity into NATC. In the event that such covenant is breached, NATC would be in default under the New Credit Agreement, pursuant to which the lenders would have all rights and remedies available to them at that time, including the right to accelerate payment of all obligations thereunder. Such acceleration would trigger an event of default under the indentures governing the New Senior Notes and the Senior Discount Notes, allowing an acceleration of the obligations thereunder. In the event of an acceleration of NATC s obligations under either the New Credit Agreement or New Senior Notes, or the Company s obligations under the Senior Discount Notes, neither NATC nor the Company would be able to satisfy their respective obligations and would likely be required to seek protection from their creditors under applicable laws. The Company is wholly dependent on NATC to service its debt and other obligations. Although there can be no assurance, the Company believes that it will be able to successfully negotiate new senior secured financing on reasonably acceptable terms, refinance out the existing lenders and avoid a default by NATC under the New Credit Agreement.

12. Income Taxes:

The income tax provision (benefit) for the years ended December 31, 2004, 2003, and 2002 consists of the following components (in thousands):

	2004	2003	2002
Deferred			
Federal	$ 15,574	$ (3,301)	$ 2,876
State and local	1,830	(388)	338
	$ 17,404	$ (3,689)	$ 3,214

Deferred tax assets and liabilities at December 31, 2004 and 2003 consist of (in thousands):

	2004		2003	
	Assets	Liabilities	Assets	Liabilities
Inventory	$	$ 4,801	$	$ 4,654
Property, plant and equipment		979		1,141
Goodwill and other intangible assets	2,764		6,372	
Accrued pension and postretirement costs	3,364		5,630	
Minimum pension liability	614		540	
NOL carryforward	16,447		8,051	
Other	2,506		1,956	
Sub-total	25,695	5,780	22,549	5,795
Valuation allowance	(25,695)	(5,780)		
Deferred income taxes	$	$	$ 22,549	$ 5,795

At December 31, 2004 the Company had NOL carryforwards for income tax purposes of approximately $37.3 million which expire in the years beginning in 2012.

The Company has determined that at December 31, 2004, its ability to realize future benefits of net deferred tax assets does not meet the more likely than not criteria in SFAS No. 109, Accounting for Income Taxes ; therefore, a valuation allowance of $19.9 million has been recorded.

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

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12. Income Taxes, continued:

Reconciliation of the federal statutory rate and the effective income tax rate for the years ended December 31, 2004, 2003, and 2002 is as follows:

	2004	2003	2002
Federal statutory rate	35.0%	35.0%	35.0%
State taxes	3.5	3.5	3.0
Permanent differences	(1.4)	(0.8%)	0.5%
Valuation	(262.8)		
Other		(0.6)	(1.6)
Effective income tax rate	(225.7)%	37.1%	36.9%

13. Pension and Postretirement Benefit Plans:

The Company has two defined benefit pension plans covering substantially all of its employees. Benefits for the hourly employees plan are based on a stated benefit per year of service, reduced by amounts earned in a previous plan. Benefits for salaried employees are based on years of service and the employees final compensation.

The Company sponsors two defined benefit postretirement plans that cover both salaried and hourly employees. One plan provides medical and dental benefits, and the other provides life insurance benefits. The post-retirement health care plan is contributory, with retiree contributions adjusted annually; the life insurance plan is noncontributory.

Effective December 31, 2003, the Company froze the defined benefit retirement plan for its salaried employees. Effective June 30, 2004 and July 31, 2004, the Company also froze the defined benefit retirement plan for the respective hourly employees of its three collective bargaining units.

Effective September 30, 2004, the Company terminated its postretirement benefit plan for its salaried employees. Accordingly, the Company recognized a reduction in the postretirement benefit plan liability of $3,811.

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13. Pension and Postretirement Benefit Plans, continued:

The following tables provide a reconciliation of the changes in the plans benefit obligations and fair value of assets for the years ended December 31, 2004 and 2003 and a statement of the funded status as of December 31 (in thousands):

	Pension Benefits		Postretirement Benefits	
	2004	**2003**	**2004**	**2003**
Reconciliation of benefit obligation:				
Benefit obligation at January 1	$ 15,298	$ 12,737	$ 14,298	$ 9,351
Service cost	161	552	238	728
Interest cost	783	803	460	807
Actuarial loss	368	1,772	1,742	3,847
Curtailment of salaried benefits	(1,386)		(7,843)	
Benefits paid	(696)	(566)	(267)	(435)
Benefit obligation at December 31	$ 14,528	$ 15,298	$ 8,628	$ 14,298
Reconciliation of fair value of plan assets:				
Fair value of plan assets at January 1	$ 9,433	$ 6,956	$	
Actual return on plan assets	1,268	1,643		
Employer contributions	1,700	1,400	267	435
Benefit paid	(696)	(566)	(267)	(435)
Fair value of plan assets at December 31	$ 11,705	$ 9,433	$	$
Funded status:				
Funded status at December 31	$ (2,823)	$ (5,865)	$ (8,628)	$ (14,318)
Unrecognized prior service cost		6		
Unrecognized net actuarial loss	1,476	3,032	2,567	4,985
Net amount recognized	$ (1,347)	$ (2,827)	$ (6,061)	$ (9,333)

The asset allocation for the Company s defined benefit plans as of December 31, 2004 and 2003, and the target allocation for 2005, by asset category, follows:

	Target Allocation	Percentage of Plan Assets at December	
	2005	2004	2003
Asset category:			
Equity securities	70.0%	71.3%	67.0%
Debt Securities	30.0%	28.7%	33.0%
Cash	0.0%	0.0%	0.0%
Total	100.0%	100.0%	100.0%

Equity securities included no shares of the Company s common stock at December 31, 2004 or 2003.

The Company s investment philosophy is to earn a reasonable return without subjecting plan assets to undue risk. The Company uses one management firm to manage plan assets, which are invested in high quality equity and debt securities. The Company s investment objective is to provide long-term growth of capital as well as current income.

