BENTLEY PHARMACEUTICALS INC
Form S-3/A
April 11, 2002

AS FILED WITH THE SECURITIES AND EXCHANGE COMMISSION ON APRIL 11, 2002

REGISTRATION NO. 333-82938

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

AMENDMENT NO. 4
TO
FORM S-3

REGISTRATION STATEMENT
UNDER
THE SECURITIES ACT OF 1933

BENTLEY PHARMACEUTICALS, INC.
(Exact name of registrant as specified in its charter)

DELAWARE	59-1513162
(State or other jurisdiction of Incorporation or organization)	(I.R.S. Employe Identification N

65 LAFAYETTE ROAD, THIRD FLOOR
NORTH HAMPTON, NEW HAMPSHIRE 03862
(603) 964-8006
(Address, including zip code, and telephone number, including area code, of registrant's principal executive offices)

JORDAN A. HORVATH, ESQ.
VICE PRESIDENT AND GENERAL COUNSEL
BENTLEY PHARMACEUTICALS, INC.
65 LAFAYETTE ROAD, THIRD FLOOR
NORTH HAMPTON, NEW HAMPSHIRE 03862
(603) 964-8006
(Name, address, including zip code, and telephone number, including area code, of agent for service)

Copy to:

GARY J. SIMON, ESQ.	PAUL BERKOWITZ, ESQ.
JENKENS & GILCHRIST PARKER CHAPIN LLP	GREENBERG TRAURIG P.A.

THE CHRYSLER BUILDING
405 LEXINGTON AVENUE
NEW YORK, NEW YORK 10174
(212) 704-6000

1221 BRICKELL AVENUE
MIAMI, FLORIDA 33131
(305) 579-0500

APPROXIMATE DATE OF COMMENCEMENT OF PROPOSED SALE TO PUBLIC: As soon as practicable after the effective date of this Registration Statement.

If the only securities on this Form are being offered pursuant to dividend or interest reinvestment plans, please check the following box. / /

If any of the securities being registered on this Form are to be offered on a delayed or continuous basis pursuant to Rule 415 under the Securities Act of 1933, other than securities offered only in connection with dividend or interest reinvestment plans, check the following box. / /

If this Form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act, please check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. / / _____

If this Form is a post-effective amendment filed pursuant to Rule 462(c) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. / / _____

If delivery of the prospectus is expected to be made pursuant to Rule 434, please check the following box. / /

THE REGISTRANT HEREBY AMENDS THIS REGISTRATION STATEMENT ON SUCH DATE OR DATES AS MAY BE NECESSARY TO DELAY ITS EFFECTIVE DATE UNTIL THE REGISTRANT SHALL FILE A FURTHER AMENDMENT WHICH SPECIFICALLY STATES THAT THIS REGISTRATION STATEMENT SHALL THEREAFTER BECOME EFFECTIVE IN ACCORDANCE WITH SECTION 8(A) OF THE SECURITIES ACT OF 1933 OR UNTIL THIS REGISTRATION STATEMENT SHALL BECOME EFFECTIVE ON SUCH DATE AS THE COMMISSION, ACTING PURSUANT TO SECTION 8(A), MAY DETERMINE.

PRELIMINARY PROSPECTUS--SUBJECT TO COMPLETION, DATED APRIL 11, 2002
THE INFORMATION IN THIS PROSPECTUS IS NOT COMPLETE AND MAY BE CHANGED. THESE SECURITIES MAY NOT BE SOLD UNTIL THE REGISTRATION STATEMENT FILED WITH THE SECURITIES AND EXCHANGE COMMISSION IS EFFECTIVE. THIS PROSPECTUS IS NOT AN OFFER TO SELL, NOR IS IT SEEKING AN OFFER TO BUY, THESE SECURITIES IN ANY STATE WHERE THE OFFER OR SALE IS NOT PERMITTED.

PROSPECTUS
2,500,000 SHARES

[LOGO]

COMMON STOCK

We are offering 2,500,000 shares of common stock. Our common stock is quoted on the American Stock Exchange and the Pacific Exchange under the symbol "BNT". On April 9, 2002, the last reported sale price of our common stock was $10.30

per share.

YOU SHOULD CONSIDER CAREFULLY THE RISKS THAT WE HAVE DESCRIBED IN RISK FACTORS BEGINNING ON PAGE 5 BEFORE DECIDING WHETHER TO INVEST IN OUR COMMON STOCK.

	PER SHARE	TOTAL
Public price		
Placement agency fee		
Proceeds to us		

NEITHER THE SECURITIES AND EXCHANGE COMMISSION NOR ANY STATE SECURITIES COMMISSION HAS APPROVED OR DISAPPROVED OF THESE SECURITIES, OR DETERMINED IF THIS PROSPECTUS IS ACCURATE OR COMPLETE. ANY REPRESENTATION TO THE CONTRARY IS A CRIMINAL OFFENSE.

Raymond James & Associates, Inc. will act as the placement agent in connection with the offering and will use its best efforts to introduce us to investors. Raymond James has no commitment to buy any of the shares. The shares are being offered on an all-or-none basis only to institutional and selected retail investors. All investor funds received prior to the closing of the offering will be deposited into escrow with Citibank, N.A. until the closing. If the escrow agent does not receive investor funds for the full amount of the offering, the offering will terminate not later than May 10, 2002 and any funds received will be returned promptly without interest.

RAYMOND JAMES

THE DATE OF THIS PROSPECTUS IS APRIL , 2002

[Beaker shape collage with photos of products and facilities.]

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SUMMARY

ABOUT US

We are a specialty pharmaceutical company focused on advanced drug delivery technologies and pharmaceutical products. Our proprietary drug delivery technologies enhance or facilitate the absorption of pharmaceutical compounds across membranes of the skin, mouth, nose, vagina and eye. We seek to license our technologies to major pharmaceutical and biotechnology companies for incorporation into their existing and new pharmaceutical products. We also develop products that incorporate our technologies and seek to form strategic alliances with major pharmaceutical and biotechnology companies for the development and commercialization of these products. We currently have strategic alliances regarding our drug delivery technologies with Pfizer and Auxilium and are in preliminary discussions with a number of other pharmaceutical companies to form additional alliances.

In Spain we manufacture and market a growing portfolio of generic and branded pharmaceuticals within four primary therapeutic areas: cardiovascular, gastrointestinal, infectious and neurological diseases. We seek to grow our pharmaceutical operations through the acquisition of currently approved and late stage products and through strategic alliances with pharmaceutical companies. We currently have a strategic alliance with Teva Pharmaceutical Industries granting us the right to register and market in Spain more than 75 of Teva's pharmaceutical products through our sales force of approximately 150 full-time personnel located in major cities throughout Spain. For the year ended December 31, 2001, we generated net sales of $26.4 million and net income of $1.4 million, which included our sale during that year of drug licenses, which sale generated pre-tax gains of approximately $5 million.

INDUSTRY OVERVIEW

Drug delivery companies develop technologies to improve the administration of therapeutic compounds. These technologies are designed to enhance safety, efficacy, ease-of-use and patient compliance with prescribed therapy. The worldwide market for drug delivery systems was estimated to be $35 billion in 2000 and is projected to increase to $75 billion by 2005. Drug delivery technologies provide pharmaceutical and biotechnology companies with opportunities to:

- extend the commercial life of branded drugs that are about to lose patent protection in their current formulation;

- provide product differentiation to compounds that no longer have patent protection; and

- commercialize compounds that previously had limited or no commercialization potential because they could not be delivered safely and efficaciously.

The European Union, with an increasingly affluent population of approximately 375 million, represents the second largest pharmaceutical market in the world with approximately $75 billion in pharmaceutical sales in 2000, according to IMS Health. With Spain's entry into the European Union in 1986, the Spanish pharmaceutical market has been evolving steadily into a market that is increasingly similar to those of other countries in Western Europe and the United States. With approximately $6.6 billion in sales in 1999, Spain's pharmaceutical market ranked as the seventh largest in the world and is expected to grow to more than $10 billion by 2005, according to IMS Health. Although comprising less than three percent of the Spanish pharmaceutical market, generic pharmaceuticals are expected to significantly increase their market penetration due to increases in drug utilization by an aging population, opportunities to launch new generic products as patents expire for numerous blockbuster drugs and initiatives by the Spanish government to stimulate the use of generic pharmaceuticals in response to rising healthcare costs. As sales of generic pharmaceuticals increase, competition may increase as well.

OUR STRATEGY

Our primary objective is to be a leading specialty pharmaceutical company focused on advanced drug delivery and formulation technologies to improve the effectiveness of existing and new pharmaceuticals, while expanding our generic and branded operations in Spain and Europe. Our strategy to accomplish this objective includes the following:

FOCUS ON MARKETING AND COMMERCIALIZING OUR CPE-215 PERMEATION ENHANCEMENT PLATFORM TECHNOLOGY

Our CPE-215 platform technology enhances the absorption of a broad range of pharmaceutical compounds across membranes of the skin, mouth, nose, vagina and eye. We market our CPE-215 technology to major pharmaceutical and biotechnology companies whose products we believe would benefit from its permeation enhancement. Auxilium, one of our strategic partners, has filed a New Drug Application for a product using this technology. Although we are in various stages of developing products that incorporate our permeation enhancement technology, to date no such products have yet been commercialized.

DEVELOP PROPRIETARY PRODUCTS BASED ON OUR DRUG TECHNOLOGIES

We apply our drug delivery and oral drug formulation technologies to attempt to improve the performance of existing pharmaceutical products with respect to their method of delivery and effectiveness. Our proprietary manufacturing process improves the purity, stability and production yields of certain products and has the potential to significantly reduce manufacturing time and costs. Product development is underway for various applications of these technologies in order to obtain regulatory approval for commercialization.

INCREASE OUR PRODUCT SALES THROUGH TARGETED PROMOTION AND EXPANSION OF OUR PRODUCT PORTFOLIO

We plan to expand our portfolio of generic and branded products in Spain through the acquisition of currently marketed and late stage products, as well as through strategic alliances with other pharmaceutical and biotechnology companies. We face competition in obtaining new products as well as in partnering with other companies. In addition to our currently marketed products, we intend to directly promote and sell in Spain newly acquired

products through our own sales force of approximately 150 full-time personnel located in major cities throughout Spain.

RISKS

Since our inception through December 31, 2001, we have incurred an accumulated deficit of $74,332,000. In 2001, our net income increased to $1,361,000 in 2001 ($.10 per basic common share, $.08 per diluted common share) from a net loss of $745,000 in 2000 ($.06 per basic and diluted share) partially as a result of a $5,050,000 pre-tax gain in 2001 on the sale of drug licenses. We have invested our operating income and financing proceeds in our operations, funding working capital needs by a combination of internally generated funds from our Spanish operations and financing activities, including direct sales of stock as well as proceeds from the exercise of warrants. The proceeds of this offering will add to our working capital for general corporate purposes.

Our success will depend upon our competitive strengths and strategies, however, an investment in our common shares involves risks, including risks related to the identification of drugs suitable for our drug delivery technologies, expansion of our generic and branded drug operations, development and commercialization of new products, relationships with our strategic partners, the conduct of clinical trials, the regulatory approval process, product sales concentration, price competition, product reimbursement rates, reliance upon intellectual property protection, the effect of economic conditions and other uncertainties. These risks are described in more detail in the section of this prospectus titled "Risk Factors" which begins on page 5.

WHERE TO CONTACT US

Our headquarters are located at 65 Lafayette Road, Third Floor, North Hampton, New Hampshire 03862 and our telephone number is (603) 964-8006. Our website is located at www.bentleypharm.com. Information contained on our website is not part of this prospectus.

THE OFFERING

Common stock offered.....	2,500,000 shares
Common stock outstanding prior to this offering.....	14,719,194 shares (1)
Common stock outstanding immediately following this offering.....	17,219,194 shares (1)
Use of proceeds.....	We intend to use the net proceeds of this offering for general corporate purposes, including research and development, product development and capital expenditures, and for possible acquisitions.
American Stock Exchange symbol.....	BNT

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(1) Unless we state otherwise, the information in this prospectus concerning the number of shares of our common stock, stock options and warrants outstanding, currently and after this offering, is based on the number of

shares of common stock, stock options and warrants outstanding as of April 9, 2002. The shares set forth above do not include:

- 3,003,360 shares of common stock issuable upon the exercise of Class B Warrants (some of which we issued as underwriter's compensation as a result of our 1996 public offering), exercisable at $5.00 per share and expiring on December 31, 2002;

- 3,292,928 shares of common stock issuable upon the exercise of outstanding stock options, exercisable at a weighted average of $5.70 per share;

- 420,000 shares of common stock issuable upon the exercise of other outstanding common stock purchase warrants, exercisable at a weighted average of $2.38 per share; and

- 523,500 additional shares of common stock reserved for issuance under our stock option plans.

SUMMARY CONSOLIDATED FINANCIAL INFORMATION

The following sets forth a summary of consolidated statement of operations data for each of the five years in the period ended December 31, 2001 and consolidated balance sheet data as of December 31, 2000 and 2001, all of which are derived from our audited consolidated financial statements and related notes. The following summary financial data for each of the three years in the period ended December 31, 2001 and as of December 31, 2000 and 2001 should be read together with our consolidated financial statements and related notes appearing elsewhere in this prospectus and "Management's Discussion and Analysis of Financial Condition and Results of Operations." The consolidated statement of operations data for each of the two years in the period ended December 31, 1998 are derived from our audited consolidated financial statements and related notes not included in this prospectus.

CONSOLIDATED STATEMENT OF OPERATIONS DATA

	YEAR ENDED DECEMBER 31,				
	1997	1998	1999	2000	20
	(IN THOUSANDS, EXCEPT PER SHARE DATA)				
Net sales	$14,902	$15,243	$20,249	$18,617	$26,
Cost of sales	8,010	6,601	8,445	7,189	11,
Gross profit	6,892	8,642	11,804	11,428	14,
Operating expenses	8,438	10,710	11,226	11,942	16,
Gain on sale of drug licenses	--	--	--	--	5,
Provision for income taxes	621	236	781	222	2,
Net income (loss)	$(3,815)	$(2,876)	$(1,090)	$ (745)	$ 1,
Income (loss) per common share--basic	$ (.97)	$ (.35)	$ (.12)	$ (.06)	$
Income (loss) per common share--diluted	$ (.97)	$ (.35)	$ (.12)	$ (.06)	$
Weighted average number of common shares outstanding--basic	4,072	8,431	9,147	12,981	14,
Weighted average number of common shares					

outstanding--diluted.....	4,072	8,431	9,147	12,981	16,

CONSOLIDATED BALANCE SHEET DATA

	DECEMBER 31,		
	2000	2001	2001(1) AS ADJUSTED
	(IN THOUSANDS)		
Working capital.....	$3,742	$6,276	$29,076
Non-current assets.....	15,773	16,280	16,280
Total assets.....	28,877	32,119	54,919
Non-current liabilities.....	1,699	2,132	2,132
Stockholders' equity.....	17,816	20,424	43,224

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(1) Reflects the sale of 2,500,000 shares of common stock offered by us hereby on a best efforts basis, at an assumed offering price of $10.00 per share, after deducting placement agent fees and estimated offering expenses.

RISK FACTORS

YOU SHOULD CAREFULLY CONSIDER THE FOLLOWING RISK FACTORS AND WARNINGS BEFORE MAKING AN INVESTMENT DECISION. THE RISKS DESCRIBED BELOW ARE NOT THE ONLY RISKS WE FACE. ADDITIONAL RISKS THAT WE DO NOT YET KNOW OF OR THAT WE CURRENTLY THINK ARE IMMATERIAL MAY ALSO IMPAIR OUR BUSINESS OPERATIONS. IF ANY OF THE EVENTS OR CIRCUMSTANCES DESCRIBED IN THE FOLLOWING RISKS ACTUALLY OCCURS, OUR BUSINESS, FINANCIAL CONDITION, OR RESULTS OF OPERATIONS COULD BE MATERIALLY ADVERSELY AFFECTED. IN SUCH CASE, THE TRADING PRICE OF OUR COMMON STOCK COULD DECLINE, AND YOU MAY LOSE ALL OR PART OF YOUR INVESTMENT.

OUR GROWTH DEPENDS ON IDENTIFYING DRUGS SUITABLE FOR OUR DRUG DELIVERY TECHNOLOGIES AND EXPANDING OUR GENERIC AND BRANDED DRUG OPERATIONS.

Bentley's growth depends on the identification of pharmaceutical products that are suitable for delivery using our technologies. Our principal drug delivery technology is our CPE-215 permeation enhancement platform technology. This technology, like other drug delivery enhancement technologies, operates to enhance the amount and rate of absorbtion of certain drugs across biological membranes. This technology does not operate independently and must be coupled with suitable pharmaceutical products in order to provide value. Consequently, our growth will depend to a great extent on identifying and commercializing these suitable drugs, with respect to which we intend to expend significant resources and efforts. Identifying suitable products is a lengthy and complex process that may not succeed. Even if identified, products may not be available to us or we may otherwise be unable to enter into licenses or other agreements for their use. In our efforts to identify suitable products, we compete with other pharmaceutical delivery companies with greater research and development, financial, marketing and sales resources. If we do not effectively identify drugs to be used with our technologies, improve the delivery of drugs with our technologies and bring the improved drugs to commercial success, then we will not be able to continue our growth and we will be adversely affected.

We intend to expend significant resources and efforts toward identifying and commercializing products and technologies to expand our generic and branded drug operations in Spain. Although we already manufacture and market generic and branded drugs in Spain, the growth of these operations in particular and Bentley in general will depend to a great extent on identifying and commercializing additional such drugs for which we have existing capacity and infrastructure and, to a lesser extent, on increasing sales of existing products. Identifying and pursuing these new opportunities involves significant time and expense and we may not succeed. Even if identified, these products and technologies may not be commercially successful. Once identified, products to be manufactured and/or marketed by us under generic or branded names are subject to successful negotiation of acceptable economic and legal terms, and successful progress of the product through commercialization, as to which we cannot assure you. In these efforts, we compete with other pharmaceutical companies having generic and branded drug operations with greater financial, marketing and sales resources. If we do not effectively identify generic and branded drug products and technologies and bring them to commercial success, then we will not be able to continue our growth and we will be adversely affected.

The growth of our generic and branded operations may be adversely impacted by claims by others that our products infringe on the proprietary rights of their existing "brand-name" products. For example, in February 2002 we were notified that a legal proceeding seeking an injunction had been commenced in Madrid against us by Merck & Co. Inc. and its Spanish subsidiary alleging that we violated their patents in our production of the product simvastatin. Although the court in the same month dismissed the action, which could be brought in another proceeding, we cannot assure you that similar actions will not be brought nor that they will not have an adverse effect on us.

PRODUCTS USING OUR TECHNOLOGIES ARE IN VARIOUS STAGES OF DEVELOPMENT AND MAY NOT ACHIEVE COMMERCIAL SUCCESS.

Independently as well as in conjunction with strategic partners, we are investigating the use of our technologies with respect to a variety of pharmaceutical compounds and products that are in various stages of development. We are unable to predict whether any of these products will receive regulatory clearances or be successfully developed, manufactured or commercialized. Further, due to the extended testing and regulatory review process required before marketing clearance can be obtained, the time periods before commercialization of any of these products are long and uncertain. Risks during development include the possibility that:

- any or all of the proposed products will be found to be ineffective;
- the proposed products will have adverse side effects or will otherwise fail to receive necessary regulatory clearances;
- the proposed products may be effective but uneconomical to market; or
- other pharmaceutical companies may market equivalent or superior products.

WE WILL RELY ON STRATEGIC PARTNERS TO COMMERCIALIZE PRODUCTS THAT USE OUR DRUG DELIVERY TECHNOLOGIES.

In light of our resources and the significant time, expense, expertise and infrastructure necessary to bring new drugs and formulations from inception to market, we are particularly dependent on resources from third parties to commercialize products incorporating our technologies. Our strategy involves forming alliances with others to develop, manufacture, market and sell our

products in the United States and other countries. We continue to pursue strategic partners for these purposes. We may not be successful in finding strategic partners or in otherwise obtaining financing, in which case the development of our products would be delayed or curtailed.

We must enter into agreements with strategic partners to conduct clinical trials, manufacturing, marketing and sales necessary to commercialize product candidates. In addition, our ability to apply our drug delivery technologies to any proprietary drugs will depend on our ability to establish and maintain strategic partnerships or other collaborative arrangements with the holders of proprietary rights to such drugs. Arrangements with strategic partners may be established through a single comprehensive agreement or may evolve over time through a series of discrete agreements, such as letters of intent, research agreements and license agreements. We cannot assure you that we will be able to establish such strategic partnerships or collaborative arrangements on favorable terms or at all or that any agreement entered into with a strategic partner will lead to further agreements or ultimately result in commercialization of a product.

In collaborative arrangements, we will depend on the efforts of our strategic partners and will have limited participation in the development, manufacture, marketing and commercialization of the products subject to the collaboration. We cannot assure you that these strategic partnerships or collaborative arrangements will be successful, nor can we assure you that strategic partners or collaborators will not pursue alternative technologies or develop alternative products on their own or with others, including our competitors. We could have disputes with our existing or future strategic partners or collaborators. Any such disagreements could lead to delays in the research, development or commercialization of potential products or could result in time-consuming and expensive litigation or arbitration.

A SIGNIFICANT PORTION OF OUR REVENUES ARE GENERATED BY THE SALE OF PRODUCTS THAT ARE FORMULATED FROM ONE ACTIVE INGREDIENT.

Revenues from products whose active ingredient is omeprazole accounted for approximately 56% of our net sales in 2001. We currently purchase omeprazole from a single supplier. If we lose and

cannot effectively replace this supplier, or are otherwise unable to continue the sales of products that contain this active ingredient, our revenues would decline significantly.

IF OUR CLINICAL TRIALS FAIL, WE WILL BE UNABLE TO MARKET PRODUCTS.

Any human pharmaceutical product developed by us would require clearance by the U.S. Food and Drug Administration for sales in the United States, by Spain's Ministry of Health for sales in Spain and by comparable regulatory agencies for sales in other countries. The process of conducting clinical trials and obtaining FDA and other regulatory approvals is lengthy and expensive and we cannot assure you of success. In order to obtain FDA approval of any product candidates using our technologies, a New Drug Application must be submitted to the FDA demonstrating that the product candidate, based on preclinical research and animal studies as well as human clinical trials, is safe for humans and effective for its intended use. Positive results from preclinical studies and early clinical trials do not ensure positive results in more advanced clinical trials designed to permit application for regulatory approval. We may suffer significant setbacks in clinical trials, even in cases where earlier clinical trials show promising results. Any of our product candidates may produce undesirable side effects in humans that could cause us or regulatory authorities to interrupt, delay or halt clinical trials of a product candidate. We, the FDA

or other regulatory authorities may suspend our clinical trials at any time if we or they believe the trial participants face unacceptable health risks or if they find deficiencies in any of our regulatory submissions. Other factors that can cause delay or terminate our clinical trials include:

- slow or insufficient patient enrollment;
- slow recruitment and completion of necessary institutional approvals at clinical sites;
- longer treatment time required to demonstrate efficacy;
- lack of sufficient supplies of the product candidate;
- adverse medical reactions or side effects in treated patients;
- lack of effectiveness of the product candidate being tested;
- regulatory requests for additional clinical trials; and
- instability of the pharmaceutical formulations.

OUR PATENT POSITIONS AND INTENDED PROPRIETARY OR SIMILAR PROTECTIONS ARE UNCERTAIN.

We have filed numerous patent applications and have been granted licenses to, or have acquired, a number of patents. We cannot assure you, however, that our pending applications will be issued as patents or that any of our issued or licensed patents will afford adequate protection to us or our licensees. We cannot determine the ultimate scope and validity of patents that are now owned by or may be granted to third parties, the extent to which we may wish or be required to acquire rights under such patents or the cost or availability of such rights.