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13. Pension and Postretirement Benefit Plans, continued:

The following table provides the amounts recognized in the balance sheets as of December 31 (in thousands):

	Pension Benefits		Postretirement Benefits	
	2004	**2003**	**2004**	**2003**
Accrued benefit cost	$ (1,347)	$ (2,827)	$ (6,061)	$ (9,333)
Minimum pension liability	(1,965)	(1,769)		
Deferred tax asset	614	540		
Accumulated other comprehensive income	1,351	1,229		
Net amount recognized	$ (1,347)	$ (2,827)	$ (6,061)	$ (9,333)

The following table provides the components of net periodic pension and postretirement benefit costs for the plans for the years ended December 31 (in thousands):

	Pension Benefits			Postretirement Benefits		
	2004	**2003**	**2002**	**2004**	**2003**	**2002**
Service cost	$ 161	$ 552	$ 550	$ 238	$ 728	$ 421
Interest cost	782	803	803	460	808	473
Expected return on plan assets	(850)	(582)	(658)			
Amortization of gains and losses	121	85		133	408	
Curtailment of salaried benefits				(3,811)		
Net periodic benefit cost	$ 214	$ 858	$ 695	$ (3,080)	$ 1,944	$ 894

The Company is required to make assumptions regarding such variables as the expected long-term rate of return on plan assets and the discount rate applied to determine service cost and interest cost. The rate of return on assets used is determined based upon analysis of the plans historical performance relative to the overall markets and mix of assets. The assumptions listed below represents Management s review of relevant market conditions and have been adjusted, as appropriate. The weighted average assumptions used in the measurement of the Company s benefit obligation are as follows:

	Pension Benefits			Postretirement Benefits		
	2004	2003	2002	2004	2003	2002
Discount rate	5.50%	5.50%	6.75%	5.75%	6.25%	6.75%
Expected return on plan assets	8.50%	8.50%	8.50%			
Rate of compensation increase	N/A	4.00%	4.00%			

For measurement purposes of the postretirement benefits, the assumed health care cost trend rate for participants under age 65 as of December 31, 2004, 2003 and 2002 was 11.0%, 12.0% and

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13. Pension and Postretirement Benefit Plans, continued:

12.0%, respectively, and for participants age 65 and over the rate was 11.0%, 12.0% and 12.0%, respectively. The health care cost trend rate was assumed to decline gradually to 5.5% for pre-age 65 and for post-age 65 costs over 6 years.

Assumed health care cost trend rates could have a significant effect on the amounts reported for the postretirement benefit plans. A 1% increase in assumed health care cost trend rates would have the following effects (in thousands):

	2004	2003	2002
Effect on total of service and interest cost components of net periodic postretirement cost	$ 123	$ 269	$ 3
Effect on the health care component of the accumulated postretirement benefit obligation	$ 1,100	$ 2,280	$ 49

The following benefit payments, which reflect expected future service, as appropriate, are expected to be paid:

	Pension Benefits U.S. Plans	Other Postretirement Benefits (U.S. Plans)
	(In Thousands)	(In Thousands)
2005	$ 681	$ 204
2006	736	244
2007	766	280
2008	811	330
2009	861	385
2010-2014	$ 5,083	$ 2,851

The Company s policy for the postretirement benefits plan is to make contributions equal to the benefits paid during the year. The Company expects to make $0.3 million of contributions to the plan in the year ending December 31, 2005.

The Company also sponsors a voluntary 401(k) retirement savings plan. Eligible employees may elect to contribute up to 15% of their annual earnings subject to certain limitations. The Company match for the hourly employees is 100.0% of each eligible participant s contribution up to 6% of compensation for the plan year. The Company s matching for hourly employees is subject to a 3-year vesting schedule. The Company match for the salaried employees is 100.0% of each eligible participant s contribution up to 6% of compensation for the plan year. Company matching is immediate for salaried employees. Additional discretionary matching contributions by the

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13. Pension and Postretirement Benefit Plans, continued:

Company are determined annually by the Board of Directors. Company matching contributions to this plan were approximately $0.5 million, $0.5 million and $0.4 million for each of the years ended December 31, 2004, 2003 and 2002, respectively.

14. Lease Commitments:

The Company leases certain office space and vehicles for varying periods.

The following is a schedule of future minimum lease payments for operating leases that had initial or remaining non-cancelable lease terms in excess of one year as of December 31, 2004 (in thousands):

	Operating Leases
2005	$ 1,213
2006	1,139
2007	932
2008	510
2009	312
2010 and beyond	1,486
Total minimum lease payments	$ 5,592

Lease expense for the years ended December 31, 2004, 2003 and 2002 was $1,081, $840 and $786, respectively.

15. Mandatorily Redeemable Preferred Stock

On July 1, 2002 NATC commenced a consent solicitation (the Consent Solicitation) from registered holders of its 12% Senior Exchange Payment-in-Kind Preferred Stock, par value $0.01 per share (Preferred Stock), for certain amendments to the certificate of incorporation of NATC which would amend the terms of the Preferred Stock. The proposed amendments required the consent of the holders of a majority of the issued and outstanding shares of common stock of NATC and the consent of the holders of a majority of the issued and outstanding shares of Preferred Stock. A consent by the holders of a majority of NATC s outstanding common stock was executed on June 28, 2002. On July 29, 2002, the Consent Solicitation was successfully completed, with NATC receiving consents from the holders of more than 99% of the outstanding shares of Preferred Stock.

The amendments to the Preferred Stock, among other things: (i) accelerated the mandatory redemption date of the Preferred Stock from June 15, 2007 to June 15, 2005, which will require

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

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(dollars in thousands)

15. Mandatorily Redeemable Preferred Stock, continued:

NATC to redeem the Preferred Stock at an earlier date, (ii) reduced the liquidation preference from $25.00 to $22.00 per share, which will lower NATC s cost of redeeming the Preferred Stock and will lower the amount of dividends payable thereon (which dividends are equal to 12% of the liquidation preference per annum), (iii) eliminated any redemption premium, which will lower NATC s potential cost of redeeming the Preferred Stock prior to June 15, 2005, (iv) reduced the repurchase price that NATC must offer the holders of Preferred Stock upon a change of control from 101% to 100% of the liquidation preference, which will lower NATC s potential cost of any such repurchase obligation, (v) permitted future dividends to be paid through the issuance of additional shares of preferred stock, which will provide NATC with greater flexibility in financing its operations, and (vi) included a definition for the term Permitted Investments , which definition was inadvertently omitted from the Certificate of Designation pursuant to which the Preferred Stock was created.