Competitors may interfere with our patent process in a variety of ways. Competitors may claim that they invented the claimed invention prior to us. Competitors also may claim that we are infringing their patents, interfering with or preventing the use of our technologies. Competitors also may contest our patents by showing the patent examiner that the invention was not original, was not novel or was obvious. In litigation, a competitor could claim that our issued patents are not valid for a variety of other reasons as well. If a person claims we infringe their technology, we could face a number of consequences, including lawsuits, which take significant time and can be very expensive, payment of substantial damages for infringement, prohibition from selling or licensing the product unless the patent holder licenses the patent to us, or reformulation, if possible, of the product so it does not infringe, which could require substantial time and expense.

As an example of the risk of infringement claims, in February 2002 we were notified that a legal proceeding seeking an injunction had been commenced in Madrid against us by Merck & Co. Inc. and its Spanish subsidiary alleging that we violated their patents in our production of the product simvastatin. Although the court in the same month dismissed the action, which could be brought in another proceeding, we cannot assure you that similar such actions will not be brought nor that they will not have an adverse effect on us.

We also rely on trade secrets, unpatented proprietary technologies and continuing technological innovations in the development and commercialization of our products. We cannot assure you that others will not independently develop the same or similar technologies or obtain access to our proprietary

technologies. It is unclear whether our trade secrets will be protected under law. While we use reasonable efforts to protect our trade secrets, our employees or consultants may unintentionally or willfully disclose our information to competitors. Our employees and consultants with access to our proprietary information have entered into or are subject to confidentiality arrangements with us and have agreed to disclose and assign to us any ideas, developments, discoveries and inventions that arise from their activities for us. We cannot assure you, however, that others may not acquire or independently develop similar technologies or, if effective patents in applicable countries are not issued with respect to our products or technologies, that we will be able to maintain information pertinent to such research as proprietary technologies or trade secrets. Enforcing a claim that another person has illegally obtained and is using our trade secrets, like patent litigation, is expensive and time consuming, and the outcome is unpredictable. In addition, courts outside the United States are sometimes less willing to protect trade secrets.

REGULATORY APPROVALS MUST BE OBTAINED AND MAINTAINED FOR PRODUCTS INCORPORATING OUR TECHNOLOGIES AND, IF APPROVALS ARE DELAYED OR WITHDRAWN, WE WILL BE UNABLE TO COMMERCIALIZE THESE PRODUCTS.

Government regulations in the United States, Spain and other countries have a significant impact on our business and affect the research and development, manufacture and marketing of products incorporating our technologies. In the United States, Spain and other countries, governmental agencies have the authority to regulate the distribution, manufacture and sale of drugs. Failure to comply with applicable regulatory approvals can, among other things, result in fines, suspension or withdrawal of regulatory approvals, product recalls, operating restrictions and criminal prosecution. In addition, governmental regulations may be established that could prevent, delay, modify or rescind regulatory approval of our products.

IF WE ARE UNABLE TO OBTAIN MARKETING APPROVALS TO SELL OUR PRODUCTS IN COUNTRIES OTHER THAN SPAIN, WE MAY NOT BE ABLE TO OBTAIN ADDITIONAL REVENUES FROM SALES IN THOSE COUNTRIES.

We cannot assure you that products that have obtained marketing approval in Spain will be approved for marketing elsewhere. If we are unable to obtain marketing approval for our products in countries other than Spain, we may not be able to obtain additional revenues from sales in those countries. If we are unable to obtain these marketing approvals, we would have to seek to enter into collaborative arrangements to sell or license our products to strategic partners that have marketing approval in those countries. We can not assure you that we would find or enter into acceptable arrangements with such strategic partners to market our products, nor can we assure you that any such arrangements would be successful.

WE MUST COMPLY WITH GOOD MANUFACTURING PRACTICES IN THE PRODUCTION OF PHARMACEUTICAL PRODUCTS.

Any manufacturing facility for pharmaceutical products to be marketed in the United States is subject to FDA inspection both before and after approval of a New Drug Application to determine compliance with the FDA's Good Manufacturing Practices requirements, as well as local, state and other federal regulations. Manufacturing facilities for our compounds to be marketed in European

countries and elsewhere are also subject to European Union and/or other applicable GMP regulations. Facilities used to produce our compounds may not achieve or maintain compliance with GMP or other requirements. The GMP regulations are complex and, if we fail to comply with them, it could lead to rejection or delay of an NDA or comparable application. Any delay in approval of

an NDA or comparable application would delay product launch. Violation of GMP requirements after approval of an NDA or comparable application, could result in remedial action, penalties and delays in production.

WE OPERATE A SIGNIFICANT PORTION OF OUR BUSINESS IN, AND PLAN TO EXPAND FURTHER INTO, MARKETS OUTSIDE THE UNITED STATES, WHICH SUBJECTS US TO ADDITIONAL BUSINESS RISKS.

In the year ended December 31, 2001, substantially all of our revenues were derived from sales made by our Spanish subsidiaries in Spain and a small portion of those revenues (one to two percent) were derived from sales made by the subsidiaries to customers in other foreign countries. We believe that a significant portion of our revenues will continue to be derived from sales in foreign countries. Conducting business internationally subjects us to a number of risks and uncertainties, including:

- unexpected delays or changes in regulatory requirements;
- difficulties and costs related to complying with a wide variety of complex foreign laws and treaties;
- delays and expenses associated with tariffs and other trade barriers;
- restrictions on and impediments to repatriation of our funds and our customers' ability to make payments to us;
- political and economic instability;
- difficulties and costs associated with staffing and managing international operations and implementing, maintaining and improving financial controls;
- dependence upon independent sales representatives and other indirect resellers who may not be as effective and reliable as our employees;
- inadequate or uncertain protection of intellectual property in foreign countries;
- increased difficulty in collecting accounts receivable and longer accounts receivable cycles in certain foreign countries; and
- adverse tax consequences or overlapping tax structures.

CURRENCY FLUCTUATIONS AND THE TRANSITION TO THE EURO COULD HAVE A MATERIAL ADVERSE IMPACT ON OUR BUSINESS.

Our revenues may be impacted by fluctuations in local currencies due to the fact that substantially all of our revenues currently are generated by sales in Spain by our Spanish subsidiaries, Laboratorios Belmac S.A. and Laboratorios Davur S.L. Our Spanish subsidiaries reported an increase in net sales of 50% in local currency for the year ended December 31, 2001 compared to the prior year; this increase, however, was partially offset by a decline in the value of the Spanish Peseta, when expressed in U.S. Dollars. We do not currently engage in foreign exchange hedging transactions to manage our foreign currency exposure. Our foreign operations expose us to a number of currency related risks, including the following:

- fluctuations in currency exchange rates;
- limitations on the conversion of foreign currency;
- fluctuations of the carrying value of long lived assets; and

- limitations on the remittance of dividends by foreign subsidiaries.

On January 1, 2002, European Union countries, which includes Spain, began operating with the Euro as their single currency. Uncertainty exists as to the effect the Euro will have on the marketplace. The currency conversion to the Euro exposes us to certain risks, including the following:

- the creation of suitable clearing and settlement payment schemes for the Euro;

- the legal treatment of outstanding financial contracts after the conversion date that refer to currencies other than the Euro; and

- whether the interest rate, tax and labor regimes of the European countries participating in the Euro will successfully converge over time, if at all.

IF WE CANNOT KEEP PACE WITH RAPID TECHNOLOGICAL CHANGE AND MEET THE INTENSE COMPETITION IN OUR INDUSTRY, WE MAY NOT SUCCEED.

Our success depends, in part, on achieving and maintaining a competitive position in the development of products and technologies in a rapidly evolving industry. If we cannot maintain competitive products and technologies, our current and potential strategic partners may choose to adopt the drug delivery technologies of our competitors. We also compete generally with other drug delivery, biotechnology and pharmaceutical companies engaged in the development of alternative drug delivery technologies or new drug research and testing. Many of these competitors have substantially greater financial, technological, manufacturing, marketing, managerial and research and development resources and experience than we do and represent significant competition for us. Our competitors may succeed in developing competing technologies or obtaining governmental approval for products before we achieve success, if at all. The products of our competitors may gain market acceptance more rapidly than our products. Developments by competitors may render our existing or proposed products noncompetitive or obsolete.

Our competitive positions in our generic and branded drug operations as well as with our drug delivery enhancement technologies are uncertain and subject to risks. In Spain, and in other countries, we must demonstrate bioequivalence of our generic products, which may be challenged by branded and other generic competitors as well as regulatory authorities. In order to demonstrate bioequivalence of our generic products, we must show that the rate and extent of absorption and levels of concentration in the bloodstream of our generic products are not statistically different from other pharmaceutical equivalents that have previously been approved by the regulatory authorities of the respective country, when administered at the same dosage level under similar clinical conditions.

The competitive position of our drug delivery enhancement technologies is subject to the possible development by others of superior technologies. Other drug delivery technologies, including oral and injection methods, have wide acceptance, notwithstanding certain drawbacks, and are the subject of improvement efforts by other entities having greater resources. In addition, our drug delivery technologies are limited by the number and commercial magnitude of drugs with which they can successfully be combined.

WE MAY BE UNABLE TO MEET INCREASING EXPENSES AND DEMANDS ON OUR RESOURCES FROM FUTURE GROWTH, IF ANY, OR TO EFFECTIVELY PURSUE ADDITIONAL BUSINESS OPPORTUNITIES.

Our revenues increased 42% and our research and development expenditures

increased 89% from the year ended December 31, 2000 to the year ended December 31, 2001, challenging our management, administrative, financial, marketing, operational and research and development resources. In addition, we routinely consider acquisition and investment opportunities, although we have no current agreements or commitments with respect to any acquisitions or investments. Any future acquisitions or investments would further challenge our resources. If we do not properly meet the increasing expenses

and demands on our resources from future growth, we will be adversely affected. To properly manage our growth, we must, among other things, implement additional and improve existing administrative, financial, marketing, operational and research and development systems, procedures and controls on a timely basis. We may also need to expand our staff in these and other areas. We may not be able to complete the improvements to our systems, procedures and controls necessary to support our future operations in a timely manner. We may not be able to hire, train, integrate, retain, motivate and manage required personnel, successfully integrate acquisitions or investments, nor successfully identify, manage and pursue existing and potential market opportunities. If we fail to generate additional revenue in excess of increased operating expenses in any fiscal period, we may incur losses, or our losses may increase in that period.

PHARMACEUTICAL PRICING, CHANGES IN THIRD-PARTY REIMBURSEMENT AND GOVERNMENTAL MANDATES ARE UNCERTAIN AND MAY ADVERSELY AFFECT US.

Our revenues and profitability may be adversely affected by the continuing efforts of governmental and third party payors to contain or reduce the costs of healthcare. A substantial portion of our operations consists of marketing and manufacturing, primarily in Spain, generic and branded pharmaceutical products. The use of generic drugs is regulated in Spain, the U.S. and many other countries, subject to many changing and competing public policy considerations. In addition, in certain markets, such as Spain, pricing or profitability of prescription pharmaceuticals is subject to government control. Some governmental agencies, including those in Spain, can, due to insufficient supply, compel companies to continue to produce products that are not profitable for the company. In the U.S., there have been, and we expect that there will continue to be, a number of federal and state proposals to implement similar government controls.

Successful commercialization of many of our products, including those using our permeation enhancement technologies as well as our generic and branded products, may depend on the availability of reimbursement for the cost of such products and related treatment from third-party healthcare payors, such as the government, private insurance plans and managed care organizations. Third-party payors are increasingly challenging the price of medical products and services. Such reimbursement may not be available for any of our products at all or for the duration of the recommended treatment with a drug, which could materially adversely affect our ability to commercialize that drug. The increasing emphasis on managed care in the U.S. continues to increase the pressure on pharmaceutical pricing.

We anticipate that there will continue to be a number of proposals in the U.S. to implement government control over the pricing or profitability of prescription pharmaceuticals, as is currently the case in many foreign markets. The announcement or adoption of such proposals could adversely affect us. Further, our ability to commercialize our products may be adversely affected to the extent that such proposals materially adversely affect the business, financial condition and profitability of companies that are prospective strategic partners.

The cost of healthcare in Spain, the U.S. and elsewhere continues to be a

subject of investigation and action by various governmental agencies. Certain resulting legislative proposals may adversely affect us. For example, governmental actions to reduce or eliminate reimbursement for drugs may directly diminish our markets. In addition, legislative safety and efficacy measures may be invoked that lengthen and increase the costs of drug approval processes. Further, social, economic and other broad policy legislation may induce unpredictable changes in the healthcare environment. As examples of pending legislative proposals that may adversely affect us, groups in Spain have urged the Spanish Parliament to consider proposals that would revise the pharmaceutical laws in response to social policy. One would change the pricing and availability of drugs in Spain and the other would conform Spanish drug exportation to international standards for certain purposes. We cannot assure you whether these proposals or others may be enacted in some form, if at all, or the impact they may have if enacted.

OUR OPERATIONS COULD BE ADVERSELY AFFECTED IF WE ARE UNABLE TO RAISE OR OBTAIN NEEDED FUNDING.

We have used cash from outside financing to fund our operations. Substantial time and financial and other resources will be required to complete ongoing development and clinical testing of our products. Regulatory efforts and collaborative arrangements also will be necessary for our products that are currently under development and testing in order for them to be marketed. Assuming we continue our operations as presently conducted, we believe that with the net proceeds of this offering we have sufficient working capital to meet our needs for the foreseeable future. The net proceeds of this offering, however, together with revenues from operations and our cash may not be sufficient over the next several years for commercializing all of the products we are currently developing. Consequently, we seek strategic partners for all phases of development, marketing and commercialization of product candidates employing our technologies. Further, we cannot assure you as to the sufficiency of our resources or the time required to complete any ongoing development and clinical testing, since the extent to which we conduct such testing is dependent on resource allocation decisions that we make from time to time based on numerous financial as well as operational considerations.

In addition to development and other costs, we expect to incur capital expenditures from time to time. These capital expenditures will be influenced by our regulatory compliance efforts, our success, if any, at developing collaborative arrangements with strategic partners, our needs for additional facilities and capital equipment and the growth, if any, of our business in general. We cannot assure you that we will receive additional funding on favorable terms if at all, or that we will be successful in attracting strategic partners. If we cannot raise funds or engage strategic partners on acceptable terms when needed, we may not be able to continue our research and development activities, develop or enhance our products and services, take advantage of future opportunities, grow our business or respond to competitive pressures or unanticipated requirements.

IF WE CANNOT ATTRACT AND RETAIN KEY PERSONNEL, WE MAY NOT BE ABLE TO EXECUTE OUR BUSINESS PLAN AS ANTICIPATED.

We have assigned many key responsibilities within our company to, and are dependent on, a relatively small number of individuals. If we lose the services of our Chief Executive Officer, Chief Science Officer or Vice President of Pharmaceutical Development, our ability to execute our business plan in the manner we currently anticipate would be adversely affected. The competition for qualified personnel is intense and the loss of key personnel could adversely affect our business. We maintain key person life insurance only for our Chief Executive Officer. We have an employment agreement with each of our executive

officers.

WE MAY INCUR SUBSTANTIAL LIABILITIES AND MAY BE REQUIRED TO LIMIT COMMERCIALIZATION OF OUR PRODUCTS IN RESPONSE TO PRODUCT LIABILITY CLAIMS.

The testing and marketing of medical products entails an inherent risk of product liability. We may be held liable to the extent that there are any adverse reactions from the use of our products. Our products involve new methods of delivery for drugs, some of which may require precautions to prevent unintended use, especially since they are designed for patients' self-use rather than being administered by medical professionals. The FDA may require us to develop a comprehensive risk management program for our products. The failure of these measures could result in harmful side effects or death. As a result, consumers, regulatory agencies, pharmaceutical companies or others might make claims against us. If we cannot successfully defend ourselves against product liability claims, we may incur substantial liabilities, lose market share or be required to limit commercialization of our products.

Our inability to obtain sufficient product liability insurance at an acceptable cost to protect against potential product liability claims could inhibit or prevent the commercialization of pharmaceutical products we develop alone or with corporate collaborators. We maintain product liability insurance in

the amount of $3 million Euros (approximately $2.6 million U.S. Dollars) and clinical trial insurance in connection with our clinical testing activities in various amounts on a study-by-study basis. While management believes that this insurance is reasonable, we cannot assure you that any of this coverage will be adequate to protect us in the event of a claim. We, or any corporate collaborators, may not be able to obtain or maintain insurance at a reasonable cost, if at all. Even if our agreements with any future corporate collaborators entitle us to indemnification against losses, such indemnification may not be available or adequate if any claim arises.

WE WILL HAVE BROAD DISCRETION AS TO THE USE OF PROCEEDS OF THIS OFFERING AND MAY FAIL TO USE THE PROCEEDS EFFECTIVELY.

We expect to use the net proceeds of this offering for general corporate purposes. We have no current agreements or commitments for any business combinations or significant capital expenditures. Our management will have broad discretion in utilizing the proceeds and may use the proceeds in ways with which you and our other stockholders may disagree. We may not be able to use or invest these funds effectively.

YOUR PERCENTAGE OF OWNERSHIP AND VOTING POWER AND THE PRICE OF OUR COMMON STOCK MAY DECREASE AS A RESULT OF EVENTS THAT INCREASE THE NUMBER OF OUR OUTSTANDING SHARES.

As of December 31, 2001, we had the following capital structure:

Common stock outstanding	14,585,200
Common stock issuable upon:	
Exercise of Class B Warrants	3,003,560
Exercise of other warrants	420,000
Exercise of options which are outstanding	2,937,256
Exercise of options which have not been granted	1,006,000

Total common stock outstanding assuming exercise of all of the above	21,952,016

As of December 31, 2001, we had outstanding options and warrants to purchase approximately 6,360,816 shares of common stock at exercise prices ranging from $1.50 to $45.00 (exercisable at a weighted average of $4.83 per share), of which approximately 5,740,716 options and warrants were then exercisable. Since December 31, 2001 we have granted options to purchase 477,500 shares of common stock, exercisable at a weighted average of $9.76 per share. In addition, we may conduct future offerings of our common stock or other securities with rights to convert the securities into shares of our common stock. Exercise of our outstanding options and warrants into our common stock may significantly and negatively affect the market price for our common stock as well as decrease your percentage ownership and voting power.

OUR STOCK IS VOLATILE.

The market prices for our securities and for securities of emerging growth companies have historically been highly volatile. During the last two years, the price of our common stock has ranged from a high of $11.57 to a low of $3.56. Future announcements concerning us or our competitors may have a significant impact on the market price of our common stock. Factors which may affect our market price include:

- progress of our relationships with strategic partners;
- results of clinical studies and regulatory reviews;
- technological innovations by us or our competitors;

- market conditions in the pharmaceutical, drug delivery and biotechnology industries;
- competitive products;
- financings;
- sales or the possibility of sales of our common stock;
- our results of operations and financial condition;
- proprietary rights;
- public concern as to the safety or commercial value of our products; and
- general economic conditions.

These uncertainties have adversely affected and may continue to adversely affect the market price of our common stock. Furthermore, the stock market has experienced significant price and volume fluctuation unrelated to the operating performance of particular companies. These market fluctuations may also adversely affect the market price of our common stock.

DELAWARE LAW AND PROVISIONS IN OUR CERTIFICATE OF INCORPORATION, BYLAWS AND STOCKHOLDER RIGHTS PLAN MAY PREVENT OR DISCOURAGE THIRD PARTIES OR STOCKHOLDERS FROM ATTEMPTING TO REPLACE THE MANAGEMENT OF BENTLEY.

As a Delaware company, we are subject to Section 203 of the Delaware General

Corporation Law, as amended, which is a statutory provision intended to discourage certain takeover attempts that are not approved by the board of directors. Section 203 prohibits a Delaware corporation from engaging in any business combination with any interested stockholder for a period of three years following the date that such stockholder became an interested stockholder subject to certain exceptions.

Our certificate of incorporation and bylaws include provisions that also may have the effect of discouraging, delaying or preventing a change in control or an unsolicited acquisition proposal that a stockholder might consider favorable. Our board of directors is divided into three classes with staggered three-year terms, which makes it more difficult for an acquiror to change the overall composition of the board in a short period of time. The positive vote of at least two-thirds is required to approve a merger, a sale or lease of all or most of our assets, certain other business combinations or dissolution or liquidation, and an affirmative vote of two-thirds is required to amend any provision in our certificate of incorporation relating to our directors and officers or to amend any provision in our certificate of incorporation. Additionally, our certificate of incorporation authorizes our board of directors to issue preferred stock in one or more series with the rights, obligations and preferences of each series to be determined by our board without stockholder approval. Our staggered board, the super-majority voting provisions and the potential issuance of preferred stock may have the effect of preventing or discouraging third parties or stockholders from attempting to replace our management.

To the same potential effect, we have a stockholder rights plan designed to prevent a potential acquirer from gaining control of us and to protect us from coercive takeover attempts. The rights will become exercisable only if any person or group of affiliated persons beneficially acquires 15% or more of our common stock. Under certain circumstances, each holder of a right (other than the person or group who acquired 15% or more of our common stock) is entitled to purchase a defined number of shares of our common stock at 50% of its market price at the time that the right becomes exercisable.

CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

This prospectus contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995.

Words such as expects, anticipates, intends, believes, will and similar words are used to identify forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These forward-looking statements, including, but not limited to, the statements in the Risk Factors and Business sections and elsewhere in this prospectus, are not based on historical facts, but rather reflect our current expectations concerning future results and events. Although we believe that the expectations reflected in the forward-looking statements are reasonable, such statements involve known and unknown risks, uncertainties and other factors that may cause our actual results, performance or achievements to be different from any future results, performance and achievements expressed or implied by these statements, including the risks outlined in the Risk Factors section and elsewhere in this prospectus. You are cautioned not to place undue reliance on these forward-looking statements, which reflect our views only as of the date of this prospectus. We undertake no obligation to publicly update or revise any forward-looking statements, whether as the result of new information, future events or otherwise. You should not assume that the information contained in this prospectus is accurate as of any date other than the date on the front cover of this prospectus.

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USE OF PROCEEDS

The net proceeds to us from the sale of the 2,500,000 shares of common stock offered by us on a best efforts basis are estimated to be approximately $22,800,000 (at an assumed sale price of $10.00 per share), after deduction of estimated expenses payable by us in connection with this offering.

We expect to use the net proceeds of this offering for general corporate purposes, including working capital, research and development, product development and capital expenditures. A portion of the proceeds may also be used to acquire or invest in complementary businesses, technologies or products. The amount that we use for each of these purposes will depend on a number of factors, including the need to further develop our products to attract strategic partners and the amount of cash we generate from operations. As a result, we will retain broad discretion in the allocation of the net proceeds of this offering. We have no current agreements or commitments with respect to any acquisition or investment. Assuming we continue our operations as presently conducted, we believe that with the net proceeds of this offering we will have sufficient working capital to meet our needs for at least the next 24 months. Pending these uses, we intend to invest the net proceeds of this offering in cash equivalents and/or short-term securities.

PRICE RANGE OF COMMON STOCK

The following table sets forth, for the periods indicated, the range of quarterly high and low sales prices for our common stock as reported on the American Stock Exchange under the symbol "BNT." Our common stock began trading on the American Stock Exchange on July 31, 1990 and on the Pacific Exchange on March 27, 1996.

	HIGH	LOW
Fiscal 2000		
First Quarter	$12.50	$5.88
Second Quarter	9.50	5.88
Third Quarter	11.00	6.88
Fourth Quarter	11.00	3.56
Fiscal 2001		
First Quarter	7.50	4.40
Second Quarter	6.35	4.40
Third Quarter	7.25	5.50
Fourth Quarter	10.50	6.25
Fiscal 2002		
First Quarter (through April 9, 2002)	11.57	7.60

As of April 9, 2002 there were 1,609 holders of record of our common stock, which does not reflect stockholders whose shares are held in street name.

DIVIDENDS

We have never paid cash dividends on our common stock. We intend to retain

future earnings in order to finance the growth and development of our business.

CAPITALIZATION

The following table sets forth our capitalization as of December 31, 2001:

- on an actual basis; and
- on an as adjusted basis to reflect the sale of 2,500,000 shares of common stock at an assumed offering price of $10.00 per share, after deducting placement agent fees and estimated offering expenses. This offering is on a best efforts basis.

You should read the information below with "Use of Proceeds" and the financial information contained elsewhere in this prospectus. For a description of our capital stock, you should read the information under the caption "Description of Securities."

	DECEMBER 31, 2001	
	ACTUAL	AS ADJUSTED
	(IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA)	
Long-term debt	$ 142	$ 142
Stockholders' equity:		
Preferred stock, par value $1.00 per share; 2,000,000 shares authorized, no shares issued or outstanding	--	--
Common stock, par value $.02 per share; 35,000,000 shares authorized, 14,585,200 shares issued and outstanding and 17,085,200 shares, as adjusted	292	342
Warrants to purchase 3,423,560 shares of common stock	433	433
Additional paid-in capital	97,501	120,251
Accumulated deficit	(74,332)	(74,332)
Accumulated other comprehensive loss	(3,470)	(3,470)
Total stockholders' equity	20,424	43,224
Total capitalization	$ 20,566	$ 43,366

The number of shares of common stock to be outstanding after this offering does not include:

- 3,003,560 shares of common stock issuable upon the exercise of Class B Warrants (some of which were issued as underwriter's compensation as a result of our 1996 public offering), exercisable at $5.00 per share and expiring on December 31, 2002;
- 2,937,256 shares of common stock issuable upon the exercise of outstanding stock options, exercisable at a weighted average of $5.00 per share;
- 420,000 shares of common stock issuable upon the exercise of other outstanding common stock purchase warrants, exercisable at a weighted

average of $2.38 per share; and

- 1,006,000 additional shares of common stock reserved for issuance under our stock option plans, options to purchase 477,500 of which shares subsequently have been granted and are exercisable at a weighted average of $9.76 per share.

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SELECTED CONSOLIDATED FINANCIAL DATA

The following sets forth the selected consolidated statement of operations data for each of the five years in the period ended December 31, 2001 and consolidated balance sheet data as of December 31, 2000 and 2001, all of which are derived from our audited consolidated financial statements and related notes. The following selected financial data for each of the three years in the period ended December 31, 2001 and as of December 31, 2000 and 2001 should be read together with our consolidated financial statements and related notes appearing elsewhere in this prospectus and "Management's Discussion and Analysis of Financial Condition and Results of Operations." Our independent auditors have audited our consolidated financial statements for each of the five years in the period ended December 31, 2001. The consolidated statement of operations for each of the two years in the period ended December 31, 1998 are derived from our audited consolidated financial statements and related notes not included in this prospectus.

CONSOLIDATED STATEMENT OF OPERATIONS DATA

	YEAR ENDED DECEMBER 31,				
	1997	1998	1999	2000	20
	(IN THOUSANDS, EXCEPT PER SHARE DATA)				
Net sales	$14,902	$15,243	$20,249	$18,617	$26,
Cost of sales	8,010	6,601	8,445	7,189	11,
Gross profit	6,892	8,642	11,804	11,428	14,
Operating expenses	8,438	10,710	11,226	11,942	16,
Gain on sale of drug licenses	--	--	--	--	5,
Provision for income taxes	621	236	781	222	2,
Net income (loss)	$(3,815)	$(2,876)	$(1,090)	$ (745)	$ 1,
Income (loss) per common share--basic	$ (.97)	$ (.35)	$ (.12)	$ (.06)	$
Income (loss) per common share--diluted	$ (.97)	$ (.35)	$ (.12)	$ (.06)	$
Weighted average number of common shares outstanding--basic	4,072	8,431	9,147	12,981	14,
Weighted average number of common shares outstanding--diluted	4,072	8,431	9,147	12,981	16,

CONSOLIDATED BALANCE SHEET DATA

	DECEMBER 31,

	2000	2001	2001(1) AS ADJUSTED
		(IN THOUSANDS)	
Working capital	$3,742	$6,276	$29,076
Non-current assets	15,773	16,280	16,280
Total assets	28,877	32,119	54,919
Non-current liabilities	1,699	2,132	2,132
Redeemable preferred stock	--	--	--
Stockholders' equity	17,816	20,424	43,224

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(1) Reflects the sale of 2,500,000 shares of common stock offered by us hereby on a best efforts basis, at an assumed offering price of $10.00 per share, after deducting placement agent fees and estimated offering expenses.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

GENERAL

We are a specialty pharmaceutical company focused on advanced drug delivery technologies and pharmaceutical products. A substantial part of our operations is in Spain, where we manufacture and market generic and branded pharmaceutical products and from which market we derive the majority of our sales.

Our primary objective is to be a leading specialty pharmaceutical company focused on advanced drug delivery and formulation technologies that improve the effectiveness of existing and new pharmaceuticals. We have patents and proprietary technologies that enhance or facilitate the absorption of drugs across membranes of the skin, mouth, nose, vagina and eye. We are developing products incorporating these technologies and seek to form strategic alliances with major pharmaceutical and biotechnology companies to facilitate the development and commercialization of our products. We currently have strategic alliances with Pfizer and Auxilium and are in preliminary discussions with a number of other pharmaceutical companies to form additional alliances.

We have entered into a research services agreement with Auxilium, an emerging therapeutic pharmaceutical company focused on diseases related to aging, to develop and test various pharmaceutical compositions of a topical testosterone product using our CPE-215 permeation enhancement technology. We have licensed our drug delivery technology to Auxilium for use in the development and commercialization of a topical testosterone product. Phase III clinical trials performed by Auxilium for the approval of this product in the U.S. have been completed and a New Drug Application has been submitted to the FDA.

We have entered into a research collaboration with Pfizer in which we were granted a non-exclusive worldwide royalty-free license to use Pfizer's compounds and technology to assess the performance of our CPE-215 technology with Pfizer's compounds. As part of the agreement, we granted to Pfizer the non-exclusive right to test the ability of our CPE-215 technology to enhance delivery of certain compounds proprietary to Pfizer.

We entered into a strategic alliance with Teva in July 2000 whereby we, through our Spanish subsidiaries, received the right to register and market in

Spain more than 75 of Teva's products. The products are comprised of both branded and generic forms. Sales from the products are expected to begin gradually, but will progress over the next two to three years. An investment in additional sales representatives has been and will continue to be required, along with an increase in regulatory activities, both of which may create a short-term decrease in our earnings. Through our subsidiary, Laboratorios Davur S.L., we also submitted registrations to the Spanish Ministry of Health for generic versions of various products in response to growing interest in generic drug products in Spain. We believe that gross margins may be lower on sales of these products.

We manufacture generic and branded pharmaceutical products in our Zaragoza, Spain facility and sell and market these products to physicians and pharmacists throughout Spain. In addition to manufacturing our own products, we utilize our excess capacity by acting as a contract manufacturer for other pharmaceutical companies.

We have not realized domestic taxable income to date. At December 31, 2001, net operating losses available to offset future domestic taxable income for federal income tax purposes were approximately $36,047,000 million. Our U.S. federal net operating loss carryforwards, if not utilized, expire at various dates from 2007 to 2022. We have recorded a valuation allowance against our entire future tax benefit arising from our domestic net operating losses. The future utilization of our net operating loss carryforwards may be limited pursuant to U.S. tax regulations.

RESULTS OF OPERATIONS

FISCAL YEAR ENDED DECEMBER 31, 2001 COMPARED TO FISCAL YEAR ENDED DECEMBER 31, 2000

NET SALES. Net sales increased by 41.9% from $18,617,000 in 2000 to $26,411,000 in 2001. The $7,794,000 increase was primarily the result of our continuing efforts in the generic drug market in Spain. We anticipated the opportunities in the emerging generic drug market in Spain and began taking measures over three years ago to enter the Spanish generic drug market. We began to register, market and distribute generic pharmaceutical products in Spain and began aligning our business model to be competitive in this arena, including hiring and training a new generic products sales force, submission of generic products to the Spanish Ministry of Health for approval and a marketing campaign designed to position ourselves as a leader in the Spanish generic drug market. Although in Spain we reported an increase in net sales of 50% in local currency in 2001 compared to the prior year, a three percent decline in the value of the Spanish Peseta and related Euro negatively impacted revenues by approximately $579,000. Sales of the product Controlvas(R), which accounted for approximately $2,208,000 of net sales in 2000, declined to approximately $60,000 in 2001 as a result of our divestiture of the related drug license during the first quarter of 2001, which resulted in a pre-tax gain of approximately $4,977,000. Net sales in 2001 included sales of the product Arzimol-TM- totaling approximately $600,000, which will not continue in 2002 due to termination of our joint marketing agreement with Bristol-Myers Squibb for this product.

GROSS PROFIT. Gross profit increased by 30.8% from $11,428,000 in 2000 to $14,949,000 in 2001. The $3,521,000 increase was the direct result of the growth in our net sales from 2000 to 2001. However, our gross margins for 2001 decreased to 57% compared to gross margins of 61% in the prior year, primarily as a result of the mix of products sold, including the effects of the addition of our new generic product line and disposition of the Controlvas(R) drug license, as well as higher depreciation charges resulting from the recent renovations and improvements at our manufacturing facility. Net sales of

Controlvas(R) products contributed approximately $1,493,000 to gross profit during 2000; however, the divestiture of the Controlvas(R) drug license during the first quarter of 2001 reduced the gross profit contribution from sales of these products to approximately $41,000, in 2001. Approximately 30% of our net sales during the year ended December 31, 2001 were generic product sales, which typically have lower sales prices and gross margins than branded products. In comparison, we sold no generic drug products during the first three quarters of the prior year. As generic product sales become more significant in the future, gross margins may continue to decrease. Additionally, the Ministry of Health in Spain levies on pharmaceutical companies a tax for the purposes of funding rising healthcare costs in Spain. In 2001, this tax had the effect of reducing gross profit by $228,000, or one percentage point.

SELLING AND MARKETING EXPENSES. Selling and marketing expenses increased by 39.5% from $6,494,000 in 2000 to $9,057,000 in 2001. The $2,563,000 increase in 2001 was the result of our introduction and support of the launches of new generic drug products. Selling and marketing expenses as a percent of sales, however, declined slightly to 34.3% in 2001 compared to 34.9% in 2000. The three percent decline in the value of the Spanish Peseta and related Euro, in relation to the U.S. Dollar, during the year, had the effect of reducing selling and marketing expenses by $221,000 in 2001.

GENERAL AND ADMINISTRATIVE EXPENSES. General and administrative expenses increased by 8.5% from $3,766,000 in 2000 to $4,085,000 in 2001. The $319,000 increase in 2001 was the result of increased general and administrative activities required to support our revenue growth in 2001. General and administrative expenses as a percent of sales declined to 15.5% of net sales in 2001 compared to 20.2% of net sales in 2000. The three percent decline in the value of the Spanish Peseta and related Euro, in relation to the U.S. Dollar, during the period, had the effect of reducing general and administrative expenses by $58,000 in 2001.

RESEARCH AND DEVELOPMENT EXPENSES. Research and development expenses increased by 89.1% from $1,102,000 in 2000 to $2,084,000 in 2001. The $982,000 increase in 2001 was the result of an increase in our costs associated with Phase I Clinical Studies (treatment of nail fungal infections), preclinical programs underway in collaboration with universities and with product formulation and testing efforts being performed in the laboratory in our U.S. headquarters and at our facility in Zaragoza, Spain. We are using our U.S. laboratory to develop potential product applications using our drug delivery technologies. The expenditures in research and development, which totaled $732,000 in the fourth quarter, reflect our focus on projects that are necessary for expansion of our portfolio of marketed products and clinical trials involving our technologies. We expect that our future expenditures for research and development activities will continue to increase as a result of programs that are necessary to advance new applications of our technologies.

DEPRECIATION AND AMORTIZATION EXPENSES. Depreciation and amortization expenses increased by 57.1% from $580,000 in 2000 to $911,000 in 2001. The $331,000 increase in 2001 was the result of increased amortization charges related to our recent acquisition of drug licenses and technologies, including Codeisan(R), (approximately $289,000) and to a lesser extent, higher depreciation charges with respect to recent asset additions (approximately $107,000), partially offset by the effect of fluctuations in foreign currency exchange rates (approximately $13,000). Depreciation and amortization charges are expected to be higher than in 2001 as a result of these acquisitions.

INTEREST INCOME. Interest income decreased by 51.6% from $347,000 in 2000 to $168,000 in 2001. The $179,000 decrease was the result of lower short-term interest bearing investment balances and lower interest rates on the existing

investment balances during 2001 compared to 2000.

INTEREST EXPENSE. Interest expense decreased by 44.4% from $439,000 in 2000 to $244,000 in 2001. The $195,000 decrease was the result of the conversion of all outstanding debentures into shares of our common stock in the second quarter of 2000. Interest expense incurred during 2001 resulted primarily from the outstanding balances on lines of credit used for operating purposes and lines of credit and borrowings used to finance the purchase of the product Codeisan(R) and capital equipment and improvements in Spain.

PROVISION FOR INCOME TAXES. We generated additional U.S. federal net operating loss carryforwards in 2001. However, since we are not assured of future profitable domestic operations, we have recorded a valuation allowance for any future benefit of such losses. We recorded a provision for foreign income taxes totaling $2,452,000 for 2001 as a result of reporting taxable income in Spain (approximately $607,000) and capital gains tax (approximately $1,845,000) primarily arising from the sale of Controlvas(R) and Amantadine(R), compared to the provision for foreign income taxes of $222,000 in the prior year as a result of taxable income earned in Spain. The provision for foreign income taxes would have been $159,000 higher than reported, absent the three percent decline in the value of the Spanish Peseta and related Euro in relation to the U.S. Dollar during the year.

NET INCOME. We sold the trademarks, registration rights and dossiers for our branded pharmaceutical products, Controlvas(R) and Amantadine(R), for approximately $5,148,000 and $114,000, respectively, during 2001, generating pre-tax gains of approximately $4,977,000 and $73,000, respectively. Including the $5,050,000 pre-tax gains on sale of these drug licenses, we reported income from operations of $3,862,000 for 2001 compared to a loss from operations of $514,000 in the prior year. Excluding the $5,050,000 pre-tax gain from the sale of the Controlvas(R) and Amantadine(R) drug licenses, the loss from operations for the year ended December 31, 2001 totaled $1,188,000. The combination of income from operations of $3,862,000 and the non-operating items, primarily the provision for income taxes of $2,452,000, resulted in net income of $1,361,000, or $.10 per basic common share ($.08 per diluted common share) on 14,196,000 weighted average basic common shares outstanding (16,147,000 weighted average diluted common shares outstanding) for 2001, compared to a

net loss in the prior year of $745,000, or $.06 per basic and diluted common share on 12,981,000 weighted average common shares outstanding.

FISCAL YEAR ENDED DECEMBER 31, 2000 COMPARED TO FISCAL YEAR ENDED DECEMBER 31, 1999

NET SALES. Net sales decreased by 8.1% from $20,249,000 in 1999 to $18,617,000 in 2000. The $1,632,000 decrease was the result of increased generic drug competition that reduced sales of certain of our branded pharmaceutical products and a 16% decline in the value of the Spanish Peseta and related Euro in relation to the U.S. Dollar. The decline in the value of the local currency negatively impacted net sales by $2,736,000 in 2000, resulting in net sales generated in Spain of $18,487,000 when expressed in U.S. Dollars. Our Spanish subsidiaries reported an increase in net sales of 5% in local currency for 2000 compared to the prior year. Also impacting net sales was a decision by the Spanish Ministry of Health to suspend from commercialization a class of drugs that included Finedal, a product we previously marketed. Our net sales in 2000 included sales of Finedal totaling approximately $230,000, while net sales in 1999 included Finedal sales of approximately $880,000. We do not anticipate any future sales of this product nor do we anticipate incurring any future costs with respect to this product. Net sales in 2000 included $130,000 related to research and licensing agreements and fees from research and product formulation

activities in the U.S.

GROSS PROFIT. Gross margins for 2000 increased to 61.4% compared to 58.3% in the prior year, primarily as a result of the mix of products sold and manufacturing efficiencies realized at our manufacturing facility during 2000 compared to the prior year. However, foreign currency fluctuations during 2000 had the effect of decreasing net sales and the related gross profit by $376,000, or 3.2%, from $11,804,000 in 1999 to $11,428,000 in 2000.

SELLING AND MARKETING EXPENSES. Selling and marketing expenses increased by 5.3% from $6,166,000 in 1999 to $6,494,000 in 2000. The $328,000 increase in 2000 was the result of selling and marketing efforts to maintain and grow market share. Selling and marketing expenses, as a percent of net sales, increased to 34.9% in 2000 from 30.5% in 1999. Selling and marketing expenses, as reported in U.S. Dollars, were approximately $1,012,000 lower than would have been reported as a result of the 16% decline in the value of the Spanish Peseta and related Euro in relation to the U.S. Dollar during the period.

GENERAL AND ADMINISTRATIVE EXPENSES. General and administrative expenses decreased by 1.3% from $3,816,000 in 1999 to $3,766,000 in 2000. The $50,000 decrease was the result of a decline in the value of the Spanish Peseta and related Euro. General and administrative expenses, as reported in U.S. Dollars, were approximately $274,000 lower than would have been reported as a result of the 16% decline in the value of the Spanish Peseta and related Euro in relation to the U.S. Dollar during the period. General and administrative expenses as a percent of net sales, increased from 18.8% in 1999 to 20.2% in 2000.

RESEARCH AND DEVELOPMENT EXPENSES. Research and development expenses increased by 60.9% from $685,000 in 1999 to $1,102,000 in 2000. The $417,000 increase was the result of costs associated with conducting clinical trials, preclinical programs and product formulation and testing efforts.

DEPRECIATION AND AMORTIZATION EXPENSES. Depreciation and amortization expenses increased by 3.8% from $559,000 in 1999 to $580,000 in 2000. The $21,000 increase was the result of higher depreciation charges related to renovations and improvements in our manufacturing facility and our U.S. laboratory and higher amortization charges for recently acquired drug licenses and technologies, partially offset by the effect of fluctuations in foreign currency exchange rates.

INTEREST INCOME. Interest income increased by 42.2% from $244,000 in 1999 to $347,000 in 2000. The $103,000 increase was the result of higher short-term interest bearing investment balances and higher interest rates earned on the investment balances during 2000 as compared to 1999.

INTEREST EXPENSE. Interest expense decreased by 62.4% from $1,168,000 in 1999 to $439,000 in 2000. The $729,000 decrease was the result of the conversion into common stock of our 12% Senior Subordinated Debentures in the second quarter of 2000. Interest expense incurred during the nine months ended December 31, 2000 resulted primarily from the outstanding balances on lines of credit used for operating purposes and lines of credit and borrowings used to fund the purchase of the product Codeisan(R), in Spain, during the third and fourth quarters of 2000. We financed approximately $4,900,000 of the purchase, using short-term lines of credit and long-term borrowings. We used a portion of the deposit that we received from the sale of the trademark, registration rights and dossier for our branded pharmaceutical product, Controlvas(R), to reduce short-term borrowings during the fourth quarter of 2000.

PROVISION FOR INCOME TAXES. We generated additional U.S. federal net operating loss carryforwards in 2000. However, since we are not assured of

future profitable domestic operations, we have recorded a valuation allowance for any future benefit of such losses. We recorded a current provision for foreign income taxes totaling $222,000 for 2000 as a result of taxable income earned in Spain, compared to $781,000 in the same period of the prior year. The provision for foreign income taxes would have been $31,000 higher than reported, absent the 16% decline in the value of the Spanish Peseta and related Euro in relation to the U.S. Dollar during the period.

NET INCOME. We reported a loss from operations of $514,000 for 2000 compared to income from operations of $578,000 in the prior year. The impact of non-operating items, primarily interest income of $347,000, interest expense of $439,000 and the resulting provision for income taxes of $222,000 resulted in a net loss of $745,000, or $.06 per basic and diluted common share (12,981,000 weighted average common shares outstanding) for 2000, compared to the net loss in the prior year, of $1,090,000, or $.12 per basic and diluted common share (9,147,000 weighted average common shares outstanding).

SELECTED QUARTERLY FINANCIAL DATA

The following table sets forth certain operating data for our last eight quarters. We have derived this data from our unaudited quarterly financial statements.

	THREE MONTHS ENDED (UNAUDIT				
	FISCAL 2000				
	3/31/00	6/30/00	9/30/00	12/31/00	3/31/01
	(IN THOUSANDS, EXCEPT PER SHARE				
Net sales	$5,085	$4,594	$3,626	$5,312	$5,814
Gross profit	3,127	2,858	2,143	3,300	3,365
Income (loss) from operations	468	(101)	(476)	(405)	4,612(1
Net income (loss)	41	(182)	(419)	(185)	2,642
Net income (loss) per common share:					
Basic	$ --	$ (.01)	$ (.03)	$ (.02)	$ .19
Diluted	$ --	$ (.01)	$ (.03)	$ (.02)	$ .17

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(1) Includes pre-tax gain of approximately $4,977,000 related to the sale of the Controlvas(R) drug license.

LIQUIDITY AND CAPITAL RESOURCES

Our total assets increased from $28,877,000 at December 31, 2000 to $32,119,000 at December 31, 2001, while stockholders' equity increased from $17,816,000 at December 31, 2000 to $20,424,000 at December 31, 2001. The increase in stockholders' equity reflects primarily the net income of $1,361,000 in 2001, and net proceeds from the exercise of stock options and warrants totaling $1,827,000, partially offset by the negative impact of the fluctuation of the Spanish Peseta and related Euro exchange rate of $842,000 in 2001.

Our working capital increased from $3,742,000 at December 31, 2000 to $6,276,000 at December 31, 2001, primarily as a result of collection of the remainder of the cash due upon the sale of the product Controlvas(R) (approximately $2,582,000), most of which was used to reduce short-term and long-term borrowings, the recognition of deferred income of approximately $2,564,000 related to the sale of Controlvas(R), and net proceeds received from the exercise of stock options and warrants totaling $1,827,000 during 2001.

Cash and cash equivalents increased from $4,816,000 at December 31, 2000 to $5,736,000 at December 31, 2001, as a result of net cash generated by investing activities of $744,000, which included proceeds received from the sale of the Controlvas(R) drug license (approximately $2,582,000) partially offset by additions to fixed assets of approximately $1,595,000 and additions to drug licenses of approximately $437,000. Cash and cash equivalents also increased as a result of proceeds from the exercise of stock options and warrants (approximately $1,827,000), which was partially offset by net repayments of borrowings (approximately $1,704,000).

Receivables increased from $5,135,000 at December 31, 2000 to $6,937,000 at December 31, 2001 as a direct result of sales growth. Receivables increased by approximately $2,222,000 in local currency, but fluctuations in foreign currency exchange rates offset the increase by approximately $344,000. We have not experienced any material delinquencies on our receivables. Inventories increased from $1,827,000 at December 31, 2000 to $2,563,000 at December 31, 2001 primarily as a result of raw materials purchases in anticipation of demand for our generic products.

The combined total of accounts payable and accrued expenses increased from $3,613,000 at December 31, 2000 to $7,310,000 at December 31, 2001, primarily due to accruals for social security taxes payable, salaries payable and taxes payable (approximately $866,000), as well as for inventory purchases (approximately $1,445,000), additions to fixed assets (approximately $322,000) and reserves for potential sales returns (approximately $402,000), partially offset by the effect of fluctuations in foreign currency exchange rates (approximately $472,000).

Short-term borrowings and current portion of long-term debt decreased from $3,185,000 at December 31, 2000 to $1,757,000 at December 31, 2001, as a result of utilizing proceeds from the sale of the product Controlvas(R) to reduce balances outstanding, combined with the effect of fluctuations in foreign currency exchange rates, partially offset by additional borrowings during the year ended December 31, 2001 to finance capital expenditures at our manufacturing plant in Spain and working capital needs. The weighted average interest rate on our short-term borrowings is 5.9%.