As consideration for these amendments, NATC paid each registered holder of Preferred Stock that consented thereto $0.40 per share in cash. A total of approximately $985 in consent fees were paid. NATC paid an additional amount of approximately $236 in legal and other fees related to the Consent Solicitation. As a result of the Consent Solicitation NATC recognized a gain of $5.4 million.

For the preferred stock dividend payments on September 15, 2002, December 15, 2002, March 15, 2003, June 15, 2003, September 15, 2003 and December 15, 2003, NATC chose to make this payment in kind. For the preferred stock dividend payment due on March 15, 2004 NATC chose to make this payment in cash.

Persons affiliated with the initial purchases of the Preferred Stock were also issued warrants, with an original fair value of $0.7 million, to purchase 19,050 shares of common stock of the Company for $0.01 per share, exercisable immediately. The original fair value of these warrants has been recorded in equity, with a corresponding amount capitalized and included in deferred financing costs.

On March 18, 2004, in connection with the refinancing of its existing debt, NATC redeemed all outstanding shares of the preferred stock, at the applicable redemption price equal to the liquidation preference of the preferred stock ($22.00 per share), plus an amount in cash equal to all accumulated and unpaid dividends for a total of $65,080.

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16. Share Incentive Plans:

The Company has two share incentive plans covering certain key employees which provide for the granting of options to purchase common stock of the Company and other stock related benefits. As of December 31, 2004, no benefits other than the stock options described below had been granted. The total number of shares available for granting under the plans is 111,856. Stock option activity is summarized below:

	Incentive Shares	Weighted Average Exercise Price	Weighted Average Grant Date Fair Value
Outstanding, December 31, 2002	$ 95,271	$ 43.38	$ 25.19
Granted	2,500	90.00	22.75
Exercised			
Forfeited	(4,500)	(90.00)	(22.75)
Outstanding, December 31, 2003	93,271	42.38	26.37
Granted	14,085	62.00	20.95
Exercised			
Forfeited	(1,000)	(62.00)	(22.75)
Outstanding, December 31, 2004	106,356	32.33	32.75

At December 31, 2004, the outstanding stock options exercise price for 61,856 options is $9.99 per share (reduced from $18.19 per share in August 2004), all of which are exercisable. The outstanding stock options exercise price for 44,500 options is $62.00 (reduced from $90.00 per share in August 2004), 19,690 of which are exercisable with the remaining 24,810 becoming exercisable from 2005 through 2014. All stock options expire 10 years from the grant date. The weighted average of the remaining lives of the outstanding stock options is approximately 7.3 years for the options with the $9.99 exercise price and 8.5 years for the options with the $62.00 exercise price. The Company estimates that all of the stock options granted will be exercised and that the expected life of all stock options is five years from the date of grant. The weighted average fair value of the options was determined as the difference between the fair value of the common stock on the grant date and the present value of the exercise price over the expected life of five years at a risk free interest rate of 6%, with no assumed dividend yield.

Of the stock options described above, 47,986 include a provision under which the Company will reimburse the employee for the difference between their ordinary income tax liability and the liability computed using the capital gains rate in effect upon exercise of the options. The effect of this provision is accounted for as a variable portion of the option plan.

The Company has recorded compensation expense related to the options based on the provisions of SFAS No. 123 under which the fixed portion of such expense is determined as the fair value of the options on the date of grant and amortized over the vesting period. The variable portion of the compensation expense is measured on each reporting date with the expense amount adjusted for changes in the fair value of the Company s stock on that date. As the result of the reduction in exercise prices referred to above, the Company recognized additional compensation expense of $670. Compensation expense of approximately $832, $417 and $102 ($164, $258 and $63, net of deferred income tax benefit) has been recognized in the Statements of Operations for the years ended December 31, 2004, 2003 and 2002, respectively.

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17. Income (Loss) Per Common Share Reconciliation (dollars in thousands, except per share amounts):

	For the Year Ended December 31, 2004		
	Income (Numerator)	Shares (Denominator)	Per Share Amount
Net loss	$ (25,116)		
Less: Preferred stock dividends	(1,613)		
Basic and diluted:			
Net loss available to common stockholders	$ (26,729)	577,795	$ (46.26)

	For the Year Ended December 31, 2003		
	Income (Numerator)	Shares (Denominator)	Per Share Amount
Net income	$ (6,241)		
Less: Preferred stock dividends	7,275		
Basic:			
Net income available to common stockholders	$ (13,516)	528,241	$ (25.59)

	For the Year Ended December 31, 2002		
	Income (Numerator)	Shares (Denominator)	Per Share Amount
Net income	$ 5,485		
Less: Preferred stock dividends	(6,976)		
Plus: Net gain on restructuring of preferred stock	5,395		
Basic:			
Net loss available to common stockholders	$ 3,904	528,241	$ 7.39
Diluted:			
Net loss available to common stockholders	$ 3,904	664,939	$ 5.87

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The calculations above are based on the weighted average number of shares of common stock outstanding during the year. For the year ended December 31, 2003, common equivalent shares from stock options of 93,271 are excluded from the computations as their effect is antidilutive. For the year ended December 31, 2003, warrants of 63,490 are excluded from the computations as their effect is antidilutive.

18. Fourth Quarter Adjustment:

The fourth quarters of 2004, 2003 and 2002 included adjustments to increase the LIFO expense and decrease pre-tax income by approximately $2.1 million, $1.9 million and $0.4 million, respectively. The fourth quarter of 2004 also included adjustments to decrease pension/postretirement benefit expense by approximately ($0.2) million. The fourth quarter of 2003 also included adjustments to increase the postretirement benefits expense by approximately $1.1 million, as a result of year-end actuarial computations.

19. Selected Quarterly Financial Data (unaudited):

All amounts are in thousands except net income (loss) per share.