Long-term debt, which totaled $623,000 at December 31, 2000, was reduced to zero during the year ended December 31, 2001 as a result of using proceeds from the sale of Controlvas(R) to reduce the outstanding balance and was subsequently increased to $214,000 as of December 31, 2001 as a result of a Government-sponsored loan program in Spain, whereby a non-interest bearing loan has been provided for product development. We have recorded a discount on the obligation of $72,000 using an imputed interest rate of 6%. The discount will be amortized to interest expense over the ten-year term of the loan.

In addition to our short-term borrowings and long-term debt, we have fixed contractual obligations under various lease agreements. Our contractual obligations were comprised of the following as of December 31, 2001:

CONTRACTUAL OBLIGATIONS	TOTAL	PAYMENTS DUE BY PER: LESS THAN 1 YEAR	1-3 YEARS	4-6 YEARS
		(IN THOUSANDS)		
Short-term borrowings	$1,757	$1,757	$ --	$ --
Long-term debt, including imputed interest of $72,000	214	--	30	92
Operating leases	2,945	736	2,117	92
Total contractual cash obligations	$4,916	$2,493	$2,147	$184

Operating activities for the year ended December 31, 2001 provided net cash of $139,000. Investing activities, primarily the proceeds from the sale of drug licenses ($2,698,000), partially offset by additions to machinery and equipment and capital improvements to our facilities in Spain and the U.S. ($1,595,000) and the purchase of drug licenses ($437,000) provided net cash of $744,000 during the year ended December 31, 2001. Financing activities, primarily proceeds from the exercise of stock options and warrants ($1,827,000), partially offset by net repayments of borrowings ($1,704,000) provided net cash of $122,000 during the year ended December 31, 2001.

SEASONALITY, EFFECT OF INFLATION AND LIQUIDITY. In the past, we have experienced lower sales in the third calendar quarter and higher sales in the fourth calendar quarter due to seasonality. As we market more pharmaceutical products whose sales are seasonal, seasonality of sales may become more significant. Neither inflation nor changing prices has materially impacted our net sales or income from operations for the periods presented. We expect to have sufficient liquidity to fund operations for at least the next twelve months. We continue to explore alternative sources for financing our business activities, including the possibility of public and/or private offerings of our securities. In appropriate situations, that will be strategically determined, we may seek financial assistance from other sources, including contribution by others to joint ventures and other collaborative or licensing arrangements for the development, testing, manufacturing and marketing of products under development.

MARKET RISK

FOREIGN CURRENCY. A substantial amount of our business is conducted in Europe and is therefore influenced to the extent to which there are fluctuations in the U.S. Dollar's value against other currencies, specifically the Euro and the Spanish Peseta. On January 1, 1999, the Euro became the official currency of European Union (EU) member states with a fixed conversion rate against their national currencies. The value of the Euro against the U.S. Dollar and all other currencies, including the EU member states that are not participating in the Euro zone, will fluctuate according to market conditions. The permanent value of one Euro in Spain was fixed at 166.386 Spanish Pesetas. The exchange rate at December 31, 2001 and 2000 was 186.93 Spanish Pesetas (1.12 Euros) and 178.02 Spanish Pesetas (1.07 Euros) per U.S. Dollar, respectively. The weighted average exchange rate for the years ended December 31, 2001 and 2000 was 185.93 Spanish Pesetas (1.12 Euros) and 180.66 Spanish Pesetas (1.09 Euros) per U.S. Dollar, respectively. The effect of foreign currency fluctuations on long lived assets for the year ended December 31, 2001 was a decrease of $842,000 and the cumulative historical effect was a decrease of $3,470,000, as reflected in our Consolidated Balance Sheets as accumulated other comprehensive loss. Although exchange rates fluctuated significantly in recent years, including, the

weakening of the Euro in relation to the U.S. Dollar in 1999, 2000 and the first six months of 2001, we do not believe that the effect of foreign currency fluctuation is material to our results of operations as the expenses related to much of our foreign currency revenues are in the same

currency as such revenues. However, the carrying value of assets and reported values can be materially impacted by foreign currency translation, as can the translated amounts of net sales and expenses.

We have relied primarily upon financing activities to fund our operations in the U.S. In the event that we are required to fund U.S. operations or cash needs with funds generated in Spain, currency rate fluctuations in the future could have a significant impact on us. However, at the present time, we do not anticipate altering our business plans and practices to compensate for future currency fluctuations.

INTEREST RATES. The weighted average interest rate on our short-term borrowings is 5.9% and the balance outstanding is $1,757,000 as of December 31, 2001. Our long-term borrowings are non-interest bearing and the balance outstanding at December 31, 2001 is $214,000 including imputed interest (at 6.0%) of $72,000. The effect of an increase in the interest rate of one hundred basis points (to 6.9% on short-term borrowings and to 7.0% on long-term borrowings) would have the effect of increasing interest expense by approximately $20,000 annually.

CRITICAL ACCOUNTING POLICIES

Our significant accounting policies are more fully described in Note 2 to our consolidated financial statements. However, certain of our accounting policies are particularly important to the portrayal of our financial position and results of operations and require the application of significant judgment by our management; as a result they are subject to an inherent degree of uncertainty. In applying those policies, our management uses its judgment to determine the appropriate assumptions to be used in the determination of certain estimates. Those estimates are based on our historical experience, terms of existing contracts, our observance of trends in the industry, information provided by our customers and information available from other outside sources, as appropriate. Our significant accounting policies include:

- INVENTORIES. Inventories are stated at the lower of cost or market, cost being determined on the first-in, first-out method. Reserves for slow moving and obsolete inventories are provided based on historical experience and current product demand. We evaluate the adequacy of these reserves quarterly.

- REVENUE RECOGNITION AND ACCOUNTS RECEIVABLE. Revenue on product sales is recognized when persuasive evidence of an arrangement exists, the price is fixed and final, delivery has occurred and there is a reasonable assurance of collection of the sales proceeds. We generally obtain oral or written purchase authorizations from our customers for a specified amount of product at a specified price and consider delivery to have occurred at the time of shipment. We provide our customers with a limited right of return. Revenue is recognized at shipment and a reserve for sales returns is recorded. We have demonstrated the ability to make reasonable and reliable estimates of product returns in accordance with SFAS No. 48 and of allowances for doubtful accounts based on significant historical experience. Revenue from service sales is recognized when the service procedures have been completed or applicable milestones have been achieved. Revenue from research and development contracts is recognized over applicable contractual periods or as defined milestones are attained,

as specified by each contract and as costs related to the contracts are incurred.

- FOREIGN CURRENCY TRANSLATION. The financial position and results of operations of our foreign subsidiaries are measured using local currency as the functional currency. Assets and liabilities of each foreign subsidiary are translated at the rate of exchange in effect at the end of the period. Revenues and expenses are translated at the average exchange rate for the period. Foreign currency translation gains and losses not impacting cash flows are credited to or charged against other comprehensive income (loss). Foreign currency translation gains and losses arising from cash transactions are credited to or charged against current earnings.

- DRUG LICENSES AND RELATED COSTS. Drug licenses and related costs incurred in connection with acquiring licenses, patents and other proprietary rights related to our commercially developed products are capitalized. Capitalized drug licenses and related costs are being amortized on a straight-line basis over fifteen years from the dates of acquisition. Carrying values of such assets are reviewed quarterly and are adjusted for any diminution in value.

NEW ACCOUNTING STANDARDS

In June 1998, the Financial Accounting Standards Board issued SFAS No. 133, ACCOUNTING FOR DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES. The new standard, which was adopted on January 1, 2001, requires that all companies record derivatives on the balance sheet as assets or liabilities, measured at fair value. Gains or losses resulting from changes in the values of those derivatives are accounted for depending on the use of the derivative and whether it qualifies for hedge accounting. The adoption of this standard on January 1, 2001 had no impact on our financial position or results of operations.

In June 2001, the Financial Accounting Standards Board issued SFAS No. 141, BUSINESS COMBINATIONS, and SFAS No. 142, GOODWILL AND OTHER INTANGIBLE ASSETS. SFAS No. 141 supersedes APB No. 16, BUSINESS COMBINATIONS, and SFAS No. 38, ACCOUNTING FOR PREACQUISITION CONTINGENCIES OF PURCHASED ENTERPRISES and requires that all business combinations be accounted for by a single method--the purchase method. SFAS No. 141 also provides guidance on the recognition of intangible assets identified in a business combination and requires enhanced financial statement disclosures. SFAS No. 142 adopts a more aggregate view of goodwill and bases the accounting for goodwill on the units of the combined entity into which an acquired entity is integrated. In addition, SFAS No. 142 concludes that goodwill and intangible assets that have indefinite useful lives will not be amortized but rather will be tested at least annually for impairment. Intangible assets that have finite lives will continue to be amortized over their useful lives. SFAS No. 141 is effective for all business combinations initiated after June 30, 2001. The adoption of SFAS No. 142 is required for fiscal years beginning after December 15, 2001 (the year 2002 for us), except for the nonamortization and amortization provisions which are required for goodwill and intangible assets acquired after June 30, 2001. We believe that the adoption of SFAS No. 141 and SFAS No. 142 will not have a material impact on our financial position or results of operations.

In October 2001, the Financial Accounting Standards Board issued SFAS No. 144 ACCOUNTING FOR THE IMPAIRMENT OR DISPOSAL OF LONG-LIVED ASSETS. SFAS No. 144 supersedes previous guidelines for financial accounting and reporting for the impairment or disposal of long-lived assets and for segments of a business to be disposed of. We believe that the adoption of SFAS No. 144 will not have a material impact on our financial position or results of operations.

BUSINESS

OVERVIEW

We are a specialty pharmaceutical company focused on advanced drug delivery technologies and pharmaceutical products. We have U.S. and international patent and other proprietary rights to technologies that enhance or facilitate the absorption of drugs across membranes of the skin, mouth, nose, vagina and eye. We are developing products incorporating these technologies and seek to form strategic alliances with major pharmaceutical and biotechnology companies to facilitate the development and commercialization of our products. We currently have strategic alliances regarding our drug delivery technologies with Pfizer Inc and Auxilium Pharmaceuticals, Inc. and are in preliminary discussions with a number of other pharmaceutical companies to form additional alliances.

We have a significant commercial presence in Spain, where we manufacture and market more than 100 pharmaceutical products, representing various dosage strengths and product formulations of more than 30 chemical entities. Our product line consists of generic and branded products within four primary therapeutic areas: cardiovascular, gastrointestinal, infectious and neurological diseases. Additionally, we have a strategic alliance with Teva Pharmaceutical Industries Ltd. granting us the right to register and market in Spain more than 75 of Teva's pharmaceutical products through our sales force of approximately 150 full-time personnel located in major cities throughout Spain.

INDUSTRY OVERVIEW

DRUG DELIVERY INDUSTRY

Drug delivery companies develop technologies to improve the administration of therapeutic compounds. These technologies are designed to enhance safety, efficacy, ease-of-use and patient compliance with prescribed therapy. Drug delivery technologies provide opportunities for pharmaceutical and biotechnology companies to extend their drug franchises as well as develop new and innovative products. The worldwide market for drug delivery systems was estimated to be $35 billion in 2000 and is projected to increase to $75 billion by 2005.

The vast majority of the drugs currently on the market are taken orally or are administered by injection. Oral drug delivery methods, while simple to use, typically subject drugs to first-pass metabolism in the body, which results in drug degradation in the stomach and further neutralization in the liver before reaching the bloodstream. In order to achieve efficacy, higher drug dosages are often used, with increased risks of side effects. The injection of pharmaceuticals, while avoiding first-pass metabolism in the body, also has major limitations, including pain, which can lead to decreased patient acceptance and compliance with prescribed therapy. A decline in patient compliance can increase the risk of medical complications and lead to higher healthcare costs. Also, the costs of injectable drugs typically are higher as a result of the additional costs associated with medical personnel to administer the injections and the costs associated with the purchase and disposal of syringes.

Pharmaceutical and biotechnology companies look to drug delivery enhancements as a way of gaining a competitive advantage. Alternative drug delivery technologies, which avoid first-pass metabolism and are less invasive, are often sought by pharmaceutical and biotechnology companies to extend the period of market exclusivity for a branded drug and thus postpone competition from generic drugs. In order to maintain the competitiveness of their proprietary drug candidates, large pharmaceutical companies seek delivery

enhancements that will increase safety and efficacy, reduce side effects and make administration more convenient. Further, drug delivery companies can apply their technologies to off-patent products to formulate their own proprietary products, which they often commercialize by seeking marketing collaborations with larger pharmaceutical companies that have greater capabilities and resources.

Developing safer and more efficacious ways of delivering existing drugs generally is less risky than attempting to discover new drugs, because of the lower product development cost. On average, it takes 15 years for an experimental new drug to progress from the laboratory to commercialization in the U.S., with an average cost of approximately $500 million. Typically, only one in 5,000 compounds entering preclinical testing advances into human testing and only one in five tested in humans is approved. By contrast, drug delivery companies typically target drugs that already have been approved, have a track record of safety and efficacy and have established markets for which there is a proven medical need. Consequently, clinical trials related to drug delivery technologies applied to previously-approved pharmaceuticals need only show that carrier technologies deliver the drug without harming the patient or changing the clinical attributes of the drug.

MARKET OVERVIEW OF EUROPE AND SPAIN

The European Union, with an increasingly affluent population of approximately 375 million people, represents the second largest pharmaceutical market in the world with approximately $75 billion in pharmaceutical sales in 2000, according to IMS Health. Healthcare expenditures in Western Europe, as in the U.S., are growing at a rate faster than the overall economy and drug expenditures as a percentage of total gross domestic product are lower than the 2.3% in the U.S., according to IMS Health.

With Spain's entry into the European Union in 1986, the Spanish pharmaceutical market has been evolving steadily into a market that is increasingly similar to those of other countries in Western Europe and the U.S. With a population of approximately 40 million, Spain was ranked in 1999 as the seventh largest pharmaceutical market in the world. Pharmaceutical sales in Spain reached approximately $6.6 billion in 1999 and are expected to grow to more than $10 billion by 2005, according to IMS Health.

Over the last decade, there has been significant evolution of patent and similar protections of pharmaceutical products in Spain. Prior to 1992, manufacturing processes for active pharmaceutical ingredients could be patented, but active pharmaceutical ingredients could not be patented as products. Commencing in late 1992, active ingredients may be patented with protection running for 20 years from the date of application. This was followed by legislation in December 1996 that created a legal class of generic pharmaceuticals. Generic products are required to be therapeutically equivalent, have a similar composition to that of the original branded product and demonstrate their safety and efficacy. Safety and efficacy is presumed if the original reference product has been commercialized in Spain for 10 years. Generic products also must comply with product labeling requirements and be priced at a discount, typically 20-30%, to the price of the original branded product.

Although comprising less than three percent of the Spanish pharmaceutical market, generic pharmaceuticals are expected to significantly increase their market penetration due to increases in drug usage driven by an aging population and opportunities to launch new generic products as patents expire for blockbuster drugs. Several initiatives are underway by the Spanish government, including education, financial incentives to prescribing physicians and public

campaigns to stimulate the use of generic pharmaceuticals in response to the rise in healthcare costs.

OUR STRATEGY

Our primary objective is to be a leading specialty pharmaceutical company focused on advanced drug delivery and formulation technologies to improve the effectiveness of new and existing pharmaceuticals, while expanding our generic and branded operations in Spain and Europe. Our strategy to accomplish this objective includes the following:

FOCUS ON MARKETING AND COMMERCIALIZING OUR CPE-215 PERMEATION ENHANCEMENT PLATFORM TECHNOLOGY

Our CPE-215 technology enhances the absorption of drugs across membranes of the skin, mouth, nose, vagina and eye. Our CPE-215 technology can be incorporated into a wide variety of pharmaceutical formats and products, including those formulated as creams, ointments, gels, solutions, lotions, sprays or patches. CPE-215 has a record of safety in humans as a food additive and fragrance. In addition, preclinical testing to date on CPE-215 as a drug delivery enhancement has further indicated its safety. We believe that this past experience with CPE-215 may result in reduced preclinical development time relating to its use in new formulations of previously approved compounds. We market our CPE-215 technology to major pharmaceutical and biotechnology companies whose products we believe would benefit from its permeation enhancement properties.

These benefits include:

- improving efficacy relative to oral administration, which subjects the drug to first-pass metabolism;

- extending the period of market exclusivity for a branded compound based on the grant of a patent that incorporates new drug delivery methods;

- allowing branded and generic drug companies to differentiate their products from those of competitors;

- improving utilization of costly and/or scarce drugs and active ingredients;

- expanding the market to patients less suitable for injection, especially children and the elderly; and

- improving patient convenience and compliance, and lowering costs relative to a doctor's office visit for an injection.

We currently have a research licensing agreement with Pfizer and a royalty-based license agreement with Auxilium and are in preliminary discussions with other pharmaceutical companies to commercialize our technologies across a wide range of pharmaceutical applications.

DEVELOP PROPRIETARY PRODUCTS BASED ON OUR TECHNOLOGIES

We apply our drug delivery and oral drug formulation technologies to improve the performance of existing pharmaceutical products with respect to their method of delivery and effectiveness. We also may be able to reduce manufacturing costs for certain products as a result of our proprietary manufacturing process, which permits improved purity, stability and production yields.

In addition to marketing our CPE-215 technology to pharmaceutical companies for application with their branded or generic products, we selectively apply this technology to our own development of certain products. We target compounds with established market demand or that face limited market acceptance as a result of inferior drug delivery methods. As an illustration of this strategy, we currently are completing Phase I/II clinical trials for the treatment of nail fungus infections and currently are engaged in preliminary negotiations with several pharmaceutical companies to continue the development of and to commercialize the product.

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Also, as part of this strategy, we have developed and filed a patent for improved oral dosage forms of acetaminophen, and improved manufacturing of omeprazole and lansoprazole. In the case of acetaminophen, we believe that we have developed dosages that result in increased solubility in water for administration to patients who have difficulty swallowing pills, faster relief of pain and inflammation and better taste. With respect to omeprazole and lansoprazole, we believe that we have created an improved method of manufacture, requiring less time and producing higher purity amid better stability.

Once we have brought our internally developed products to an advanced stage of development, we intend to develop collaborative relationships that leverage the clinical development and marketing and sales capabilities of our strategic partners. We believe that this will allow us to license our products on terms that are more favorable than those that would be possible earlier in the development cycle. In Spain we may directly market these new products through our existing sales force. We also seek to manufacture and supply our pharmaceutical partners with the products they have licensed from us.

INCREASE OUR PRODUCT SALES THROUGH TARGETED PROMOTION AND EXPANSION OF OUR PRODUCT PORTFOLIO

We plan to expand our portfolio of products in Spain through the acquisition of currently marketed and late stage pharmaceutical products, as well as through strategic alliances with other pharmaceutical and biotechnology companies. We intend to directly promote and sell these products in Spain through our own sales force of approximately 150 full-time personnel located in major cities throughout Spain.

We focus on obtaining the rights to pharmaceutical products that are less actively promoted by larger pharmaceutical companies or are in a late stage of development and have good potential for acceptance in our markets. We believe that we have expertise in assessing potential market opportunities related to particular pharmaceuticals and in negotiating and acquiring from pharmaceutical companies the rights to market pharmaceuticals in Spain and other countries. Products that already are selling in the U.S. or other major markets demonstrate commercialllers that are customized for its products. In addition, it provides the Company with a

The acquisition was accounted for as a purchase under SFAS No. 141, Business Combinations. The valuation is finalized and the allocation of the excess of the purchase price over the estimated fair value of the net tangible assets acquired is included in goodwill as follows:

(In thousands)	
Current assets	$
Fixed assets	1,050
Fair value of tangible assets acquired	1,050
Goodwill	450

Consideration	$ 1,500

Note 4 Net Income Per Share

Basic earnings per share is computed by dividing net income by the weighted average number of shares outstanding. In computing diluted earnings per share, the weighted average number of shares outstanding is adjusted to reflect the potentially dilutive securities. Options to purchase 7,632,141 and 10,110,879 shares of common stock were outstanding at September 30, 2006 and 2005, respectively. In addition, 206,000 restricted stock units payable in shares of common stock were outstanding at September 30, 2006. There were no outstanding restricted stock units at September 30, 2005. For each of the three months ended September 30, 2006 and 2005, potentially dilutive securities consisted solely of options and restricted stock units and resulted in potential common shares of 2,032,942 and 1,907,889, respectively. For each of the nine months ended September 30, 2006 and 2005, potentially dilutive securities consisted solely of options and restricted stock units and resulted in potential common shares of 1,383,294 and 1,483,286, respectively.

Share-Based Compensation

On January 1, 2006, the Company adopted SFAS 123(R), Share-Based Payment, which was issued in December 2004. SFAS 123(R) is a revision to SFAS 123, Accounting for Stock-Based Compensation, and supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees and its related interpretations. SFAS 123(R) requires the measurement of the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award. The cost will be recognized

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over the period during which an employee is required to provide service in exchange for the award. No compensation expense is recognized for equity instruments for which employees do not render service. The Company adopted SFAS No. 123(R) using the modified prospective method. Accordingly, prior period amounts have not been restated. Under this application, the Company is required to record compensation expense for all awards granted after the date of adoption and for the unvested portion of previously granted awards that remain outstanding at the date of adoption.

On December 19, 2005, the Company s board of directors approved the termination of its Employee Stock Purchase Plan (ESPP) and the acceleration of the vesting of all then current unvested stock options awarded under its 2000 Stock Incentive Plan, including stock options held by its employees, officers, directors and consultants. These unvested stock options consisted of both in-the-money as well as out-of-the-money options. Based upon the closing price of SimpleTech common stock of $3.79 per share on December 19, 2005, approximately 47% of the total accelerated stock options were in-the-money with a weighted average exercise price of $3.20 per share. In accordance with SFAS 123, the Company expensed the remaining unrecognized compensation expense associated with the options with accelerated vesting in the pro forma disclosure. The decision to terminate the ESPP and accelerate vesting of the stock options was made primarily to avoid recognizing the related compensation expense in the Company s future consolidated financial statements with respect to the shares issued under the ESPP and the unvested stock options upon the Company s adoption of Statement SFAS 123(R) on January 1, 2006. As a result of adopting FAS 123(R) on January 1, 2006, the Company s share based compensation expense related to stock options was $4,000 and $10,000 for the three and nine months ended September 30, 2006, respectively. In addition, the Company s share-based compensation expense related to restricted stock was $46,000 and $51,000 for the three and nine months ended September 30, 2006.

Prior to the adoption of SFAS 123(R), the Company accounted for stock-based awards to employees and directors using the intrinsic value method in accordance with Accounting Principles Board (APB) Opinion No. 25 as allowed under Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation (SFAS 123). Under the intrinsic value method, no stock-based compensation expense had been recognized in the Company s consolidated statement of operations because the exercise price of the Company s stock options granted to employees and directors equaled the fair market value of the underlying stock at the date of grant.

For purposes of pro forma disclosures, the estimated fair value of the options is amortized to expense over the options vesting period. The table below sets forth the Company s pro forma information for the three and nine months ended September 30, 2005, assuming the Company had determined compensation expense for awards under stock option plans based on the fair value at the grant date.

	Three Months Ended September 30,	Nine Months Ended September 30,
(In thousands, except per share amounts)	**2005**	**2005**
Net income, as reported	$ 1,840	$ 4,809
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(1,027)	(2,977)
Pro forma net income	$ 813	$ 1,832
Income per share:		
Basic as reported	$ 0.04	$ 0.11
Basic pro forma	$ 0.02	$ 0.04
Diluted as reported	$ 0.04	$ 0.11
Diluted pro forma	$ 0.02	$ 0.04

The fair value of each option award is estimated on the date of grant using the Black-Scholes option valuation model that uses the assumptions noted in the following table. Expected volatility is based upon the historical volatility of our stock for a period approximating the expected life. The risk-free interest rate is estimated using the U.S. Treasury rates corresponding to the grant date and expected life. Dividend yield is based on our history of dividend payouts. The expected life of options granted is estimated based on historical exercise patterns and represents the period of time the options are expected to be outstanding.