	QUARTER			
	1st	**2nd**	**3rd**	**4th**
2004				
Net sales	$ 22,105	$ 37,207	$ 30,741	$ 25,267
Gross profit	9,853	20,140	16,966	9,744
Net income (loss)	(7,945)	812	5,932	(25,528)
Basic net income (loss) per share	(14.70)	1.38	10.03	(43.17)
Diluted net income (loss) per share	(14.70)	1.11	8.25	(43.17)
2003				
Net sales	$ 14,249	$ 30,251	$ 28,718	$ 28,375
Gross profit	6,549	17,496	16,882	12,049
Net income (loss)	(5,164)	(11,822)	232	3,237
Basic net income (loss) per share	(9.78)	(22.38)	0.44	6.13
Diluted net income (loss) per share	(9.78)	(22.38)	0.38	6.13

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

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20. Contingencies:

Litigation with Republic Tobacco

On July 15, 1998, North Atlantic Operating Company, Inc. (NAOC) and National Tobacco Company, L.P. (NTC) filed a complaint (the Kentucky Complaint) against Republic Tobacco, Inc. and its affiliates (Republic Tobacco) in Federal District Court for the Western District of Kentucky. Republic Tobacco imports and sells Roll-Your-Own (RYO) premium cigarette papers under the brand names JOB and TOP as well as other brand names. The Kentucky Complaint alleges, inter alia, that Republic Tobacco s use of exclusivity agreements, rebates, incentive programs, buy-backs and other activities related to the sale of premium cigarette papers in the southeastern United States violate federal and state antitrust and unfair competition laws and that Republic Tobacco defaced and directed others to deface NAOC s point of purchase vendor displays for premium cigarette papers by covering up the ***ZIG-ZAG*** brand name and advertising material with advertisements for Republic Tobacco s RYO cigarette paper brands. The Kentucky Complaint alleges that these activities constitute unfair competition under federal and state laws.

On June 30, 1998, Republic Tobacco filed a complaint against NATC, NAOC and NTC in the U.S. District Court of the Northern District of Illinois (the Illinois Complaint) and served it on NATC after the institution of the Kentucky action. In the Illinois Complaint, Republic Tobacco seeks declaratory relief with respect to the Company s claims. In addition, the Illinois Complaint alleges that certain actions taken by NATC to inform its customers of its claims against Republic Tobacco constitute tortuous interference with customer relationships, false advertising, violations of Uniform Deceptive Trade Practices and Consumer Fraud Acts, defamation and unfair competition. In addition, although not included in its original complaint but in its amended complaint, Republic Tobacco alleged that NATC has unlawfully monopolized and attempted to monopolize the market on a national and regional basis for premium cigarette papers. Republic sought unspecified compensatory damages, injunctive relief and attorneys fees and costs.

On October 20, 2000, Republic Tobacco filed a motion to dismiss, stay, or transfer the Kentucky Complaint to the Illinois Court. On December 19, 2000, the Court denied Republic Tobacco s motion, holding that it was premature. The Court noted also that it had communicated with the Court in Illinois and that it had concluded that Republic Tobacco may not be entitled to any preference on forum selection, which would ordinarily be given because it was first to file. The Kentucky complaint is still on file.

Prior to the completion of discovery, the Court dismissed Republic Tobacco s antitrust claims against NATC. After discovery was completed in 2001, both parties moved for summary judgment on the others claims. In April 2002, the District Court for the Northern District of Illinois decided the summary judgment motions by dismissing all claims of both NATC and Republic Tobacco and its affiliates, except for Republic Tobacco s claim of defamation per se against NATC, on which it granted summary judgment on liability in favor of Republic Tobacco, and a Lanham Act false advertising claim, based on the same facts as the defamation claim, for equitable relief. In February 2003, the District Court granted Republic s motion for summary judgment on NATC s counterclaim that Republic tortuously interfered with NATC s business relationships and economic advantage. The only claim that remained to be tried was Republic s

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(dollars in thousands)

20. Contingencies, continued:

Lanham Act claim and damages on the defamation claim on which the Court previously ruled that Republic could only obtain equitable relief if successful.

On July 8, 2003, following a four-day trial, an Illinois jury returned a verdict in favor of Republic on the defamation claims of $8.4 million in general damages and $10.2 million in punitive damages, for a total damage award of $18.6 million. NATC recorded an $18.8 million charge during the second quarter 2003 relating to this transaction. NATC filed post-trial motions for a new trial and, in the alternative, for a reduction of the awards. On August 1, 2003, NATC posted a judgment bond in the amount of $18.8 million with the U.S. District Court. This was accomplished by obtaining a $19.0 million senior secured term loan pursuant to a July 31, 2003 amendment to NATC s existing credit facility. On November 20, 2003, the court ruled that the awards were excessive and reduced the awards by approximately 60%, with the award of compensatory damages being reduced to $3.36 million and the award of punitive damages being reduced to $4.08 million, for a total of $7.44 million. On December 18, 2003, Republic accepted these reduced awards. NATC reversed $11.16 million during the fourth quarter 2003 due to this court ruling.

On January 8, 2004, NATC appealed the final judgment, including the finding of liability in this case as well as the amount of the award. On January 22, 2004, Republic filed a general notice of cross appeal and argued in its appellate briefs that the judgment should be affirmed and also asserted, in its cross-appeal, that the original judgment should be reinstated despite its acceptance of the District Court s order reducing the judgment amount.

On September 1, 2004, the Court of Appeals issued its ruling affirming the finding of liability against NATC for defamation, but reducing the amount of the damage award to $3.0 million. The Court of Appeals also affirmed the dismissal of NATC s antitrust claim against Republic and the dismissal of Republic s motion to re-instate the original jury award of $18.8 million. As a result of these rulings, in October 2004 NATC received approximately $4.5 million relating to the cash bond it had posted with the Court in 2003. This amount was included in Other income during 2004.

NATC has also applied to the Court of Appeals for an order awarding NATC approximately $1.0 million for the difference in the expense of the original bond of $18.8 million and the subsequent reduced bond of $7.0 million, on the one hand, and the lesser expense NATC would have incurred to bond the final $3.0 million judgment, on the other hand. On November 30, 2004, the Court of Appeals ruled that the application for costs should be directed to the District Court. On December 17, 2004, NATC filed this motion with the District Court. That motion has been fully briefed and the parties are waiting for the Court to rule.

Litigation Related to Counterfeiting

Texas Infringing Products Litigation. In Bolloré, S.A. v. Import Warehouse, Inc., Civ. No. 3-99-CV-1196-R (N.D. Texas), Bolloré, the Company s Licensor of ***ZIG-ZAG*** brand premium cigarette papers, obtained a sealed order allowing it to conduct a seizure of infringing and counterfeit ***ZIG-ZAG*** products in the United States. On June 7, 1999, seizures of products occurred in Michigan and Texas. Subsequently, all named defendants have been enjoined from buying and selling such infringing or counterfeit goods. Bolloré and NATC negotiated

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20. Contingencies, continued:

settlements with all defendants. These defendants included Import Warehouse, Ravi Bhatia, Tarek Makki and Adham Makki. Those settlements included a consent injunction against distribution of infringing or counterfeit goods.

On May 18, 2001, NATC, in conjunction with Bolloré and law enforcement authorities conducted raids on the businesses and homes of certain defendants previously enjoined (including Tarek Makki and Adham Makki) from selling infringing or counterfeit ***ZIG-ZAG*** brand products in the Bolloré S.A. v. Import Warehouse litigation. Evidence was uncovered that showed that these defendants and certain other individuals were key participants in importing and distributing counterfeit ***ZIG-ZAG*** premium cigarette papers. After a two day hearing in the U.S. District Court for the Northern District of Texas, on May 30, 2001, the Court held the previously enjoined defendants in contempt of court, and enjoined the additional new defendants, including Ali Makki, from selling infringing or counterfeit ***ZIG-ZAG p***remium cigarette papers.

NATC entered into a settlement with the defendants, the principal terms of which included a cash payment, an agreed permanent injunction, the withdrawal of the defendants appeal of the civil contempt order, an agreed judgment of $11.0 million from the civil contempt order and an agreement to forbear from enforcing that $11.0 million money judgment until such time in the future that the defendants violate the terms of the permanent injunction. Two of the defendants, Tarek Makki and Adham Makki, also agreed to provide complete information concerning the counterfeiting conspiracy as well as information on other parties engaged in the purchase and distribution of infringing ***ZIG-ZAG*** premium cigarette papers.

On February 17, 2004, NATC and Bolloré filed a motion in the U.S. District Court for the Northern District of Texas, which had issued the original injunctions against the infringing defendants, seeking, with respect to respondents Adham Makki, Tarek Makki and Ali Makki, to have the $11.0 million judgment released from the forbearance agreement and to have the named respondents held in contempt of court. The motion alleged that the three respondents had trafficked in counterfeit ***ZIG-ZAG*** cigarette papers after the execution of the settlement, citing evidence that all three had been charged in the United States District Court for the Eastern District of Michigan with criminal violations of the United States counterfeiting laws by trafficking in counterfeit ***ZIG-ZAG*** cigarette papers, which trafficking occurred after the settlement agreement.

On April 13, 2004, the Court entered an order (the Contempt 2 Order), finding Ali Mackie, Tarek Makki, Adham Mackie and their companies Best Price Wholesale (the Makki Defendants) and Harmony Brands LLC in civil contempt, freezing all of their assets, releasing the July 12, 2002 Final Judgment of $11.0 million from the forbearance agreement as to the Makki Defendants, and again referring the matter to the United States Attorney for Criminal Prosecution. Subsequent to the entry of the Contempt 2 Order, the Company settled with defendant Harmony Brands and its members for the amount of $750,000 and the entry of a permanent injunction. The Company is seeking to execute on the outstanding $11.0 million judgment against the remaining Makki Defendants and those efforts are currently underway.

Pursuant to the U.S. Distribution Agreement and a related agreement between Bolloré and NATC, any collections on the judgments issued in the Bolloré v. Import Warehouse case are to be divided evenly between Bolloré and NATC after the payment of all expenses.

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20. Contingencies, continued:

On February 7, 2002, Bolloré, NAOC and NATC filed a motion with the District Court in the Texas action seeking to hold Ravi Bhatia and Import Warehouse Inc. in contempt of court for violating the terms of the consent order and injunction entered against those defendants. NATC alleges that Mr. Bhatia and Import Warehouse sold counterfeit goods to at least three different companies over an extended period of time. On June 27, 2003, the Court found Import Warehouse and Mr. Bhatia in contempt of court for violating an existing injunction barring those parties from distributing infringing ***ZIG-ZAG*** cigarette paper products. The Court requested that NATC and Bolloré (NATC s co-plaintiff in the case) file a submission detailing the damages incurred. NATC and Bolloré filed their submission on July 25, 2003 which reported and requested damages of $2.4 million.

On July 1, 2004, the Court issued an Order awarding approximately $2.5 million in damages to NATC for the damages incurred by the Company as a result of the Import Warehouse Defendants civil contempt. On July 15, 2004, the Court entered a Final Judgment in that amount for which defendants Import Warehouse, Inc. and Ravi Bhatia are jointly and severally liable. After NATC and Bolloré commenced collection proceedings, Import Warehouse paid NATC and Bolloré an amount equal to the entire judgment plus the expenses incurred in collection. Accordingly, approximately $1.2 million has been recorded in Other income during 2004. The Import Warehouse Defendants filed a notice of appeal on July 24, 2004. No briefing schedule has been established.

Litigation Related to Alleged Personal Injury

West Virginia Complaints. Trial of the West Virginia complaints against the smokeless tobacco defendants has been postponed indefinitely, as described below. On October 6, 1998 NTC was served with a summons and complaint on behalf of 65 individual plaintiffs in an action in the Circuit Court of Kanawha County, West Virginia, entitled Kelly Allen, et al. v. Philip Morris Incorporated, et al. (Civil Action Nos. 98-C-240l). On November 13, 1998, NTC was served with a second summons and complaint on behalf of 18 plaintiffs in an action in the Circuit Court of Kanawha County, West Virginia, entitled Billie J. Akers, et al. v. Philip Morris Incorporated et al. (Civil Action Nos. 98-C-2696 to 98-C-2713). The complaints are identical in most material respects. In the Allen case, the plaintiffs have specified the defendant companies for each of the 65 cases. NTC is named in only one action. One Akers plaintiff alleged use of an NTC product, alleging lung cancer.