For purposes of calculating the compensation cost consistent with SFAS No. 123, the fair value of each option granted to employees is estimated using the Black-Scholes option-pricing model on the date of grant using the following assumptions for each of the three and nine months ended September 30, 2005:

	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2005
Expected volatility	63%	63%
Weighted-average risk-free interest rate	3.84% to 4.28%	3.63% to 4.28%
Dividend yield	none	none
Average expected life	5	5
Weighted-average grant-date fair value	$2.39	$2.20

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Note 5 Supplemental Balance Sheet Information

Inventory consists of the following:

(in thousands)	September 30, 2006	December 31, 2005
Raw materials	$ 34,262	$ 22,994
Work-in-progress	7,838	1,132
Finished goods	36,700	14,938
	78,800	39,064
Valuation allowances	(3,296)	(1,956)
Inventory, net	$ 75,504	$ 37,108

The Company has had to write down inventory in the past for reasons such as obsolescence, excess quantities and declines in market value below its costs. These inventory write-downs were $460,000 and $1,611,000 in the three and nine months ended September 30, 2006, respectively, compared to $164,000 and $664,000 in the three and nine months ended September 30, 2005, respectively. In addition, the Company offers some of its Consumer Division customers limited price protection rights for inventories of the Company s products held by them. If the Company reduces the list price of its products, these customers may receive credits from the Company. The Company incurred price protection charges of $1.6 million and $2.9 million in the three and nine months ended September 30, 2006, respectively, compared to $84,000 and $665,000 in the three and nine months ended September 30, 2005, respectively. The Company also offers rebate programs through some of its Consumer Division customers to end-users. The Company incurred rebate charges of $1.5 million and $2.8 million in the three and nine months ended September 30, 2006, respectively, compared to $30,000 and $360,000 in the three and nine months ended September 30, 2005, respectively. Rebate charges increased significantly in the three and nine months ended September 30, 2006 compared to the three and nine months ended September 30, 2005 due primarily to the expansion of the Company s revenues from the retail channel, which typically involves the frequent use of rebate programs.

Accrued and other liabilities consisted of the following as of:

(in thousands)	September 30, 2006	December 31, 2005
Payroll costs	$ 4,860	$ 3,423
Marketing	2,308	2,148
Other	1,529	1,624
Total	$ 8,697	$ 7,195

Note 6 Commitments and Contingencies

Lemelson Medical, Education & Research Foundation, LLP Patent Infringement

The Company received notice on November 26, 2001 that the Lemelson Medical, Education & Research Foundation, LLP (Lemelson Foundation) filed a complaint on November 13, 2001 against the Company and other defendants. The complaint was filed in the District Court of Arizona and alleges that the Company s manufacturing processes infringe several patents that the Lemelson Foundation allegedly owns. The complaint also states that these allegedly infringed patents relate to machine vision technology and bar coding technology. On March 7, 2002, the Company was served with the Lemelson Foundation complaint. Thereafter, the case was stayed pending the outcome of related cases against other parties involving the same patents. On September 9, 2005, in one of these related cases, the U.S. Court of Appeals for the Federal Circuit affirmed a decision by the U.S. District Court for the District of Nevada that found several Lemelson Foundation patents to be unenforceable. Because the final outcome of the related cases are expected to affect the Lemelson Foundation s lawsuit against the Company, an estimate of potential damages, if any, would be premature and speculative. The Company believes this lawsuit is without merit and it intends to vigorously defend itself against it.

Hard Drive Class Action Lawsuit

On October 6, 2006, an individual, Boris Brand, filed a purported nationwide class action lawsuit against the Company in the Superior Court for the State of California, County of Los Angeles, alleging that the Company s description of the capacity of its hard drive products constitutes fraudulent, unfair, deceptive and false advertising under California Business and Professions Code Sections 17200 and 17500 and violates the California Consumers Legal Remedies Act. In particular, the lawsuit alleges that the Company s description of the storage capacity on its hard drives uses a decimal basis for measuring gigabytes which results in a lower storage capacity when the hard drives are incorporated into an operating system that uses a binary gigabyte basis for measurement. Plaintiff

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seeks restitution, disgorgement, compensatory damages and injunctive relief and attorneys fees. The Company believes this lawsuit is without merit and it intends to vigorously defend itself against it. The Company has submitted the defense of this lawsuit to its insurance carrier. Also, it has notified all of the suppliers who have supplied the Company with the hard drives involved, since the Company believes that those suppliers have a legal duty to indemnify the Company in the event that SimpleTech has to pay any damages. There can be no assurance, however, that the Company s insurance carrier will ultimately agree to defend this lawsuit on the Company s behalf or that any of the Company s suppliers will indemnify the Company for any damages resulting from this lawsuit. As of September 30, 2006, no amounts have been recorded in the consolidated financial statements for this matter, as management believes an unfavorable outcome is not probable.

Other Legal Proceedings

The Company is currently not a party to any other material legal proceedings. However, the Company is involved in other suits and claims in the ordinary course of business, and the Company may from time to time become a party to other legal proceedings arising in the ordinary course of business.

Indemnification

The Company has agreements whereby the Company indemnifies its officers and directors over his or her lifetime for certain events or occurrences while the officer or director is, or was serving, at the Company s request in such capacity. The maximum potential amount of future payments the Company could be required to make under these indemnification agreements is unlimited; however, the Company has a director and officer insurance policy that limits the Company s exposure and should enable the Company to recover a portion of any future amounts paid. As a result of the Company s insurance policy coverage, the Company believes the estimated potential liability related to these indemnification agreements is minimal. All of these indemnification agreements, except for the agreement for James Peterson and Rajat Bahri who joined the Board of Directors in January 2003 and November 2005, respectively, were grandfathered under the provisions of Financial Accounting Standards Board interpretation (FIN) No. 45, Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others an Interpretation of FASB Statements No. 5, 57 and 107 and Rescission of FASB Interpretation No. 34, as they were in effect prior to December 31, 2002. Accordingly, the Company has no liabilities recorded for these agreements as of September 30, 2006.

As is common in the industry, the Company currently has in effect a number of agreements in which the Company has agreed to defend, indemnify and hold harmless certain of its suppliers and customers from damages and costs which may arise from the infringement by the Company s products of third-party patents, trademarks or other proprietary rights. The scope of such indemnity varies, but may, in some instances, include indemnification for damages and expenses, including attorneys fees. The Company s insurance does not cover intellectual property infringement. The term of these indemnification agreements is generally perpetual any time after execution of the agreement. The maximum potential amount of future payments the Company could be required to make under these indemnification agreements is unlimited. The Company has never incurred significant costs to defend lawsuits or settle claims related to these indemnification agreements. As a result, the Company believes the estimated fair value of these agreements is minimal. Accordingly, the Company has no liabilities recorded for these agreements as of September 30, 2006.

In addition, a number of the Company s product sales and product purchase agreements provide that the Company will defend, indemnify and hold harmless its customers and suppliers from damages and costs which may arise from product warranty claims or claims for injury or damage resulting from defects in the Company s products. The term of these indemnification obligations are generally one to seven years. The maximum potential amount of future payments the Company could be required to make under these indemnification obligations is unlimited. The Company maintains insurance to protect against certain claims associated with the use of its products, but its insurance coverage may not be adequate to cover all or any part of the claims asserted against the Company. As a result, the Company believes the estimated fair value of these indemnification obligations is minimal. Accordingly, the Company has no liabilities recorded for these agreements as of September 30, 2006.

Other Commitments

The Company is subject to repurchase agreements with various financial institutions in connection with wholesale inventory financing. Under these agreements, the Company may be required to repurchase inventory upon customer default with a financing institution and then resell the inventory through normal distribution channels. As of September 30, 2006, the Company has not been required to repurchase inventory in connection with the customer default agreements noted above. However, it may be possible that the Company will be required to repurchase inventory, upon customer default, in the future. Sales under such agreements were approximately $113,000 and $87,000 in each of the three months ended September 30, 2006 and 2005, respectively, and $487,000 and $788,000 in each of the nine months ended September 30, 2006 and 2005, respectively.

Note 7 Segment Information

The Company reports financial results for two reportable operating segments: OEM and Consumer Divisions. The Company does not aggregate any operating segments.

The accounting policies for each of the reportable operating segments are the same as those described in Note 2 from the Company s Annual Report on Form 10-K for the year ended December 31, 2005 and reflect the information used by the Company s management to evaluate the performance of its segments. For the OEM and Consumer segments, the Company tracks separately net sales and gross profit, but does not track separately operating expenses. The Company does not maintain separate records to identify assets by operating segment.

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Summarized financial information regarding the Company s two reportable segments is shown in the following table:

(In thousands)	Three Months Ended September 30, 2006 Net Revenues	Cost of Revenues	Gross Profit
Consumer:			
Standard Memory	$ 15,395	$ 13,442	$ 1,953
Flash Memory	7,316	6,438	878
Stacked Memory	838	616	222
Hard Drive	15,481	13,782	1,699
	$ 39,030	$ 34,278	$ 4,752
OEM:			
Standard Memory	$ 6,551	$ 5,774	$ 777
Flash Memory	24,837	11,904	12,933
Stacked Memory	21,852	17,453	4,399
Other	515	54	461
	$ 53,755	$ 35,185	$ 18,570
Total:			
Standard Memory	$ 21,946	$ 19,216	$ 2,730
Flash Memory	32,153	18,342	13,811
Stacked Memory	22,690	18,069	4,621
Hard Drive/other	15,996	13,836	2,160
	$ 92,785	$ 69,463	$ 23,322

	Three Months Ended September 30, 2005 Net Revenues	Cost of Revenues	Gross Profit
Consumer:			
Standard Memory	$ 15,908	$ 13,972	$ 1,936
Flash Memory	9,280	8,047	1,233
Stacked Memory	1,348	1,034	314
Hard Drive	7,839	6,307	1,532
	$ 34,375	$ 29,360	$ 5,015
OEM:			
Standard Memory	$ 3,748	$ 2,819	$ 929
Flash Memory	14,548	8,522	6,026
Stacked Memory	14,464	12,568	1,896
Other	86	44	42
	$ 32,846	$ 23,953	$ 8,893
Total:			
Standard Memory	$ 19,656	$ 16,791	$ 2,865
Flash Memory	23,828	16,569	7,259
Stacked Memory	15,812	13,602	2,210
Hard Drive/other	7,925	6,351	1,574

$ 67,221	$ 53,313	$ 13,908

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	Nine Months Ended September 30, 2006		
	Net Revenues	Cost of Revenues	Gross Profit
Consumer:			
Standard Memory	$ 37,237	$ 31,762	$ 5,475
Flash Memory	18,633	16,406	2,227
Stacked Memory	2,452	1,992	460
Hard Drive	38,005	33,750	4,255
	$ 96,327	$ 83,910	$ 12,417
OEM:			
Standard Memory	$ 18,007	$ 15,377	$ 2,630
Flash Memory	62,055	32,703	29,352
Stacked Memory	60,753	49,986	10,767
Other	653	121	532
	$ 141,468	$ 98,187	$ 43,281
Total:			
Standard Memory	$ 55,244	$ 47,139	$ 8,105
Flash Memory	80,688	49,109	31,579
Stacked Memory	63,205	51,978	11,227
Hard Drive/other	38,658	33,871	4,787
	$ 237,795	$ 182,097	$ 55,698

	Nine Months Ended September 30, 2005		
	Net Revenues	Cost of Revenues	Gross Profit
Consumer:			
Standard Memory	$ 49,360	$ 43,384	$ 5,976
Flash Memory	25,676	22,826	2,850
Stacked Memory	4,508	3,484	1,024
Hard Drive	21,372	17,444	3,928
	$ 100,916	$ 87,138	$ 13,778
OEM:			
Standard Memory	$ 17,286	$ 13,664	$ 3,622
Flash Memory	26,668	15,433	11,235
Stacked Memory	53,422	44,611	8,811
Other	445	208	237
	$ 97,821	$ 73,916	$ 23,905
Total:			
Standard Memory	$ 66,646	$ 57,048	$ 9,598
Flash Memory	52,344	38,259	14,085
Stacked Memory	57,930	48,095	9,835
Hard Drive/other	21,817	17,652	4,165
	$ 198,737	$ 161,054	$ 37,683

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Note 8 Intangible Assets and Goodwill

The following table presents detail of the Company s intangible assets, related accumulated amortization and goodwill:

	As of September 30, 2006			As of December 31, 2005		
	Gross	Accumulated Amortization	Net	Gross	Accumulated Amortization	Net
Developed technology (five years)	$ 400,000	$ 167,000	$ 233,000	$ 400,000	$ 107,000	$ 293,000
Customer relationships (five years)	900,000	281,000	619,000	900,000	157,000	743,000
Total intangible assets	$ 1,300,000	$ 448,000	$ 852,000	$ 1,300,000	$ 264,000	$ 1,036,000
Goodwill	$ 1,682,000	$	$ 1,682,000	$ 733,000	$	$ 733,000

In accordance with SFAS 142, Goodwill and Other Intangible Assets, goodwill and other intangible assets with indeterminate lives are not subject to amortization but are tested for impairment annually or whenever events or changes in circumstances indicate that the asset might be impaired. The increase of $949,000 in goodwill is the result of $450,000 related to the acquisition of the flash controller group of the logic division of Integrated Circuit Solution Incorporation on January 15, 2006 and due to the Company determining the final tax liability of $499,000 related to the acquisition of Memtech SSD, Corporation. This tax liability related to Memtech s fiscal year ended June 30, 2005 and was recorded to goodwill in the first quarter of 2006. Intangible assets with finite lives continue to be subject to amortization, and any impairment is determined in accordance with SFAS 144, Accounting for the Impairment or Disposal of Long-Lived Assets. The Company recorded amortization expense of $61,000 and $20,000 for each of the three months ended September 30, 2006 and 2005, respectively. Estimated intangible asset amortization expense (based on existing intangible assets) for the remainder of year ending December 31, 2006 and the years ending December 31, 2007, 2008, 2009 and 2010 is $61,000, $245,000, $245,000, $218,000, and $83,000, respectively. Amortization will be completed as of the end of 2010.

Note 9 Shareholders Equity

The 2000 Stock Incentive Plan (the Plan) was adopted by the Company s board of directors and approved by its shareholders in September 2000. On April 17, 2006, the Plan was amended and restated by the Board and approved by the Company s shareholders on May 25, 2006. The Plan provides for the direct issuance or sale of shares and the grant of options to purchase shares of the Company s common stock to officers and other employees, non-employee board members and consultants. Under the Plan, eligible participants may be granted options to purchase shares of common stock at an exercise price not less than 100% of the fair market value of those shares on the grant date. In addition, the Plan as amended and restated, allows for the issuance of restricted stock units to officers and other employees, non-employee board members and consultants. Restricted stock units are share awards that entitle the holder to receive shares of the Company s common stock upon vesting. The Company s board of directors, its compensation committee or its equity awards committee determines eligibility and vesting schedules for options and restricted stock units granted under the Plan. Options expire within a period of not more than ten years from the date of grant.

At September 30, 2006, the Plan provided for the issuance of up to 17,226,648 shares of common stock. The number of shares of common stock reserved for issuance under the Plan will automatically increase on the first trading day in January in each calendar year by an amount equal to 4% of the total number of shares of common stock outstanding on the last trading day in December of the prior calendar year, but in no event will exceed 2,500,000 shares.

A summary of the option activity under the Plan is as follows:

	Shares	Weighted-Avg Option Price	Weighted-Avg Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding, December 31, 2005	10,452,888	$ 4.25		
Granted	25,000	4.16		
Exercised	(2,428,963)	2.97		

Forfeited/Expired	(416,784)	6.18		
Outstanding, September 30, 2006	7,632,141	4.54	7.24	$ 35,046,000
Exercisable, September 30, 2006	7,607,141	4.55	7.24	34,922,000

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The Company received $6,729,000 in cash proceeds for the exercise of 2,428,963 options with a $1,977,000 tax benefit for disqualifying dispositions of incentive stock options. The intrinsic value for options exercised for the three and nine months ended September 30, 2006 was $5,098,000 and $6,877,000, respectively.

As of September 30, 2006, total unrecognized compensation expense related to unvested share-based compensation arrangements already granted under the Plan was $57,000, which the Company expects to recognize over a weighted-average period of 3.4 years.

At September 30, 2006, 3,700,218 shares of common stock were available for grant under the Plan.

	Options Outstanding			Exercisable	
Range of Exercise Prices	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Life (Years)	Number of Shares	Weighted Average Exercise Price
$1.50 to $2.20	19,520	$ 1.94	5.75	19,520	$ 1.94
$2.20 to $3.30	1,553,049	3.01	6.34	1,553,049	3.01
$3.30 to $5.50	3,684,603	3.98	8.19	3,659,603	3.98
$5.50 to $6.60	1,715,269	5.78	5.87	1,715,269	5.78
$6.60 to $11.00	659,700	8.19	7.70	659,700	8.19
	7,632,141			7,607,141	

There were no stock options granted during the three months ended September 30, 2006.

The Company has not and does not expect to pay dividends, therefore, no specific dividend yield is utilized under the Black-Scholes option pricing model. The risk-free interest rate assumption is based upon observed interest rates appropriate for the term of the Company s employees stock option grants. The volatility assumption used to value option grants is based exclusively on the Company s historical available closing stock price information. The Company can rely exclusively on this historical information if (1) the Company has no reason to believe that its future volatility over the expected or contractual term is likely to differ from the past, (2) the computation of historical volatility uses a simple average calculation method, (3) a sequential period of historical data at least equals the expected or contractual term of the share options is used and (4) a reasonably sufficient number of price observations are used. The expected life of employee stock options represents the historical weighted-average period the stock options are expected to remain outstanding. The expected life of employees stock option grants are impacted by all of the underlying assumptions used in the Company s model. The Black-Scholes option pricing model assumes that employees exercise behavior is a function of the options remaining contractual life and the extent to which the option is in-the-money. The Black-Scholes option pricing model estimates the probability of exercise as a function of these two variables based on the history of exercises and cancellations of past option grants made by the Company.

During the nine months ended September 30, 2006, the Company issued 206,000 restricted stock units with a grant fair value per share determined by the closing price of the common stock on the issuance date. Each unit represents the right to receive one share of the Company s common stock as each restricted stock unit vests. The Company records compensation expense for the amount of the grant date fair value over the period which the restrictions lapse. There were no outstanding restricted stock units as of September 30, 2005.

The following table presents a summary of the status of the Company s restricted stock units as of December 31, 2005, and changes during the nine months ended September 30, 2006:

	Restricted Units	Weighted Average Grant Fair Value
Non-vested restricted units at December 31, 2005		$
Granted	206,000	3.89

Forfeited		
Non-vested restricted units at September 30, 2006	206,000	$ 3.89

As of September 30, 2006, there was approximately $752,000 of total unrecognized compensation expense related to non-vested restricted stock units granted under the Plan, as amended and restated.

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

Cautionary Statement

Certain statements in this report, including statements regarding our strategy, financial performance and revenue sources, are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, Section 21E of the Securities Exchange Act of 1934, as amended, and Section 27A of the Securities Act of 1933, as amended, and are subject to the safe harbors created by those sections. These forward-looking statements are based on our current expectations, estimates and projections about our industry, management s beliefs, and certain assumptions made by us. Such statements are not guarantees of future performance and are subject to certain risks, uncertainties and assumptions that are difficult to predict. Therefore, our actual results could differ materially and adversely from those expressed in any forward-looking statements as a result of various factors. The section entitled Risk Factors set forth in this Form 10-Q and similar discussions in filings with the Securities and Exchange Commission made from time to time, including other quarterly reports on Form 10-Q, our Annual Reports on Form 10-K, and in our other SEC filings, discuss some of the important risk factors that may affect our business, results of operations and financial condition.

The following discussion should be read in conjunction with our consolidated financial statements and notes thereto.

Overview

SimpleTech, Inc. was originally incorporated in California in March 1990 as Simple Technology, Inc. Our name was then changed to SimpleTech, Inc. in May 2001. SimpleTech designs, develops, manufactures and markets custom and open-standard memory solutions based on Flash memory and DRAM technologies and external storage solutions. Headquartered in Santa Ana, California, we specialize in developing high-density DRAM memory modules and high-speed, high-capacity Flash solutions and memory cards used in sensitive and highly-volatile environments.

We sell our products through our Consumer and OEM Divisions. Our Consumer Division sells our products through a variety of distribution channels, including VARs, mail order, distributors, and mass market retailers. Our OEM Division markets our products to OEMs, leveraging our custom design capabilities to offer custom memory solutions to address their specific needs.

We are focusing on several revenue growth initiatives, including:

- Developing and qualifying customized OEM Flash-based products for industrial applications;
- Targeting new customers for our value-add OEM DRAM memory solutions;
- Increasing retail sales of our storage product line; and
- Expanding our international OEM business in Asia and Europe.

Over the past several years we have expanded our custom design capabilities of Flash products for OEM applications. We have invested significantly in the design and development of customized OEM Flash controllers, firmware and hardware form factors. We expanded our OEM Flash design capabilities and sales and marketing infrastructure through our acquisition in July 2005 of Memtech SSD, Corporation, a provider of ultra-rugged and reliable solid state Flash drives. The acquisition highlighted our continuing commitment to the OEM Flash market and enabled us to create one of the most comprehensive offerings of solid state drives and other Flash-based solutions for industrial and military applications. In January 2006, we acquired substantially all of the assets of the Flash controller group of the logic division of Integrated Circuit Solution Incorporation, a Taiwanese company, adding a team of engineers specializing in Flash controller design. In October 2006, we acquired substantially all of the assets of Gnutek Ltd., a privately-held company based in the United Kingdom that designs and develops high-performance NAND Flash-based solid state drives. This acquisition will enable us to address the enterprise storage market s rapidly increasing need for Flash-based drive solutions. We believe that our continued investment in our OEM Flash capabilities will positively impact the future growth of our OEM Flash revenues.

OEM Flash product revenue increased 70.7% from $14.5 million in the third quarter of 2005 to $24.8 million in the third quarter of 2006, and 132.7% from $26.7 million in the first nine months of 2005 to $62.1 million in the first nine months of 2006. We expect continued revenue growth from our OEM Flash product line for the remainder of 2006. OEM Flash product gross margins were our highest gross margin product line in each of the third quarters of 2006 and 2005 and in each of the first nine months of 2006 and 2005.

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We offer monolithic DRAM memory modules and DRAM memory modules based on our stacking technology. The majority of our Consumer DRAM business has been comprised of monolithic DRAM memory modules. Prior to 2005, the substantial majority of our OEM DRAM business has been comprised of stacked DRAM memory modules. As a result of the introduction of new DRAM technologies, we expect that a higher percentage of our OEM DRAM business will be derived from monolithic DRAM memory modules. In recent quarters, our OEM stacked DRAM memory module revenues have been volatile and difficult to project, and we expect this product line to remain difficult to project for the next several quarters as our customers continue to qualify the latest generation modules.

In the past few years, we have invested in the design, development and launch of our product line of 3.5 and 2.5 consumer external storage drives. As a result of our penetration into numerous major U.S. retailers in the past year and the introduction of our new form factor designed by the Pininfarina Group in Turin, Italy, we believe this product line is gaining momentum. Our external storage product revenue increased from $7.8 million in the third quarter of 2005 to $15.5 million in the third quarter of 2006 and from $21.4 million in the first nine months of 2005 to $38.0 million in the first nine months of 2006.

We continue to make progress toward one of our long-term revenue growth initiatives to expand of our international business in Asia and Europe. Since the beginning of 2004, we have opened sales, marketing, procurement and engineering offices in France, Hong Kong, Japan, the Netherlands, Taiwan and the United Kingdom in order to build the necessary infrastructure to support revenue growth in those geographic regions. We also plan to build a manufacturing facility in Malaysia, which we expect to help us lower our overall long-term effective tax rate, reduce average production and engineering labor costs, have better access to growing markets in Asia, improve supply chain efficiency, reduce lead times, and increase manufacturing efficiency through investments in new state-of-the-art equipment. The 200,000 square foot manufacturing facility in Malaysia is expected to be operational in the first quarter of 2008.