On September 14, 2000, NTC was served with a summons and complaint on behalf of 539 separate plaintiffs filed in Circuit Court of Ohio County, West Virginia, entitled Linda Adams, et al. v. Philip Morris Inc., et al. (Civil Action Nos. 00-C-373 to 00-C-911). Only one of these plaintiffs alleged use of a product currently manufactured by NTC. The time period during which this plaintiff allegedly used the product has not yet been specified. Thus, it is not yet known whether NTC is a proper defendant in this case.

On September 19, 2000, NTC was served with a second summons and complaint on behalf of 561 separate plaintiffs filed in Circuit Court of Ohio County, West Virginia, entitled Ronald Accord, et al. v. Philip Morris Inc., et al. (Civil Action Nos. 00-C-923 to 00-C-1483). A total of five of these plaintiffs alleged use of a product currently manufactured by NTC. One of these plaintiffs

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20. Contingencies, continued:

does not specify the time period during which the product was allegedly used. Another alleges use that covers, in part, a period when NTC did not manufacture the product. On motion by cigarette company defendants, this claim was dismissed on February 11, 2004, for failure to follow the case management order. Of the remaining three, one alleges consumption of a competitor s chewing tobacco from 1966 to 2000 and NTC s ***Beech-Nut*** chewing tobacco from 1998 to 2000; another alleges a twenty-four year smoking history ending in 1995 and consumption of ***Beech-Nut*** chewing tobacco from 1990 to 1995; and the last alleges a thirty-five year smoking history ending in 2000, and consumption of NTC s ***Durango Ice*** chewing tobacco from 1990 to 2000 (although ***Durango Ice*** did not come onto the market until 1999).

In November 2001, NTC was served with an additional four separate summons and complaints in actions filed in the Circuit Court of Ohio County, West Virginia. The actions are entitled Donald Nice v. Philip Morris Incorporated, et al. (Civil Action No. 01-C-479), Korene S. Lantz v. Philip Morris Incorporated, et al. (Civil Action No. 01-C-480), Ralph A. Prochaska, et al. v. Philip Morris, Inc., et al. (Civil Action No. 01-C-481), and Franklin Scott, et al. v. Philip Morris, Inc., et al., (Civil Action No. 0l-C-482).

All of the West Virginia smokeless tobacco actions have been consolidated before the West Virginia Mass Litigation Panel for discovery and trial of certain issues. Trial of these matters was planned in two phases. In the initial phase, a trial was to be held to determine whether tobacco products, including all forms of smokeless tobacco, cigarettes, cigars and pipe and roll-your-own tobacco, can cause certain specified diseases or conditions. In the second phase, individual plaintiffs would attempt to prove that they were in fact injured by tobacco products. Fact and expert discovery in these cases has closed, however, in the cigarette cases the Court has allowed additional discovery.

The claims against NTC in the various consolidated West Virginia actions include negligence, strict liability, fraud in differing forms, conspiracy, breach of warranty and violations of the West Virginia consumer protection and antitrust acts. The complaints in the West Virginia cases request unspecified compensatory and punitive damages.

The manufacturers of smokeless tobacco products (as well as the manufacturers of cigarettes) moved to sever the claims against the smokeless tobacco manufacturer defendants from the claims against the cigarette manufacturer defendants. That motion was granted and the trial date on the smokeless tobacco claims has now been postponed indefinitely.

The trial court has now vacated the initial trial plan in its entirety because of concerns that its provisions violated the dictates of the United States Supreme Court s decision in State Farm Mutual Automobile Insurance Company v. Campbell, 538 U.S. 408 (2003). A new trial plan has not yet been implemented with regard to the consolidated claims against the cigarette manufacturer defendants. The West Virginia Supreme Court has accepted review of the case management order and the plaintiffs filed their brief on March 24, 2005. The claims against the smokeless tobacco manufacturer defendants remain servered and indefinitely stayed.

Minnesota Complaint. On September 24, 1999, NTC was served with a complaint in a case entitled Tuttle v. Lorillard Tobacco Company, et al. (Case No. C2-99-7105), brought in Minnesota. The other manufacturing defendants are Lorillard and The Pinkerton Tobacco Company. The Complaint alleges that plaintiff s decedent was injured as a result of using NTC s

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20. Contingencies, continued:

(and, prior to the formation of NTC, Lorillard s) ***Beech-Nut*** brand and Pinkerton s *Red Man* brand of loose-leaf chewing tobacco. Plaintiff asserts theories of liability, breach of warranty, fraud, and variations on fraud and misrepresentation. Plaintiff specifically requests in its complaint an amount of damages in excess of fifty thousand dollars ($50,000) along with costs, disbursements and attorneys fees, and . . . an order prohibiting defendants from disseminating in Minnesota further misleading advertising and making further untrue, deceptive and/misleading statements about the health effects and/or addictive nature of smokeless tobacco products. . . . After discovery, summary judgment motions were filed on behalf of all defendants. On March 3, 2003, the Court granted defendants motions, dismissing all claims against all defendants and the Court has since denied the plaintiff s motion for reconsideration. Plaintiff has appealed the dismissal. Briefing has been completed. Oral argument before the Court of Appeals was held on February 11, 2004. On July 30, 2004, the Court of Appeals affirmed the dismissal of all of the claims.

In addition to the above described legal proceedings, the Company is subject to other litigation in the ordinary course of its business. The Company does not believe that any of these other proceedings will have a material adverse effect on the results of operations, financial position or cash flows of the Company. For a description of regulatory matters and related industry litigation to which the Company is a party, see Part I, Item 1. Business Regulation.

Other Employment Matters

The Company may, from time to time, have claims from and make settlements with former officers or employees.

David I. Brunson, the former President, Chief Financial Officer and Treasurer of the Company, resigned from the Company effective January 19, 2005, at which time his employment agreement with the Company (the Brunson Employment Agreement) was effectively terminated. Pursuant to the Brunson Employment Agreement, the Company is required to make certain severance payments to Mr. Brunson, including $425,000, which was paid within ten business days after January 19, 2005, and an additional $425,000 payable within the next 12 months. In addition, Mr. Brunson may become entitled to a bonus payment of up to $725,000 relating to synergies achieved in the integration of the business of Stoker, Inc. that was acquired by the Company in 2003. Pursuant to the Brunson Employment Agreement, after the last severance payment is made, Mr. Brunson will have an option to require the Company to repurchase all or a portion of his shares of the Company at their fair market value. The Company will not be obligated to repurchase these shares if, upon or after the payment, it would be in default under any instrument, agreement or law by which it is bound; in this case, the repurchase may be deferred until it can be completed without such default. Similarly, the Company has an option to repurchase Mr. Brunson s shares at their fair market value. In the event the Company and Mr. Brunson are unable to agree upon the fair market value of these shares, an independent investment banking firm will be selected to determine such fair market value, in accordance with the procedure provided for by the Brunson Employment Agreement. If neither Mr. Brunson nor the Company exercise their respective options by the earliest of the fifth anniversary of the termination of Mr. Brunson s employment or the date on which the Company refinances, or uses proceeds derived from refinancing, certain of its obligations, the Company will be required to repurchase Mr. Brunson s shares on such date unless Mr. Brunson waives his right to require the Company to purchase his shares. During the first quarter of 2005, the Company expects to record approximately $1.1 million relating to the resignation of Mr. Brunson. Any options or shares of restricted stock granted to Mr. Brunson vest in full as of the date of such termination.

21. Parent-Only Financial Information:

The Company is a holding company with no independent operations and no independent assets other than its investments in its subsidiaries and deferred financing costs related to its debt. The Company is dependent on NATC s cash flows to service the interest on the unsecured Senior Discount Notes. The amount of cash interest to be paid during the next five years is as follows: $0 in each of 2005, 2006, 2007; $5,941 in 2008 and $5,951 payable on March 1 and September 1 thereafter until maturity. While there are certain restrictions on the ability of the Company to obtain funds from its subsidiaries, these specific provisions do not restrict the subsidiaries ability to fund the Company s interest requirements, assuming NATC has the ability to incur $1.00 of additional indebtedness pursuant to the terms of its New Senior Notes. Separate financial statements of the subsidiaries are not required and have not been included in these financial statements.

22. Segment Information:

The Company has been historically organized on the basis of product lines which are comprised of three reportable segments. The smokeless tobacco segment manufactures smokeless tobacco products which are distributed primarily through wholesale and food distributors in the United States. The make-your-own segment imports and distributes premium cigarette papers, tobaccos and related products primarily through wholesale distributors in the United States. The premium

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22 Segment Information, continued

cigarette segment distributes contract manufactured cigarettes through wholesale distributors in the United States.

The accounting policies of the segments are the same as those described in the Summary of Significant Accounting Policies. Segment data includes a charge allocating all corporate costs to each operating segment. Elimination and Other includes the assets of the Company not assigned to segments and the elimination of intercompany accounts between segments. The Company evaluates the performance of its segments based on earnings before interest, taxes, depreciation, amortization, certain non-cash charges and other income and expenses (Adjusted EBITDA).

The table below presents financial information about reported segments for 2004, 2003 and 2002 (in thousands):

2004	**Smokeless Tobacco**	**Make-Your-Own**	**Premium Manufactured Cigarettes**	**Other**	**Eliminations**	**Total**
Net sales	$ 46,214	$ 63,577	$ 270	$ 5,259	$	$ 115,320
Operating income	8,022	15,204	(4,830)	814		19,210
Adjusted EBITDA	9,983	16,546	(4,815)	1,085		22,799
Assets	62,172	275,713	2,788	27,370	(135,645)	232,398
2003						
Net sales	$ 36,697	$ 64,677	$ 64	$ 155	$	$ 101,593
Operating income	4,601	18,533	(2,843)	30		20,321
Adjusted EBITDA	10,504	20,143	(2,825)	32		27,754
Assets	72,570	277,612	2,218		(108,756)	243,644
2002						
Net sales	$ 35,732	$ 58,693	$	$	$	$ 94,425
Operating income	5,966	23,421				29,387
Adjusted EBITDA	9,904	25,214				35,118
Assets	67,951	256,756			(111,113)	213,594

A reconciliation of Adjusted EBITDA to total consolidated operating income for 2004, 2003 and 2002 is as follows (in thousands):

	2004	2003	2002
Adjusted EBITDA	$ 22,799	$ 27,754	$ 35,118
Depreciation expense	(816)	(589)	(700)
Amortization expense	(462)	(67)	
Incentive Pay	(2,107)		
LIFO adjustment	(2,232)	(3,459)	(3,878)
Stock option expense	(838)	(417)	(576)
Pension/Postretirement expense	2,866	(2,901)	(577)
Operating income	$ 19,210	$ 20,321	$ 29,387

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23. Terminated Asset Purchase Agreement:

On February 18, 2003, NATC entered into an asset purchase agreement (the Star Cigarette Asset Purchase Agreement) with Star Scientific, Inc. (Star Scientific), and Star Tobacco, Inc., a wholly-owned subsidiary of Star Scientific (Star Tobacco and, together with Star Scientific, Star). Pursuant to the Star Cigarette Asset Purchase Agreement, NATC was to purchase substantially all of the assets of Star relating to the manufacturing, marketing and distribution of four discount cigarette brands in the United States (the Star Cigarette Assets). The purchase price for the Star Cigarette Assets was to have been $80.0 million in cash, subject to certain closing adjustments and the assumption of certain liabilities related to the Star Cigarette Assets.

On July 15, 2003, NATC and Star reached a mutual agreement to terminate the Star Cigarette Asset Purchase Agreement. Pursuant to the termination agreement, Star Scientific retained a $2.0 million earnest money deposit that had been placed into escrow by NATC and the parties executed releases of any liabilities arising out of the Star Cigarette Asset Purchase Agreement. NATC incurred $3.3 million of direct costs during 2003, including the $2.0 million earnest money deposit referred to above, in connection with this transaction. These costs are included in Other Expenses in the Condensed Consolidated Statements of Operations.