Gross profit as a percentage of revenues for our OEM Division is typically higher than our Consumer Division. We track revenues and gross margins for our Consumer and OEM Divisions. We do not track separately, and do not intend to track separately, operating expenses for our Consumer and OEM Divisions.

Historically, a limited number of customers have accounted for a significant percentage of our revenue. Our ten largest customers accounted for an aggregate of 68.8% of our revenues in the first nine months of 2006, compared to 70.1% of our total revenues in the first nine months of 2005, and 72.6% of our revenues in the third quarter of 2006, compared to 67.8% of our revenues in the third quarter of 2005. The following table identifies each of our customers that accounted for more than 10.0% of our revenues in any of the three months and nine months ended September 30, 2006 and 2005.

	Percentage of Revenues for the Three Months Ended September 30,		Percentage of Revenues for the Nine Months Ended September 30,	
Customer	**2006**	**2005**	**2006**	**2005**
CDW Logistics, Inc. (formerly CDW Computer Centers)	11.3%	14.8%	11.8%	15.6%
Micron Semiconductor	15.6%	14.3%	14.5%	15.5%
Smart Modular	20.1%	18.2%	21.9%	20.5%

The composition of our major customer base changes from quarter to quarter as the market demand for our products changes, and we expect this variability will continue in the future. We expect that sales of our products to a limited number of customers will continue to account for a majority of our revenues in the foreseeable future. The loss of, or a significant reduction in purchases by any of our major customers, would harm our business, financial condition and results of operations. See Risk Factors Sales to a limited number of customers represent a significant portion of our revenues, and the loss of any key customer would materially reduce our revenues.

International sales of our products accounted for 13.0% of our revenues in the first nine months of 2006, compared to 12.4% of our revenues in the first nine months of 2005, and 13.1% of our revenues in the third quarter 2006, compared to 11.1% of our revenues in the third quarter of 2005. No foreign geographic area or single foreign country accounted for more than 10.0% of our revenues in each of the three and nine months ended September 30, 2006 and 2005. For each of the three and nine months ended September 30, 2006 and 2005, more than 95.0% of our international sales were denominated in U.S. dollars. In addition, our purchases of DRAM and Flash components are currently denominated in U.S. dollars. However, we do face risks associated with doing business in foreign countries. See Risk Factors We face risks associated with doing business in foreign countries, including foreign currency fluctuations and trade barriers, that could lead to a decrease in demand for our products or an increase in the cost of the components used in our products.

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In the past, we have been, and expect to continue to be, impacted by seasonal purchasing patterns resulting in lower sales in the first and second quarters of each year. Other factors, including component price fluctuations and the launch of sales of products to new customers, may distort the effect of seasonality. Our ability to adjust our short-term operating expenses in response to fluctuations in revenues is limited. As a result, should revenues decrease to a level lower than expected in any given period, our results of operations would be harmed.

On January 1, 2006, we adopted Statement of Financial Accounting Standards (SFAS) 123(R), Share-Based Payment, which was issued in December 2004. SFAS 123(R) is a revision to SFAS 123, Accounting for Stock-Based Compensation, and supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees and its related interpretations. SFAS 123(R) requires the measurement of the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award. The cost will be recognized over the period during which an employee is required to provide service in exchange for the award. Prior to our adoption of SFAS 123(R), we accounted for employee stock options for financial and accounting purposes under APB No. 25, which does not require the expensing of stock options until they are exercised.

On December 19, 2005, our board of directors terminated our Employee Stock Purchase Plan, or ESPP, and approved the acceleration of the vesting of all then current unvested stock options awarded under our 2000 Stock Incentive Plan, including options held by our employees, officers, directors and consultants. All other terms and conditions applicable to such stock options, including the exercise prices, remain unchanged. The decision to terminate the ESPP and accelerate vesting of the stock options was made primarily to avoid recognizing the related compensation expense in our future consolidated financial statements with respect to the shares issued under the ESPP and the unvested stock options upon our adoption of SFAS 123(R) on January 1, 2006. As a result of our adoption of SFAS 123(R), we are required to record compensation expense for all awards granted on and after January 1, 2006 and for the unvested portion of previously granted awards that remain outstanding as of December 31, 2005. We had outstanding unvested stock options to purchase an aggregate of 25,000 shares of common stock at September 30, 2006 and no outstanding unvested stock options as of December 31, 2005. In addition, we had 206,000 outstanding unvested restricted stock units at September 30, 2006 and no outstanding unvested restricted stock units as of December 31, 2005. Each restricted stock unit represents the right to receive one share of common stock as each restricted stock unit vests. For each of the three and nine months ended September 30, 2006, we recorded stock-based compensation expense of $50,000 and $61,000, respectively, consisting of expenses related to employee stock options and employee restricted stock units which are included in research and development and general and administrative expenses. As of September 30, 2006, total unrecognized compensation expense related to unvested share-based compensation arrangements already granted under our 2000 Stock Incentive Plan was $57,000, which we expect will be recognized over a weighted-average period of 3.4 years. We believe SFAS 123(R) will increase our compensation expense, could make our operating results less predictable and affect the way we compensate our employees or cause other changes in the way we conduct our business. As a result of our adoption of SFAS 123(R), we have begun to significantly reduce the use and quantity of stock options compared to the quantity of stock options we granted in recent years. See Notes 4 and 9 to our unaudited consolidated financial statements for additional information concerning our adoption of SFAS 123(R) and our 2000 Stock Incentive Plan.

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Results of Operations

The following table sets forth, for the periods indicated, certain consolidated statement of operations data reflected as a percentage of revenues.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Net revenues	100.0%	100.0%	100.0%	100.0%
Cost of revenues	74.9	79.3	76.6	81.0
Gross profit	25.1	20.7	23.4	19.0
Operating expenses:				
Sales and marketing	7.7	9.4	8.5	8.9
General and administrative	3.3	4.9	4.3	4.8
Research and development	2.7	2.7	2.9	2.4
Total operating expenses	13.7	17.0	15.7	16.1
Operating income	11.4	3.7	7.7	2.9
Interest income	0.4	0.5	0.6	0.6
Income before provision for income taxes	11.8	4.2	8.3	3.5
Provision for income tax	4.5	1.5	3.1	1.1
Net income	7.3	2.7	5.2	2.4

Comparison of Three Months Ended September 30, 2006 to Three Months Ended September 30, 2005

Net Revenues. Our revenues were $92.8 million in the third quarter of 2006, compared to $67.2 million in the same period in 2005. Revenues increased 38.0% in the third quarter of 2006 due primarily to a 42.1% increase in unit shipments, partially offset by a 2.1% decrease in average sales price, or ASP, from $48 in the third quarter of 2005 to $47 in the third quarter of 2006. The decrease in our ASP resulted primarily from a shift in product mix and declining DRAM and Flash component prices. The increase in unit shipments resulted primarily from a 90.5% increase in OEM Flash memory units shipped and a 192.0% increase in Consumer external storage units shipped, partially offset by a 23.3% decrease in Consumer standard DRAM units shipped. OEM Flash product shipments increased due to an increase in orders from new and existing customers in the third quarter of 2006. Consumer external storage product shipments increased in the third quarter of 2006 primarily due to business from new retail customer relationships.

Our Consumer Division revenues increased 13.5% from $34.4 million in the third quarter of 2005 to $39.0 in the third quarter of 2006. Consumer Division standard memory revenues decreased by 3.2%, Flash memory revenues decreased by 21.2% and stacked memory revenues decreased by 37.8% in the third quarter of 2006. These decreases were offset by an increase of 97.5% in revenues from Consumer Division external storage sales and a 5.8% increase in units shipped. In addition, the ASP for Consumer Division products increased by 7.3%. The increase in Consumer Division unit volume resulted primarily from an increase in Consumer external storage product units shipped from 57,000 units in the third quarter of 2005 to 166,000 units in the third quarter of 2006, primarily as a result of expanded market penetration with new retail customer relationships. The increase in our Consumer Division ASP resulted primarily from a 25.0% increase in the ASP of standard memory products and a 7.8% increase in stacked memory products, partially offset by a 32.6% decrease in the ASP for hard drive products.

Our OEM Division revenues increased 63.7% from $32.8 million in the third quarter of 2005 to $53.8 million in the third quarter of 2006. The increase in OEM Division revenues was due primarily to a 95.3% increase in OEM Division units shipped, partially offset by a 15.5% decrease in ASP from $58 in the third quarter of 2005 to $49 in the third quarter of 2006. The increase in OEM Division unit volume resulted primarily from an increase in Flash memory units shipped from 438,000 units in the third quarter of 2005 to 835,000 units in the third quarter of 2006 due primarily to an increase in qualification orders from new and existing OEM customers. The decrease in our OEM Division ASP resulted primarily from a significant shift in product mix toward lower-ASP, lower-capacity (but higher gross margin), Flash memory products.

Sales of our products are made under short-term cancelable purchase orders. We include in our backlog only those customer orders for which we have accepted purchase orders and to which we have assigned shipment dates within the upcoming six months. Since orders constituting our

backlog are subject to change due to, among other things, customer cancellations and reschedulings, and our ability to procure necessary components, backlog is not necessarily an indication of future revenues. In addition, there can be no assurance that current backlog will necessarily lead to revenues in any future period. Our combined backlog was $39.6 million as of September 30, 2006, compared to $12.1 million as of September 30, 2005. Our Consumer Division backlog was $6.2 million as of September 30, 2006, compared to $4.2 million as of September 30, 2005. Our OEM Division backlog was $33.4 million as of September 30, 2006, compared to $7.9 million as of September 30, 2005. The increase in backlog at September 30, 2006 compared to September 30, 2005 was primarily due to increased orders primarily for our OEM Flash and Consumer external storage product lines in the third quarter of 2006. Our ability to predict future sales is limited because a majority of our quarterly product revenues come from orders that are received and fulfilled in the same quarter.

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Gross Profit. Our gross profit was $23.3 million in the third quarter of 2006, compared to $13.9 million in the same period in 2005. Gross profit as a percentage of revenues was 25.1% in the third quarter of 2006, compared to 20.7% in the third quarter of 2005. Gross profit as a percentage of revenue in the third quarter of 2006 increased due primarily to a shift in product mix toward higher gross profit margin OEM Division products. Gross profit for our Consumer Division as a percentage of Consumer Division revenues decreased from 14.6% in the third quarter of 2005 to 12.2% in the third quarter of 2006. Gross profit for our OEM Division as a percentage of OEM Division revenues increased from 27.1% in the third quarter of 2005 to 34.5% in the third quarter of 2006. This increase in gross profit as a percentage of revenues for our OEM Division resulted primarily from an increase in OEM Flash product gross profit margin from 41.4% in the third quarter of 2005 to 52.1% in the third quarter of 2006 and an increase in overall revenues from OEM Flash products from $14.5 million in the third quarter of 2005 to $24.8 million in the third quarter of 2006.

Sales and Marketing. Sales and marketing expenses are primarily comprised of personnel costs and travel expenses for our domestic and international sales and marketing employees, commissions paid to internal salespersons and independent manufacturers representatives, shipping costs and marketing programs. Sales and marketing expenses were $7.1 million in the third quarter of 2006, compared to $6.4 million in the third quarter of 2005. Sales and marketing expenses as a percentage of revenue were 7.7% in the third quarter of 2006, compared to 9.4% in the third quarter of 2005. The increase in sales and marketing expenses in absolute dollars was due primarily to an increase in commissions paid and shipping expenses as a result of a higher revenue level, an increase in units shipped, the addition of sales and marketing personnel hired to execute on our revenue growth initiatives, such as expansion in Asia, and to support the continued revenue expansion of our OEM Flash products and our Consumer Division external storage products in the retail channel. We expect our sales and marketing expenses to increase in absolute dollars as our revenues grow.

General and Administrative. General and administrative expenses are primarily comprised of personnel costs for our executive and administrative employees, professional fees and facilities overhead. General and administrative expenses were $3.0 million in the third quarter of 2006, compared to $3.3 million in the third quarter of 2005. General and administrative expenses as a percentage of revenues were 3.3% in the third quarter of 2006, compared to 4.9% in the third quarter of 2005. The decrease in general and administrative expenses in absolute dollars and as a percentage of revenues was due primarily to $825,000 in legal settlements received in the third quarter of 2006 related to class action litigation involving predatory pricing practices by certain DRAM vendors. We expect our general and administrative expenses to increase in absolute dollars to support the growth in sale unit volumes and revenues.

Research and Development. Research and development expenses are comprised primarily of personnel costs for our engineering and design staff and the cost of prototype supplies. Research and development expenses were $2.5 million in the third quarter of 2006, compared to $1.8 million in the third quarter of 2005. Research and development expenses as a percentage of revenues were 2.7% in each of the third quarters of 2006 and 2005. Research and development expenses increased due primarily to an increase in payroll costs from our expanding global research and development efforts predominantly related to our OEM Flash product line.

Interest Income and other, Net. Interest income and other, net was $397,000 in the third quarter of 2006 and $367,000 in the third quarter of 2005. Interest income is comprised of interest earned on our cash, cash equivalents and marketable securities. This increase in interest income resulted primarily from higher interest rates in the third quarter of 2006 compared to the third quarter of 2005, partially offset by a decrease in the average cash balance.

Provision for Income Taxes. The provision for income taxes increased from $999,000 in the third quarter of 2005 to $4.2 million in the third quarter of 2006 due primarily to the increase in income before provision for income taxes from $2.8 million in the third quarter of 2005 to $11.0 million in the third quarter of 2006. As a percentage of income before provision for income taxes, provision for income taxes increased from 35.2% in the third quarter of 2005 to 38.0% in the third quarter of 2006, due primarily to certain federal research and development tax credits which expired at the end of 2005.

Net Income. Net income was $6.8 million in the third quarter of 2006, compared to $1.8 million in the third quarter of 2005.

Comparison of Nine Months Ended September 30, 2006 to Nine Months Ended September 30, 2005

Net Revenues. Our revenues were $237.8 million in the first nine months of 2006, compared to $198.7 million in the same period in 2005. Revenues increased 19.7% in the first nine months of 2006 due primarily to a 44.1% increase in unit shipments, partially offset by a 17.2% decrease in average sales price, or ASP, from $58 in the first nine months of 2005 to $48 in the first nine months of 2006. The decrease in our ASP resulted primarily from a shift in product mix and declining DRAM and Flash component prices. The increase in unit shipments resulted primarily from a 184.3% increase in OEM Flash memory units shipped and an 86.3% increase in

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Consumer Division external storage units shipped, partially offset by a 32.9% decrease in Consumer Division standard DRAM units shipped. OEM Flash product shipments increased from 672,000 units in the first nine months of 2005 to 1,911,000 units in the first nine months of 2006 due primarily to an increase in orders from new and existing customers. Consumer external storage product shipments increased from 226,000 units in the first nine months of 2005 to 421,000 units in the first nine months of 2006 due primarily to new retail customer relationships.

Our Consumer Division revenues decreased 4.5% from $100.9 million in the first nine months of 2005 to $96.3 million in the first nine months of 2006. Consumer Division revenues decreased in the first nine months of 2006 due primarily to a 7.0% decrease in Consumer Division ASP from $43 in the first nine months of 2005 to $40 in the first nine months of 2006, partially offset by a 4.3% increase in Consumer Division unit volume resulting primarily from a 15.8% increase in Flash memory units shipped and an 85.8% increase in external storage units shipped partially offset by a 32.9% decrease in Consumer Division standard DRAM units shipped. The decrease in Consumer Division ASP resulted from declines in DRAM and Flash component pricing in the first nine months of 2006 compared to the first nine months of 2005.

Our OEM Division revenues increased 44.6% from $97.8 million in the first nine months of 2005 to $141.5 million in the first nine months of 2006. The increase in OEM Division revenues was due primarily to a 126.7% increase in OEM Division units shipped, partially offset by a 35.6% decrease in ASP from $87 in the first nine months of 2005 to $56 in the first nine months of 2006. The increase in OEM Division unit volume resulted primarily from an increase in Flash memory units shipped from 672,000 units in the first nine months of 2005 to 1,911,000 units in the first nine months of 2006 due primarily to an increase in qualification orders from new and existing OEM customers. The decrease in our OEM Division ASP resulted primarily from a significant shift in product mix toward lower-ASP, lower-capacity (but higher gross margin), Flash memory products.

Gross Profit. Our gross profit was $55.7 million in the first nine months of 2006, compared to $37.7 million in the same period in 2005. Gross profit as a percentage of revenues was 23.4% in the first nine months of 2006, compared to 19.0% in the same period in 2005. Gross profit as a percentage of revenue in the first nine months of 2006 increased due primarily to a shift in product mix toward higher gross profit margin OEM Division products. Gross profit for our Consumer Division as a percentage of Consumer Division revenues decreased slightly from 13.7% in the first nine months of 2005 to 12.9% in the first nine months of 2006. Gross profit for our OEM Division as a percentage of OEM Division revenues increased from 24.4% in the first nine months of 2005 to 30.6% in the first nine months of 2006. This increase in gross profit as a percentage of OEM Division revenues resulted primarily from a shift in product mix and an increase in this high gross profit margin product line from 42.1% in the first nine months of 2005 to 47.3% in the first nine months of 2006 and an increase in overall revenues from this product line from $26.7 million in the first nine months of 2005 compared to $62.1 million in the first nine months of 2006.

Sales and Marketing. Sales and marketing expenses are primarily comprised of personnel costs and travel expenses for our domestic and international sales and marketing employees, commissions paid to internal salespersons and independent manufacturers representatives, shipping costs and marketing programs. Sales and marketing expenses were $20.2 million in the first nine months of 2006, compared to $17.8 million in the first nine months of 2005. Sales and marketing expenses as a percentage of revenue were 8.5% in the first nine months of 2006, compared to 8.9% in the first nine months of 2005. The increase in sales and marketing expenses in absolute dollars was due primarily to an increase in commissions paid and shipping expenses as a result of a higher revenue level, an increase in units shipped and the addition of sales and marketing personnel hired to execute on our revenue growth initiatives, such as expansion in Asia, and to support the continued expansion of our OEM Flash products and our Consumer Division external storage products in the retail channel. We expect our sales and marketing expenses to increase in absolute dollars as our revenues grow.

General and Administrative. General and administrative expenses are primarily comprised of personnel costs for our executive and administrative employees, professional fees and facilities overhead. General and administrative expenses were $10.3 million in the first nine months of 2006, compared to $9.5 million in the first nine months of 2005. General and administrative expenses as a percentage of revenues were 4.3% in the first nine months of 2006, compared to 4.8% in the first nine months of 2005. The increase in general and administrative expenses in absolute dollars was due primarily to an increase in bad debt expense, additional payroll expense and severance costs. We expect our general and administrative expenses to increase in absolute dollars to support the growth in sale unit volumes and revenues.

Research and Development. Research and development expenses are comprised primarily of personnel costs for our engineering and design staff, product development costs and the cost of prototype supplies. Research and development expenses were $6.8 million in the first nine months of 2006, compared to $4.7 million in the first nine months of 2005. Research and development expenses as a percentage of revenues were 2.9% in the first nine months of 2006, compared to 2.4% in the first nine months of 2005. Research and development expenses increased due primarily to an increase in payroll costs from our expanding global research and development efforts predominantly related to our OEM Flash product line.

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Interest Income and other, Net. Interest income and other, net was $1.4 million in the first nine months of 2006 and $1.2 million in the first nine months of 2005. Interest income is comprised of interest earned on our cash, cash equivalents and marketable securities. This increase in interest income resulted primarily from higher interest rates in the first nine months of 2006 compared to the first nine months of 2005, partially offset by a decrease in the average cash balance.

Provision for Income Taxes. The provision for income taxes increased from $2.2 million in the first nine months of 2005 to $7.4 million in the first nine months of 2006. This was due primarily to an increase in income before provision for income taxes from $7.0 million in the first nine months of 2005 to $19.8 million in the first nine months of 2006. As a percentage of income before provision for income taxes, provision for income taxes increased from 31.1% in the first nine months of 2005 to 37.5% in the first nine months of 2006, due primarily to an income tax audit refund from the California Franchise Tax Board of $235,000 in the second quarter of 2005 and certain federal research and development tax credits which expired at the end of 2005.

Net Income. Net income was $12.4 million in the first nine months of 2006, compared to $4.8 million in the first nine months of 2005.

Liquidity and Capital Resources

Working Capital, Cash and Marketable Securities

As of September 30, 2006, we had working capital of $131.2 million, including $37.8 million of cash and cash equivalents, compared to working capital of $113.2 million, including $60.0 million of cash and cash equivalents as of December 31, 2005 and working capital of $112.2 million, including $69.7 million of cash and cash equivalents as of September 30, 2005. Current assets were 3.8 times current liabilities at September 30, 2006, compared to 5.1 times current liabilities at December 31, 2005, and 4.4 times current liabilities at September 30, 2005.

Cash Used in Operating Activities in the Nine Months Ended September 30, 2006 and 2005

Net cash used by operating activities was $26.5 million for the nine months ended September 30, 2006 and resulted primarily from a $23.3 million increase in accounts receivable, net of allowances, and a $38.4 million increase in inventory, net of reserves, partially offset by net income of $12.4 million, non-cash depreciation and amortization of $3.1 million, non-cash accounts receivable provisions and inventory obsolescence expense of $5.6 million, a decrease in other assets of $900,000, an increase in accounts payable of $18.1 million and a $1.5 million increase in accrued and other liabilities. Accounts receivable, net of allowances, increased primarily due to an increase in sales for the OEM Division Flash product line orders and the continued growth of our Consumer Division external storage product line in the retail channel. Inventory, net of reserves increased due to the increase in sales as noted above, and due to new inventory consignment arrangements at two major retailers. Net cash provided by operating activities was $1.9 million for the nine months ended September 30, 2005 and resulted primarily from an $11.2 million increase in accounts payable, net income of $4.8 million, non-cash depreciation and amortization of $2.2 million and a $2.0 million decrease in accounts receivable, net of allowances, partially offset by a $17.1 million increase in inventory, net of reserves. Inventory, net of reserves, increased primarily to support increased OEM Division Flash product line orders and the continued growth of our external storage product line in the retail channel.

Cash Used in Investing Activities for the Nine Months Ended September 30, 2006 and 2005

Net cash used by investing activities was $4.4 million for the nine months ended September 30, 2006, attributable primarily to cash consideration of $500,000 paid for the acquisition of a division of Integrated Circuit Solution Incorporation in January 2006 and $3.9 million in purchases of furniture, fixtures and equipment. Net cash provided by investing activities was $5.0 million for the first nine months of 2005, attributable to $10.0 million of redemptions of marketable securities, partially offset by $3.5 million in purchases of furniture, fixtures and equipment and a $1.6 million impact from our acquisition of Memtech SSD, Corp. in July 2005. In addition, we are planning to expand our operations into Malaysia. These plans include construction of an approximately 200,000 square feet manufacturing facility which we expect to be operational in the first quarter of 2008. We are estimating an investment in land, facilities and capital equipment for our Malaysia facility of approximately $28 million over the next 5 years. We expect this investment will be sourced through existing cash on the balance sheet, cash flow from operations and, if necessary, from new debt and/or equity financings.

Cash Provided in Financing Activities for the Nine Months Ended September 30, 2006 and 2005

Net cash provided by financing activities was $8.7 million for the nine months ended September 30, 2006 and resulted from $6.7 million of proceeds realized from the exercise of stock options and a $2.0 million tax benefit from employee stock option exercises. Net cash used by financing activities was $10.6 million for the first nine months of 2005 and resulted primarily from the $11.8 million repurchase of our common stock under our stock buy back plan, partially offset by the issuance of common stock for proceeds of $1.2 million related to our employee stock

purchase plan and stock option exercises.