24. New Accounting Standards:

In December 2004, the FASB issued SFAS No. 123R (Revised 2004), Accounting for Stock Based Compensation (SFAS No. 123R). SFAS No. 123R establishes standards for the accounting for transactions in which an entity exchanges its equity instruments for goods or services. It also addresses transactions in which an entity incurs liabilities in exchange for goods or services that are based on the fair value of the entity s equity instruments or that may be settled by the issuance of those equity instruments. SFAS No. 123R eliminates the alternative to use APB 25 s intrinsic value method of accounting that was provided in SFAS No. 123 as originally issued. SFAS No. 123R requires entities to recognize the cost of employee services received in exchange for awards of equity instruments based on the grant-date fair value of those awards (with limited exceptions). That cost will be recognized over the period during which an employee is required to provide service in exchange for the award or the vesting period. No compensation cost is recognized for equity instruments for which employees do not render the requisite service. A public entity will initially measure the cost of liability based service awards based on their current fair value; the fair value of those awards will be remeasured subsequently at each reporting date through the settlement date. Changes in fair value during the requisite service period will be recognized as compensation cost over that period. The provisions of SFAS No. 123R shall become effective for the Company in the third quarter of 2005 and will apply to all awards granted after June 30, 2005 and to awards modified, repurchased, or cancelled after that date. The Company is evaluating SFAS No. 123R and believes it will not have a material effect on financial results of operations.

In December 2003, the FASB issued revised Interpretation No. 46R, Consolidation of Variable Interest Entities (FIN 46R). FIN 46R provides guidance on how to identify a variable interest entity (VIE) and determine when the assets, liabilities, non-controlling interest, and results of operations of a VIE need to be included in a company s consolidated financial statements. FIN 46R also requires additional disclosures by primary beneficiaries and other significant variable

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24. New Accounting Standards, continued:

interest holders. Application of FIN 46R is required for interests in variable interest entities for years ending after December 15, 2003. The Company has determined that it has no variable interest entities. Application of FIN 46R is required for all other types of VIE s for periods ending after March 15, 2004. The application of FIN 46R had no effect on the Company s financial statements in 2004.

In November 2004, the FASB issued SFAS No. 151, Inventory Costs an amendment of ARB No. 43, Chapter 4, to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage). SFAS No. 151 requires that items be recognized as current-period charges regardless of whether they meet the criterion of so abnormal that was previously stated in ARB No. 43, Chapter 4. In addition, SFAS No. 151 requires that allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. The provisions of this statement shall be effective for inventory costs incurred during fiscal years beginning after June 15, 2005. The Company does not expect SFAS No. 151 to have a material impact on the Company s financial condition or results of operations.

In December 2004, the FASB issued SFAS No. 152, Accounting for Real Estate Time-Sharing Transactions an amendment of FASB Statements No. 66 and 67. This Statement amends SFAS No. 66, Accounting for Sales of Real Estate, to reference the financial accounting and reporting guidance for real estate time-sharing transactions that is provided in American Institute of Certified Public Accountants (AICPA) Statement of Position 04-2 (SOP 04-2), Accounting for Real Estate Time-Sharing Transactions. This Statement also amends SFAS No. 67, Accounting for Costs and Initial Rental Operations of Real Estate Projects, to state that the guidance for (a) incidental operations and (b) costs incurred to sell real estate projects does not apply to real estate time-sharing transactions. The accounting for those operations and costs is subject to the guidance in SOP 04-2. The Accounting Standards Executive Committee of the AICPA issued SOP 04-2 to address the diversity in practice caused by a lack of guidance specific to real estate time-sharing transactions. SFAS No. 152 and SOP No. 04-2 will improve the accounting and reporting of those transactions. The guidance is effective for financial statements for fiscal years beginning after June 15, 2005, with earlier application encouraged. The Company currently does not participate in any real estate time-sharing transactions.

In December 2004, the FASB issued SFAS No. 153, Exchanges of Nonmonetary Assets - an amendment of APB Opinion No. 29, to eliminate the exception for nonmonetary exchanges of similar productive assets and replaces it with a general exception for exchanges of nonmonetary assets that do not have commercial substance. A nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. The guidance is effective for nonmonetary asset exchanges occurring in fiscal periods beginning after June 15, 2005. The Company does not expect SFAS No. 153 to have a material impact on the Company s financial condition or results of operations.

In December 2004, the FASB issued two FASB Staff Positions (FSP) regarding the accounting implications of the American Jobs Creation Act of 2004 (the Act). The Act provides a deduction for income from qualified domestic production activities, which will be phased in from 2005 through 2010. In return, the Act also provides for a two-year phase-out of the existing

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24. New Accounting Standards, continued:

extra-territorial income exclusion (ETI) for foreign sales. Under the guidance in FSP No. FAS 109-1, Application of FASB Statement 109, `Accounting for Income Taxes, to the Tax Deduction on Qualified Production Activities Provided by the American Jobs Creation Act of 2004, the deduction will be treated as a special deduction as described in FASB Statement No. 109. As such, the special deduction has no effect on deferred tax assets and liabilities existing at the enactment date and is not expected to have an impact on the Company s effective tax rate until fiscal year 2005. FSP No. FAS 109-2, Accounting and Disclosure Guidance for the Foreign Earnings Repatriation Provision within the American Jobs Creation Act of 2004, is effective for 2004 and is disclosed in Note (10) Income Taxes.

In December 2003, the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (the Act), which introduces a Medicare prescription drug benefit, as well as a federal subsidy to sponsors of retiree health care benefit plans that provide a benefit that is at least actuarially equivalent to the Medicare benefit, was enacted. In May 2004, the FASB issued Financial Staff Position No. 106-2, Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (FSP 106-2) to discuss certain accounting and disclosure issues raised by the Act. FSP 106-2 addresses accounting for the federal subsidy for the sponsors of single employer defined benefit postretirement healthcare plans and disclosure requirements for plans for which the employer has not yet been able to determine actuarial equivalency. In January 2005, the Centers for Medicare and Medicaid Services released the final regulations implementing the Medicare Prescription Drug, Improvement, and Modernization Act of 2003.

The Company has not yet determined whether the prescription drug benefits provided under the postretirement plan are actuarially equivalent to the Medicare benefit as necessary to qualify for the subsidy. The reported net periodic benefit costs of the postretirement plan in the accompanying Financial Statements and Notes to the Financial Statements do not reflect the effect of the Act. While the Company may be eligible for benefits under the Act based on the prescription drug benefits provided in the postretirement plan, the Company does not believe such benefits will have a material impact on its financial statements.

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