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We believe that our existing assets, cash, cash equivalents and investments on hand, together with cash that we expect to generate from our operations, will be sufficient to meet our capital needs for at least the next twelve months. However, it is possible that we may need or elect to raise additional funds to fund our activities beyond the next year, to expand our international operations or to consummate acquisitions of other businesses, products or technologies. We could raise such funds by selling more stock to the public or to selected investors, or by borrowing money. In addition, even though we may not need additional funds, we may still elect to sell additional equity securities or obtain credit facilities for other reasons. We cannot assure you that we will be able to obtain additional funds on commercially favorable terms, or at all. If we raise additional funds by issuing additional equity or convertible debt securities, the ownership percentages of existing shareholders would be reduced. In addition, the equity or debt securities that we issue may have rights, preferences or privileges senior to those of the holders of our common stock.

Although we believe we have sufficient capital to fund our activities for at least the next twelve months, our future capital requirements may vary materially from those now planned. The amount of capital that we will need in the future will depend on many factors, including:

- our relationships with suppliers and customers;
- the market acceptance of our products;
- the levels of promotion and advertising that will be required to launch our new products and achieve and maintain a competitive position in the marketplace;
- expansion of our international business, including the opening of offices and facilities in foreign countries;
- price discounts on our products to our customers;
- our pursuit of strategic transactions, including acquisitions, joint ventures and capital investments;
- our business, product, capital expenditure and research and development plans and product and technology roadmaps;
- the levels of inventory and accounts receivable that we maintain;
- our entrance into new markets;
- capital improvements to new and existing facilities;
- technological advances; and
- competitors responses to our products.

Contractual Obligations and Off Balance Sheet Arrangements

Set forth in the table below is our estimate of our significant contractual obligations at September 30, 2006. We do not have off-balance sheet financing arrangements as of September 30, 2006.

		Payment due by period			
		Less than			More than
Contractual Obligation	**Total**	**1 year**	**1-3 years**	**3-5 years**	**5 years**
Operating Lease Obligations	$ 7,260,000	$ 1,026,000	$ 1,485,000	$ 1,250,000	$ 3,499,000
Non-cancelable capital equipment purchase commitments	712,000	712,000			
Non-cancelable inventory purchase commitments	40,863,000	40,863,000			
Other non-cancelable purchase commitments	1,991,000	1,991,000			
Total	$ 50,826,000	$ 44,592,000	$ 1,485,000	$ 1,250,000	$ 3,499,000

Inflation

Inflation was not a material factor in either revenue or operating expenses during each of the first nine months ended September 30, 2006 and 2005.

Critical Accounting Policies and Estimates

Our discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amount of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amount of

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revenues and expenses for each period. The following represents a summary of our critical accounting policies, defined as those policies that we believe are: (a) the most important to the portrayal of our financial condition and results of operations, and (b) that require management s most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effects of matters that are inherently uncertain.

Reserves for inventory excess, obsolescence and lower of market values over costs. We purchase raw materials in quantities that we anticipate will be fully used in the near term. Changes in operating strategy, customer demand and unpredictable fluctuations in market values of raw materials can limit our ability to effectively utilize all of the raw materials purchased and result in finished goods with above market carrying costs which may cause losses on sales to customers. We regularly monitor potential excess, or obsolete, inventory by analyzing the length of time in stock and compare market values to cost. When necessary, we reduce the carrying amount of our inventory to its market value.

Allowances for doubtful accounts and price protection. We maintain allowances for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. We review our allowance for doubtful accounts quarterly and all past due balances over 90 days are reviewed for collectibility. Additionally, we maintain allowances for limited price protection rights for inventories of our products held by our customers as a result of recent sales transactions to them. If we reduce the list price of our products, these customers may receive a credit from us. By monitoring our inventory levels with our customers, we estimate the impact of such pricing changes on a regular basis and adjust our allowances accordingly.

Product returns. We offer a majority of our customers that purchase products through our consumer channels limited rights to return unsold inventory. In addition, while we may not be contractually obligated to accept returned products, we may determine that it is in our best interest to accept returns in order to maintain good relationships with our customers. We provide for estimated future returns of inventory at the time of sale based on historical experience, and actual results have been within our expectations.

Sales and marketing incentives. Sales and marketing incentives are offset against revenues or charged to operations in accordance with Emerging Issues Task Force Issue No. 01-09 (EITF 01-09), *Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor s Products)* . Sales and marketing incentives amounted to $5.9 million and $2.1 million for each of the three months ended September 30, 2006 and 2005, respectively, of which $5.9 million and $2.0 million, respectively, were offset against revenues, and $20,000 and $112,000, respectively, were charged as an operating expense. Sales and marketing incentives amounted to $12.1 million and $6.6 million for each of the nine months ended September 30, 2006 and 2005, respectively, of which $11.9 million and $6.2 million, respectively, were offset against revenues, and $151,000 and $452,000, respectively, were charged as an operating expense.

Consideration generally given by us to a customer is presumed to be a reduction of selling price, and therefore, a reduction of revenue. However, if we receive an identifiable benefit in return for the consideration given to our customer that is sufficiently separable from our sales to that customer, such that we could have paid an independent company to receive that benefit; and we can reasonably estimate the fair value of that benefit, then the consideration is characterized as an expense. We estimate the fair value of the benefits we receive by tracking the advertising done by our customers on our behalf and calculating the value of that advertising using a comparable rate for similar publications.

Income taxes. As part of the process of preparing our consolidated financial statements, we are required to estimate our income taxes in each of the jurisdictions in which we operate. The process incorporates an assessment of the current tax exposure together with temporary differences resulting from different treatment of transactions for tax and financial statement purposes. Such differences result in deferred tax assets and liabilities, which are included within the consolidated balance sheet. The recovery of deferred tax assets from future taxable income must be assessed and, to the extent that recovery is not likely, we establish a valuation allowance. Increases in valuation allowances result in the recording of additional tax expense. Further, if our ultimate tax liability differs from the periodic tax provision reflected in the consolidated statements of operations, additional tax expense may be recorded.

Litigation and other contingencies. Management regularly evaluates our exposure to threatened or pending litigation and other business contingencies. Because of the uncertainties related to the amount of loss from litigation and other business contingencies, the recording of losses relating to such exposures requires significant judgment about the potential range of outcomes. As additional information about current or future litigation or other contingencies becomes available, our management will assess whether such information warrants the recording of additional expense relating to our contingencies. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable. The results of these estimates form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

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Valuation of long-lived assets. We assess the potential impairment of long-lived tangible and intangible assets whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Changes in our operating strategy can significantly reduce the estimated useful life of such assets.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Interest Rate Risk

At any time, fluctuations in interest rates could affect interest earnings on our cash and cash equivalents. We believe that the effect, if any, of reasonably possible near term changes in interest rates on our financial position, results of operations, and cash flows would not be material. Currently, we do not hedge these interest rate exposures. The primary objective of our investment activities is to preserve capital. We have not used derivative financial instruments in our investment portfolio.

At September 30, 2006, our cash and cash equivalents were $37.8 million invested in money market and other interest bearing accounts.

From time to time, we invest in marketable securities, however, at September 30, 2006, our investment in marketable securities was $0.

If interest rates were to decrease 1%, the result would be an annual decrease in our interest income related to our cash and cash equivalents of approximately $378,000. However, due to the uncertainty of the actions that would be taken and their possible effects, this analysis assumes no such action. Further, this analysis does not consider the effect of the change in the level of overall economic activity that could exist in such an environment.

The carrying amount, principal maturity and estimated fair value of our cash and cash equivalents as of September 30, 2006 were as follows:

	Expected Maturity Date Before October 1, 2007	Thereafter	Total	Fair Value 9/30/2006
Investments				
Cash and cash equivalents:				
Money Market Funds	$ 37,826,000	$ 0	$ 37,826,000	$ 37,826,000
Weighted average interest rate	3.48%		3.48%	3.48%
Total cash and cash equivalents	$ 37,826,000	$ 0	$ 37,826,000	$ 37,826,000
Weighted average interest rate	3.48%		3.48%	3.48%

Foreign Currency Exchange Rate Risk

More than 95.0% of our international sales are denominated in U.S. dollars. Consequently, if the value of the U.S. dollar increases relative to a particular foreign currency, our products could become relatively more expensive. In addition, we purchase a majority of all of our DRAM and Flash components from local distributors of Japanese, Korean and Taiwanese suppliers. Fluctuations in the currencies of Japan, Korea or Taiwan could have an adverse impact on the cost of our raw materials. To date, we have not entered any derivative instruments to manage risks related to interest rate or foreign currency exchange rates.

ITEM 4. CONTROLS AND PROCEDURES

(a) *Evaluation of Disclosure Controls and Procedures*. An evaluation as of the end of the period covered by this report was carried out under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, of the effectiveness of our disclosure controls and procedures, as such term is defined under Rule 13a-15(e) and Rule 15d 15 promulgated under the Securities Exchange Act of 1934, as amended (the Exchange Act). Based on their evaluation, our principal executive officer and principal financial officer concluded that our disclosure controls and procedures are effective to ensure that we record, process, summarize, and report information required to be disclosed by us in our quarterly reports filed under the Securities Exchange Act within the time periods specified by the Securities and Exchange Commission s rules and forms.

(b) *Changes in Internal Controls*. During the quarterly period covered by this report, there have not been any changes in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) that have materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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PART II OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

Lemelson Medical, Education & Research Foundation, LLP Patent Infringement

We received notice on November 26, 2001 that the Lemelson Medical, Education & Research Foundation, LLP filed a complaint on November 13, 2001 against us and other defendants. The complaint was filed in the District Court of Arizona and alleges that our manufacturing processes infringe several patents that the Lemelson Foundation allegedly owns. The complaint also states that these allegedly infringed patents relate to machine vision technology and bar coding technology. On March 7, 2002, we were served with the Lemelson Foundation complaint. Thereafter, the case was stayed pending the outcome of related cases against parties involving the same patents. On September 9, 2005, in one of these related cases, the U.S. Court of Appeals for the Federal Circuit affirmed a decision by the U.S. District Court for the District of Nevada that found several Lemelson Foundation patents to be unenforceable. Because the final outcome of the related cases are expected to affect the Lemelson Foundation s lawsuit against us, an estimate of potential damages, if any, would be premature and speculative. We believe this lawsuit is without merit and we intend to vigorously defend ourselves against it.

Hard Drive Class Action Lawsuit

On October 6, 2006, an individual, Boris Brand, filed a purported nationwide class action lawsuit against us in the Superior Court for the State of California, County of Los Angeles, alleging that our description of the capacity of our hard drive products constitutes fraudulent, unfair, deceptive and false advertising under California Business and Professions Code Sections 17200 and 17500 and violates the California Consumers Legal Remedies Act. In particular, the lawsuit alleges that our description of the storage capacity on our hard drives uses a decimal basis for measuring gigabytes which results in a lower storage capacity when the hard drives are incorporated into an operating system that uses a binary gigabyte basis for measurement. Plaintiff seeks restitution, disgorgement, compensatory damages and injunctive relief and attorneys fees. We believe this lawsuit is without merit and we intend to vigorously defend ourselves against it. We have submitted the defense of this lawsuit to our insurance carrier. Also, we have notified all of the suppliers who have supplied us with the hard drives involved, since we believe that those suppliers have a legal duty to indemnify us in the event that SimpleTech has to pay any damages. There can be no assurance, however, that our insurance carrier will ultimately agree to defend this lawsuit on our behalf or that any of our suppliers will indemnify us for any damages resulting from this lawsuit.

We are not currently involved in any other material legal proceedings. From time to time, however, we may become subject to additional legal proceedings, claims, and litigation arising in the ordinary course of business, including, but not limited to, employee, customer and vendor disputes. In addition, in the past we have received, and we may continue to receive in the future, letters alleging infringement of patent or other intellectual property rights. Our management believes that these letters generally are without merit and intend to contest them vigorously.

ITEM 1A. RISK FACTORS

This Report contains forward-looking statements based on the current expectations, assumptions, estimates and projections about our industry and us. These forward-looking statements involve risks and uncertainties. Our actual results could differ materially from those discussed in these forward-looking statements as a result of certain factors, as more fully described in this section and elsewhere in this Report. You should carefully consider the following risks before you decide to buy shares of our common stock. The risks and uncertainties described below are not the only ones facing us. Additional risks and uncertainties, including those risks set forth in Management s Discussion and Analysis of Financial Condition and Results of Operations below, may also adversely impact and impair our business. If any of the following risks actually occur, our business, results of operations or financial condition would likely suffer. In such case, the trading price of our common stock could decline, and you may lose all or part of the money you paid to buy our stock. We do not undertake to update publicly any forward-looking statements for any reason, even if new information becomes available or other events occur in the future.

We expect our quarterly operating results to fluctuate in future periods, causing our stock price to fluctuate or decline.

Our quarterly operating results have fluctuated in the past, and we believe they will continue to do so in the future. Our future results of operations will depend on many factors including:

Our suppliers production levels for the components used in our products;

Our ability to procure required components or fluctuations in the cost of such components;

Fluctuating market demand for, and changes in the average sales prices of our products;

Changes in our customer and product revenue mix;

Our ability to successfully integrate any acquired businesses or assets;

Seasonal purchasing patterns for our Consumer Division products with lower sales generally occurring in the first and third quarters followed by higher sales in the fourth quarter of each year;

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Market acceptance of new and enhanced versions of our products;

Expansion of our international business, including the opening of offices and facilities in foreign countries;

The timing of the introduction of new products or components and enhancements to existing products or components by us, our competitors or our suppliers;

Order cancellations, product returns, inventory write-downs, price protections, and rebates;

Manufacturing inefficiencies associated with the start-up of new products and volume production;

Expenses associated with strategic transactions, including acquisitions, joint ventures and capital investments;

Our ability to adequately support future rapid growth;

Our ability to absorb manufacturing overhead;

The effects of litigation;

Increases in our sales and marketing expenses in connection with decisions to pursue new product initiatives; and

Expenses associated with the start up of new operations or divisions.

Due to the above and other factors, quarterly revenues and results of operations are difficult to forecast, and period-to-period comparisons of our operating results may not be predictive of future performance. In one or more future quarters, our results of operations may fall below the expectations of securities analysts and investors. In that event, the trading price of our common stock would likely decline. In addition, the trading price of our common stock may fluctuate or decline regardless of our operating performance.

Our dependence on a small number of suppliers for key components used in the manufacture of our products and inability to obtain a sufficient supply of these components on a timely basis could harm our ability to fulfill orders.

Typically, IC devices represent more than 90% of the component costs of our manufactured Flash products and DRAM modules. We are dependent on a small number of suppliers that supply key components used in the manufacture of our products, such as Flash and DRAM components and raw hard drives. We have no long-term supply contracts. Some of our competitors have entered into long-term contracts with suppliers that guarantee them a certain allocation of components, such as Flash IC devices. We have no assurance that our existing suppliers will agree to supply the quantities of components we may need to meet our production goals. We periodically review opportunities to develop alternative sources for our Flash and DRAM IC device needs. However, our options are very limited because of the small number of memory manufacturers. Samsung currently supplies substantially all of the IC devices used in our OEM Division Flash memory products. Elpida, Qimonda and Samsung currently supply a majority of the DRAM IC devices used in our DRAM and IC Tower stacking DRAM memory products. In addition, Western Digital and Bell Microproducts currently supply a majority of the raw hard drives used in our external storage products. Our dependence on a small number of suppliers and the lack of any guaranteed sources of supply expose us to several risks, including the inability to obtain an adequate supply of components, price increases, late deliveries and poor component quality. A disruption in or termination of our supply relationship with any of these significant suppliers due to natural disasters or other factors, or our inability to develop relationships with new suppliers, if required, would cause delays, disruptions or reductions in product shipments or require product redesigns which could damage relationships with our customers and negatively affect our revenues and could increase our costs or the prices of our

products. In particular, if our supply relationships with Bell Microproducts, Elpida, Infineon Technologies, Samsung and Western Digital are disrupted or terminated, our ability to manufacture and sell our products would be harmed and our business would be adversely affected.

Ineffective management of inventory levels or product mix, order cancellations, product returns, inventory write-downs, price protection and rebates could adversely affect our results of operations.

If we are unable to properly monitor, control and manage our inventory and maintain an appropriate level and mix of products with our customers, we may incur increased and unexpected costs associated with this inventory. For example, if our Consumer Division customers are unable to sell their inventory in a timely manner, we may choose or be required to lower the price of our products or allow our customers to exchange the slow-moving products for newer products. Similarly, if we manufacture products in anticipation of future demand that does not materialize, or if a customer cancels outstanding orders, we could experience an unanticipated increase in our inventory that we may be unable to sell in a timely manner, if at all. As a result, we could incur increased expenses associated with writing off excess or obsolete inventory. A majority of our sales through commercial channels include limited rights to return unsold inventory. In addition, while we may not be contractually obligated to accept returned products, we may determine that it is in our best interest to accept returns in order to maintain good relations with our customers. Product returns would increase our inventory and reduce our revenues. In addition, some of our inventory is sold on a consignment basis, and we have very little ability to control or manage that inventory. Alternatively, we could end up with too little inventory and we may not be able to satisfy

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demand, which could have a material adverse effect on our customer relationships. Our risks related to inventory management are exacerbated by our strategy of closely matching inventory levels with product demand, leaving limited margin for error.

We are also subject to repurchase agreements with various financial institutions in connection with wholesale inventory financing. Under these agreements, we may be required to repurchase inventory upon customer default with a financing institution and then resell the inventory through normal distribution channels. As of September 30, 2006, we have never been required to repurchase inventory in connection with the customer default agreements noted above. However, it may be possible that we will be required to repurchase inventory, upon customer default, in the future. Sales under such agreements were approximately $113,000 and $87,000 in each of the three months ended September 30, 2006 and 2005, respectively, and $487,000 and $788,000 in each of the nine months ended September 30, 2006 and 2005, respectively.

We have no long-term volume commitments from our customers. Sales of our products are made through individual purchase orders and, in certain cases, are made under master agreements governing the terms and conditions of the relationships. Customers may change, cancel or delay orders with limited or no penalties. We have experienced cancellations of orders and fluctuations in order levels from period-to-period and we expect to continue to experience similar cancellations and fluctuations in the future, which could result in fluctuations in our revenues.

Declines in our average sales prices may result in declines in our revenues and gross profit.

Our industry is competitive and characterized by historical declines in average sales prices. Our average sales prices may decline due to several factors. From time to time, overcapacity in the DRAM memory component market has resulted in significant declines in component prices, which has negatively impacted our average sales prices, revenues and gross profit. During periods of overcapacity, our revenues and gross profit will decline if we do not increase unit sales of existing products or fail to introduce and sell new products in quantities sufficient to offset declines in sales prices. Any efforts to reduce costs and develop new products to offset the impact of further declines in average sales prices may not be successful. Declines in average sales prices would also enable OEMs to pre-install higher capacity base memory into new systems at existing price points, and thereby reduce the demand for our aftermarket memory products. Our competitors and customers also impose significant pricing pressures on us. Since a large percentage of our sales are to a small number of customers that are primarily retail consumer chains, distributors and large OEMs, these customers have exerted, and we expect they will continue to exert, pressure on us to make price concessions.

In addition, the continued transition to smaller design geometries and the use of 300 millimeter wafers by existing memory manufacturers could lead to a significant increase in the worldwide supply of DRAM and Flash components. Increases in the worldwide supply of DRAM and Flash components could also result from manufacturing capacity expansions. If not offset by increases in demand, these increases would likely lead to further declines in the average sales prices of our products and have a material adverse effect on our business and operating results. Furthermore, even if supply remains constant, if demand were to decrease, it would harm our average sales prices.

We are subject to the cyclical nature of the semiconductor industry and any future downturn could adversely affect our business.

The semiconductor industry, including the memory markets in which we compete, is highly cyclical and characterized by constant and rapid technological change, rapid product obsolescence and price erosion, evolving standards, short product life cycles and wide fluctuations in product supply and demand. The industry has experienced significant downturns often connected with, or in anticipation of, maturing product cycles of both semiconductor companies and their customers products and declines in general economic conditions. These downturns have been characterized by diminished product demand, production overcapacity, high inventory levels and accelerated erosion of average sales prices. Prior downturns in the semiconductor industry negatively impacted our average sales prices, revenues and earnings. Any future downturns could have a material adverse effect on our business and results of operations.

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Sales to a limited number of customers represent a significant portion of our revenues, and the loss of any key customer would materially reduce our revenues.

Our dependence on a limited number of customers means that the loss of a major customer or any reduction in orders by a major customer would materially reduce our revenues. We have no long-term contracts with our customers. Historically, a relatively limited number of customers have accounted for a significant percentage of our revenues. Our ten largest customers accounted for an aggregate of 72.6% and 68.8% of our revenues in the three and nine months ended September 30, 2006, respectively, compared to 67.8% and 70.1% of our revenues in the three and nine months ended September 30, 2005, respectively. Our ten largest Consumer Division customers accounted for an aggregate of 88.1% and 79.2% of our Consumer Division revenues in the three and nine months ended September 30, 2006, respectively, or 37.1% and 32.1% of our revenues in the three and nine months ended September 30, 2006, respectively, compared to 69.6% and 63.7% of our Consumer Division revenues in the three and nine months ended September 30, 2005, respectively, or 35.6% and 32.4% of our revenues, in the three and nine months ended September 30, 2005, respectively. The following table sets forth certain information about our Consumer Division customer that accounted for more than 10.0% of our revenues in any of the three and nine months ended September 30, 2006 and 2005.

	Three Months Ended September 30, 2006		Three Months Ended September 30, 2005		Nine Months Ended September 30, 2006		Nine months Ended September 30, 2005	
Consumer Division Customer(s)	% of Total Revenues	% of Consumer Division Revenues	% of Total Revenues	% of Consumer Division Revenues	% of Total Revenues	% of Consumer Division Revenues	% of Total Revenues	% of Consumer Division Revenues
CDW Logistics, Inc. (formerly CDW Computer Centers)	11.3%	26.8%	14.8%	28.9%	11.8%	29.1%	15.6%	30.8%

Our ten largest OEM Division customers accounted for an aggregate of 78.9% and 78.5% of our OEM Division revenues in the three and nine months ended September 30, 2006, respectively, or 46.2% and 46.9% of our revenues in the three and nine months ended September 30, 2006, respectively, compared to 85.4% and 86.6% of our OEM Division revenues in the three and nine months ended September 30, 2005, respectively, or 41.7% and 42.6% of our revenues in the three and nine months ended September 30, 2005, respectively. The following table sets forth certain information about each of our OEM Division customers that accounted for more than 10.0% of our revenues in any of the three or nine months ended September 30, 2006 and 2005.

	Three Months Ended September 30, 2006		Three Months Ended September 30, 2005		Nine Months Ended September 30, 2006		Nine Months Ended September 30, 2005	
OEM Division Customer(s)	% of Total Revenues	% of OEM Division Revenues	% of Total Revenues	% of OEM Division Revenues	% of Total Revenues	% of OEM Division Revenues	% of Total Revenues	% of OEM Division Revenues
Smart Modular	20.1%	34.6%	18.2%	37.3%	21.9%	36.8%	20.5%	41.7%
Micron Semiconductor	15.6%	27.0%	14.3%	29.2%	14.5%	24.4%	15.5%	31.5%

Consolidation in some of our customers industries may result in increased customer concentration and the potential loss of customers as a result of acquisitions. In addition, the composition of our major customer base changes from quarter to quarter as the market demand for our customers products changes, and we expect this variability to continue in the future. We expect that sales of our products to a limited number of customers will continue to contribute materially to our revenues in the foreseeable future. The loss of, or a significant reduction in purchases by any of our major customers, could harm our business, financial condition and results of operations.

We may be less competitive if we fail to develop new and enhanced products and introduce them in a timely manner.

The memory, high-performance computing, networking and communications, consumer electronics and OEM markets are subject to rapid technological change, product obsolescence, frequent new product introductions and enhancements, changes in end-user requirements and evolving industry standards. Our ability to compete in these markets will depend in significant part upon our ability to successfully develop, introduce and sell new and enhanced products on a timely and cost-effective basis, and to respond to changing customer requirements.

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We have experienced, and may in the future experience, delays in the development and introduction of new products. These delays would provide a competitor a first-to-market opportunity and allow a competitor to achieve greater market share. Our product development is inherently risky because it is difficult to foresee developments in technology, anticipate the adoption of new standards, coordinate our technical personnel, and identify and eliminate design flaws. Defects or errors found in our products after commencement of commercial shipments could result in delays in market acceptance of these products. New products, even if first introduced by us, may not gain market acceptance. Accordingly, there can be no assurance that our future product development efforts will result in future profitability or market acceptance. Lack of market acceptance for our new products will jeopardize our ability to recoup research and development expenditures, hurt our reputation and harm our business, financial condition and results of operations.

We may also seek to develop products with new standards for our industry. It will take time for these new standards and products to be adopted, for consumers to accept and transition to these new products and for significant sales to be generated from them, if this happens at all. Moreover, broad acceptance of new standards or products by consumers may reduce demand for our older products. If this decreased demand is not offset by increased demand for our new products, our results of operations could be harmed. We cannot assure you that any new products or standards we develop will be commercially successful.

Our efforts to expand our business internationally may not be successful and may expose us to additional risks that may not exist in the United States, which in turn could cause our business and operating results to suffer.

We sell our products to customers in foreign countries and seek to increase our level of international business activity through the expansion of our operations into select international markets, including Asia and Europe. Such strategy may include opening sales offices in foreign countries, the outsourcing of manufacturing operations to third party contract manufacturers, establishing joint ventures with foreign partners, and the establishment of manufacturing operations in foreign countries. Since the beginning of 2004, we have opened sales, marketing, procurement and engineering offices in France, Hong Kong, Japan, the Netherlands, Taiwan and the United Kingdom. In addition, we announced in August 2006 plans to build a 200,000 square foot manufacturing facility in Malaysia that is expected to be operational in the first quarter of 2008.

Establishing operations in any other foreign country or region presents numerous risks, including:

- foreign laws and regulations, which may vary country by country, may impact how we conduct our business;
- higher costs of doing business in certain foreign countries, including different employment laws;
- difficulty protecting our intellectual property rights from misappropriation or infringement;
- difficulties and costs of staffing and managing operations in certain foreign countries;
- political or economic instability;
- changes in import/export duties;
- necessity of obtaining government approvals;
- trade restrictions;

work stoppages or other changes in labor conditions;

difficulties in collecting of accounts receivables on a timely basis or at all;

taxes;

longer payment cycles and foreign currency fluctuations; and

seasonal reductions in business activity in some parts of the world, such as Europe.

In addition, changes in policies and/or laws of the United States or foreign governments resulting in, among other things, higher taxation, currency conversion limitations, restrictions on fund transfers or the expropriation of private enterprises, could reduce the anticipated benefits of our international expansion. We may also encounter potential adverse tax consequences if taxing authorities in different jurisdictions worldwide disagree with our interpretation of various tax laws or our determinations as to the income and expenses attributable to specific jurisdictions, which could result in our paying additional taxes, interest and penalties. Furthermore, any actions by countries in which we conduct business to reverse policies that encourage foreign trade or investment could adversely affect our business. If we fail to realize the anticipated revenue growth of our future international operations, our business and operating results could suffer.

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We expect that our strategy to expand our international operations will require the expenditure of significant resources and involve the efforts and attention of our management. Unlike some of our competitors, we have limited experience operating our business in foreign countries. Some of our competitors may have substantial advantage over us in attracting customers in certain foreign countries due to earlier established operations in that country, greater knowledge with respect to cultural differences of customers residing in that country and greater brand recognition and longer-standing relationships with customers in that country. If our international expansion efforts in any foreign country are unsuccessful, we may decide to cease these foreign operations, which would likely harm our reputation and cause us to incur expenses and losses.

Failure to maintain effective internal control over financial reporting could result in a negative market reaction.

Section 404 of the Sarbanes-Oxley Act of 2002 requires that we undertake a thorough examination of our internal control systems and procedures for financial reporting. We also are required to completely document and test those systems. Ultimately, our management will be responsible for assessing the effectiveness of our internal control over financial reporting, and our independent registered public accounting firm will be requested to attest to that report. We cannot be certain as to the timing of completion of our evaluation, testing and remediation actions or the impact of the same on our operations since there is no precedent available by which to measure compliance adequacy.

Our filing of our annual report on a timely basis will depend upon our timely completion of these tasks. A late annual report could have material adverse effects on us, both legally and with respect to the opinions of the participants in the securities market.

If we identify one or more material weaknesses in our internal control over financial reporting, our management will be unable to assert such internal controls are effective. If we are unable to assert that our internal controls over financial reporting are effective, or if our independent registered public accounting firm is unable to attest that our management s report is fairly stated or they are unable to express an opinion on the effectiveness of our internal controls, it could result in a negative market reaction. At the present time the Company is not an accelerated filer and is not subject to Section 404 of the Sarbanes-Oxley Act of 2002.

Compliance with changing regulation of corporate governance and public disclosure may result in additional expenses.

Changing laws, regulations and standards relating to corporate governance and public disclosure, including the Sarbanes-Oxley Act of 2002, new SEC regulations and Nasdaq National Market rules, have required most public companies, including us, to devote additional internal and external resources to various governance and compliance matters. Because we have a relatively small corporate staff, we rely heavily on outside professional advisers to assist us with these efforts. Although we are uncertain about the total costs we will incur in connection with these efforts, we know they will at least be substantial.

These costs will include increased accounting related fees associated with preparing the attestation report on our internal controls over financial reporting as required under Section 404 of the Sarbanes-Oxley Act of 2002. These new or changed laws, regulations and standards are subject to varying interpretations, as well as modifications by the government and Nasdaq. The way in which they are applied and implemented may change over time, which could result in even higher costs to address and implement revisions to compliance (including disclosure) and governance practices. We intend to invest the necessary resources to comply with evolving laws, regulations and standards. If our efforts to comply with new or changed laws, regulations and standards differ from the activities intended by regulatory or governing bodies due to ambiguities related to practice, our reputation may be harmed and we will be required to incur additional expenses.

We may make acquisitions that are dilutive to existing shareholders, result in unanticipated accounting charges or otherwise adversely affect our results of operations.

We intend to grow our business through business combinations or other acquisitions of businesses, products or technologies that allow us to complement our existing product offerings, expand our market coverage, increase our engineering workforce or enhance our technological capabilities. If we make any future acquisitions, we could issue stock that would dilute our shareholders percentage ownership, incur substantial debt, reduce our cash reserves or assume contingent liabilities.

Furthermore, acquisitions may require material infrequent charges and could result in adverse tax consequences, substantial depreciation, deferred compensation charges, in-process research and development charges, the amortization of amounts related to deferred compensation and identifiable purchased intangible assets or impairment of goodwill, any of which could negatively impact our results of operations.

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Our limited experience in acquiring other businesses, product lines and technologies may make it difficult for us to overcome problems encountered in connection with any acquisitions we may undertake.

We continually evaluate and explore strategic opportunities as they arise, including business combinations, strategic partnerships, capital investments and the purchase, licensing or sale of assets. Our experience in acquiring other businesses, product lines and technologies is limited. The attention of our small management team may be diverted from our core business if we undertake any future acquisitions. Our recent acquisition of Memtech, SSD Corporation, the assets of a division of Integrated Circuit Solution Incorporation, the assets of Gnutek Ltd. and any potential future acquisitions also involve numerous risks, including, among others:

- problems and delays in successfully assimilating and integrating the purchased operations, personnel, technologies, products and information systems;
- unanticipated costs and expenditures associated with the acquisition, including any need to infuse significant capital into the acquired operations;
- adverse effects on existing business relationships with suppliers, customers and strategic partners;
- risks associated with entering markets and foreign countries in which we have no or limited prior experience;
- contractual, intellectual property or employment issues;
- potential loss of key employees of purchased organizations; and
- potential litigation arising from the acquired company s operations before the acquisition.

These risks could disrupt our ongoing business, distract our management and employees, harm our reputation and increase our expenses. Our inability to overcome problems encountered in connection with any acquisitions could divert the attention of management, utilize scarce corporate resources and otherwise harm our business. These challenges are magnified as the size of an acquisition increases, and we cannot assure you that we will realize the intended benefits of any acquisition. For example, in September 2004 we discontinued the operation of our Xiran Division, which was formed in 2002 as a result of our acquisition of the assets of Irvine Networks, LLC. The Xiran Division developed advanced board-level solutions that optimize server performance for networked storage applications, including IP storage. We were unable to successfully bring the Xiran Division products to market after funding its operations for over two years. In connection with the discontinued operation, we recorded a one-time charge of approximately $3.0 million in the third quarter of 2004.

We are unable to predict whether or when any prospective acquisition candidate will become available or the likelihood that any acquisition will be completed. Even if we do find suitable acquisition opportunities, we may not be able to consummate the acquisitions on commercially acceptable terms or realize the anticipated benefits of any acquisitions we do undertake.

Three of our beneficial shareholders have substantial influence over our operations and could control all matters requiring shareholder approval.

Manouch Moshayedi, Mike Moshayedi and Mark Moshayedi, each of whom is an executive officer and director of SimpleTech, are brothers and beneficially own approximately 58.7% of our outstanding common stock at October 31, 2006 (assuming the inclusion of shares of common stock subject to options that are presently exercisable or will become exercisable within 60 days of such date). In addition, they have a non-binding understanding that at any shareholders meeting of SimpleTech where action is to be taken with respect to the election of directors, they each would cause the shares of SimpleTech common stock beneficially owned by them to be voted in favor of their election as directors. As a result, they have the ability to control all matters requiring approval by our shareholders, including the election and removal of directors,

approval of significant corporate transactions and the decision of whether a change in control will occur. This control could affect the price that certain investors may be willing to pay in the future for shares of our common stock.

We are involved from time to time in claims and litigation over intellectual property rights, which may adversely affect our ability to manufacture and sell our products.

The semiconductor industry is characterized by vigorous protection and pursuit of intellectual property rights. We believe that it may be necessary, from time to time, to initiate litigation against one or more third parties to preserve our intellectual property rights. Some of our suppliers and licensors have generally agreed to provide us with various levels of intellectual property indemnification for products and technology we purchase or license from them. A third-party could claim that our products, which incorporate the products purchased or technology licensed from our suppliers and licensors, infringes a patent or other proprietary right. In addition, from time to time, we have received, and may continue to receive in the future, notices that claim we have infringed upon, misappropriated or misused other parties proprietary rights. Any of the foregoing events or claims could result in litigation. Such

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litigation, whether as plaintiff or defendant, would likely result in significant expense to us and divert the efforts of our technical and management personnel, whether or not such litigation is ultimately determined in our favor. In the event of an adverse result in such litigation, we could be required to pay substantial damages, cease the manufacture, use and sale of certain products, expend significant resources to develop non-infringing technology, discontinue the use of certain processes or obtain licenses to use the infringed technology. In addition, our suppliers and licensors obligation to indemnify us for intellectual property infringement may be insufficient or inapplicable to any such litigation. A license may not be available on commercially reasonable terms, if at all. Our failure to obtain a license on commercially reasonable terms, or at all, could cause us to incur substantial costs and suspend manufacturing products using the infringed technology. If we obtain a license, we would likely be required to pay license fees or make royalty payments for sales under the license. Such payments would increase our costs of revenues and reduce our gross margins and gross profit. If we are unable to obtain a license from a third party for technology, we could incur substantial liabilities or be required to expend substantial resources redesigning our products to eliminate the infringement. There can be no assurance that we would be successful in redesigning our products or that we could obtain licenses on commercially reasonable terms, if at all. Product development or license negotiating would likely result in significant expense to us and divert the efforts of our technical and management personnel.

We are currently a party to one lawsuit regarding intellectual property as further described under Legal Proceedings. Because litigation is inherently uncertain, we cannot predict the outcome of this lawsuit. Although this lawsuit has been stayed pending the outcome of related lawsuits against other parties, we expect that if this lawsuit resumes, it is likely to divert the efforts and attention of our key management and technical personnel. In addition, we expect to incur substantial legal fees and expenses in connection with this lawsuit if it resumes. As a result, our defense of this lawsuit, regardless of its eventual outcome, is expected to be costly and time consuming.

Our Consumer Division depends on our third-party contract manufacturers and our business could be harmed if our contract manufacturers do not perform as expected.

Our Consumer Division relies on third-party contract manufacturers for the manufacture and assembly of certain our of DRAM, Flash and external storage products. From time- to- time, our contract manufacturers have experienced difficulty in meeting our requirements. If we are unable to increase the capacity of our current contract manufacturers or qualify and engage additional contract manufacturers, we may not be able to meet demand for our products. We do not have long-term contracts with our existing contract manufacturers nor do we expect to have long-term contracts with any new contract manufacturers. We cannot, and will not, be able to directly control product delivery schedules. Furthermore, we manufacture on a turnkey basis with some of our contract manufacturers. In these arrangements we do not have complete visibility and control of their inventories of purchased parts necessary to build our products or of the progress of our products through their assembly line. Any significant problems that occur at our contract manufacturers, or their failure to perform at the level we expect, could lead to product shortages or quality assurance problems, either of which would have adverse effects on our operating results.

To manage our growth, we may need to improve our systems, controls and procedures and relocate portions of our business to new or larger facilities.

We have experienced and may continue to experience rapid growth, which has placed, and could continue to place a significant strain on our managerial, financial and operations resources and personnel. We expect that our number of employees, including management-level employees, will continue to increase for the foreseeable future. We must continue to improve our operational, accounting and financial systems and managerial controls and procedures, including fraud procedures, and we will need to continue to expand, as well as, train and manage our workforce. From time- to- time, we may need to relocate portions of our business to new or larger facilities which could result in disruption of our business or operations. For example, we recently increased our manufacturing capacity by adding a third manufacturing shift at our corporate headquarters, and we announced in August 2006 plans to build a 200,000 square foot manufacturing facility in Malaysia that is expected to be operational in the first quarter of 2008. If we do not manage our growth effectively, including transitions to new or larger facilities, our business could be harmed.

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Our indemnification obligations for the infringement by our products of the intellectual property rights of others could require us to pay substantial damages.

As is common in the industry, we currently have in effect a number of agreements in which we have agreed to defend, indemnify and hold harmless our customers and suppliers from damages and costs which may arise from the infringement by our products of third-party patents, trademarks or other proprietary rights. The scope of such indemnity varies, but may, in some instances, include indemnification for damages and expenses, including attorneys fees. Our insurance does not cover intellectual property infringement. The term of these indemnification agreements is generally perpetual any time after execution of the agreement. The maximum potential amount of future payments we could be required to make under these indemnification agreements is unlimited. We may periodically have to respond to claims and litigate these types of indemnification obligations. Any such indemnification claims could require us to pay substantial damages.

Our indemnification obligations to our customers and suppliers for product defects could require us to pay substantial damages.

A number of our product sales and product purchase agreements provide that we will defend, indemnify and hold harmless our customers and suppliers from damages and costs which may arise from product warranty claims or claims for injury or damage resulting from defects in our products. We maintain insurance to protect against certain claims associated with the use of our products, but our insurance coverage may not be adequate to cover all or any part of the claims asserted against us. A successful claim brought against us that is in excess of, or excluded from, our insurance coverage could substantially harm our business, financial condition and results of operations.

Our intellectual property may not be adequately protected, which could harm our competitive position.

Our intellectual property is critical to our success. We protect our intellectual property rights through patents, trademarks, copyrights and trade secret laws, confidentiality procedures and employee disclosure and invention assignment agreements. It is possible that our efforts to protect our intellectual property rights may not:

Prevent the challenge, invalidation or circumvention of our existing patents;

Result in patents that lead to commercially viable products or provide competitive advantages for our products;

Prevent our competitors from independently developing similar products, duplicating our products or designing around the patents owned by us;

Prevent third-party patents from having an adverse effect on our ability to do business;

Provide adequate protection for our intellectual property rights;

Prevent disputes with third parties regarding ownership of our intellectual property rights;

Prevent disclosure of our trade secrets and know-how to third parties or into the public domain; and

Result in patents from any of our pending applications.

As part of our confidentiality procedures, we enter into non-disclosure and invention assignment agreements with all of our employees and attempt to control access to and distribution of our technology, documentation and other proprietary information. However, if such agreements are found to be unenforceable, we may be unable to adequately protect our intellectual property rights. In addition, despite these procedures, third parties could copy or otherwise obtain and make unauthorized use of our technologies or independently develop similar technologies.

In addition, if our IC Tower stacking patent is found to be invalid, our ability to exclude competitors from making, using or selling the same or similar products to our IC Tower stacking products would cease. We have on at least one occasion applied for and may in the future apply for patent protection in foreign countries. The laws of foreign countries, however, may not adequately protect our intellectual property rights. Many U.S. companies have encountered substantial infringement problems in foreign countries. Because we sell some of our products overseas, we have exposure to foreign intellectual property risks.

We may not be able to maintain or improve our competitive position because of the intense competition in the memory industry.

We conduct business in an industry characterized by intense competition, rapid technological change, evolving industry standards, declining average sales prices and rapid product obsolescence. Our primary competitors in the third-party memory module industry include: Crucial Memory, a division of Micron Technology, Kingston Technology, PNY Technologies, SanDisk, and SMART Modular. Our competitors include many large domestic and international companies that have substantially greater financial, technical, marketing, distribution and other resources, broader product lines, lower cost structures, greater brand

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recognition and longer-standing relationships with customers and suppliers. As a result, our competitors may be able to respond better to new or emerging technologies or standards and to changes in customer requirements. Further, some of our competitors are in a better financial and marketing position from which to influence industry acceptance of a particular industry standard or competing technology than we are. Our competitors may also be able to devote greater resources to the development, promotion and sale of products, and may be able to deliver competitive products at a lower price.

We expect to face competition from existing competitors and new and emerging companies that may enter our existing or future markets with similar or alternative products, which may be less costly or provide additional features. In addition, some of our significant suppliers, including Infineon Technology and Samsung Semiconductor, are also our competitors, many of whom have the ability to manufacture competitive products at lower costs as a result of their higher levels of integration. We also face competition from current and prospective customers that evaluate our capabilities against the merits of manufacturing products internally. Competition may arise due to the development of cooperative relationships among our current and potential competitors or third parties to increase the ability of their products to address the needs of our prospective customers. Accordingly, it is possible that new competitors or alliances among competitors may emerge and rapidly acquire significant market share.

We expect our competitors will continue to improve the performance of their current products, reduce their prices and introduce new products that may offer greater performance and improved pricing, any of which could cause a decline in sales or loss of market acceptance of our products. In addition, our competitors may develop enhancements to, or future generations of, competitive products that may render our technology or products obsolete or uncompetitive.

The Flash-based storage market is constantly evolving, and we may not have rights to manufacture and sell certain types of products utilizing emerging new Flash formats, or we may be required to pay a royalty to sell products utilizing these formats.

The Flash-based storage market is constantly undergoing rapid technological change and evolving industry standards. Many consumer devices, such as digital cameras, PDAs and smartphones, may transition to emerging Flash memory formats, which we do not currently manufacture and do not have rights to manufacture. This will likely result in a decline in demand, on a relative basis, for other products that we manufacture such as CompactFlash, Secure Digital, Mini-SD and MultiMedia cards. If we decide to manufacture Flash products utilizing emerging formats, we may be required to secure licensing arrangements to give us the right to manufacture such products which may not be available at reasonable rates or at all. If we are not able to supply all Flash card formats at competitive prices or if we were to have product shortages, our revenues could be adversely impacted and our customers would likely cancel orders or seek other suppliers to replace us.

The manufacturing of our OEM Division products is complex and subject to yield problems, which could decrease available supply and increase costs.

The manufacture of our OEM Division Flash memory products, stacked DRAM products and Flash controllers is a complex process, and it is often difficult for companies to achieve acceptable product yields. Reduced yields could decrease available supply and increase costs. Flash controller yields depend on both our product design and the manufacturing process technology unique to our semiconductor foundry partners. Because low yields may result from either design defects or process difficulties, we may not identify yield problems until well into the production cycle, when an actual product defect exists and can be analyzed and tested. In addition, many of these yield problems are difficult to diagnose and time consuming or expensive to remedy.

Our failure to successfully promote our brand and achieve strong brand recognition in target markets could limit or reduce the demand for our products and services in those markets.

We believe that brand recognition will be important to our ability of our Consumer Division to succeed as the digital media and external storage markets continue to develop. We plan to continue to invest in marketing programs to create and maintain prominent brand awareness. If we fail to promote our brand successfully, or if the expenses associated with doing so become increasingly high, our business may not grow as we anticipate. Some of our competitors, some of whom have significantly more resources to promote their own brands than we do, have been aggressively promoting their Flash and external storage product brands through various advertising campaigns, promotions and rebate programs. If we are unable to effectively maintain and build brand recognition for our products or if our products exhibit poor performance or other defects, our brand may be adversely affected, which would inhibit our ability to attract or retain customers.

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The execution of our growth strategy depends on our ability to retain key personnel, including our executive officers, and to attract qualified personnel.

Competition for employees in our industry is intense. We have had and may continue to have difficulty hiring the necessary engineering, sales and marketing and management personnel to support our growth. The successful implementation of our business model and growth strategy depends on the continued contributions of our senior management and other key research and development, sales and marketing and operations personnel, including Manouch Moshayedi, our Chief Executive Officer, Mike Moshayedi, our President, Mark Moshayedi, our Chief Operating Officer, Chief Technical Officer and Secretary, and Dan Moses, our Executive Vice President and Chief Financial Officer. In addition, as a result of our adoption of SFAS 123(R), we have begun to significantly reduce the use and quantity of stock options compared to the quantity of stock options we granted in recent years. We may be at a disadvantage in our ability to maintain and recruit qualified employees since many of the companies that compete with us for the same pool of qualified employees continue to offer stock options as part of their compensation package. We have experienced difficulties maintaining and attracting qualified employees as a result of our reduction in the use of stock options and we expect this difficulty to continue in the future unless we are able to develop other forms of incentive compensation to replace stock options. The loss of any key employee, the failure of any key employee to perform in his or her current position, or the inability of our officers and key employees to expand, train and manage our employee base would prevent us from executing our growth strategy.

We face risks associated with doing business in foreign countries, including foreign currency fluctuations and trade barriers, that could lead to a decrease in demand for our products or an increase in the cost of the components used in our products.

The volatility of general economic conditions and fluctuations in currency exchange rates affect the prices of our products and the prices of the components used in our products. International sales of our products accounted for 13.1% and 13.0% of our revenues for the three and nine months ended September 30, 2006, respectively, and 11.1% and 12.4% of our revenues for the three and nine months ended September 30, 2005, respectively. No foreign geographic area or single foreign country accounted for more than 10.0% of our revenues in the three and nine months ended September 30, 2006 or 2005. For the three and nine months ended September 30, 2006 and 2005, more than 95.0% of our international sales were denominated in U.S. dollars. However, if there is a significant devaluation of the currency in a specific country, the prices of our products will increase relative to that country s currency and our products may be less competitive in that country. In addition, we cannot be sure that our international customers will continue to be willing to place orders denominated in U.S. dollars. If they do not, our revenues and results of operations will be subject to foreign exchange fluctuations, which could harm our business. We do not hedge against foreign currency exchange rate risks.

We purchase a majority of the DRAM and Flash components used in our products from local distributors of foreign suppliers. Although our purchases of DRAM and Flash components are currently denominated in U.S. dollars, devaluation of the U.S. dollar relative to the currency of a foreign supplier would likely result in an increase in our cost of DRAM and Flash components.

Our international sales are subject to other risks, including regulatory risks, tariffs and other trade barriers, timing and availability of export licenses, political and economic instability, difficulties in accounts receivable collections, difficulties in managing distributors, lack of a significant local sales presence, difficulties in obtaining governmental approvals, compliance with a wide variety of complex foreign laws and treaties and potentially adverse tax consequences. In addition, the United States or foreign countries may implement quotas, duties, taxes or other charges or restrictions upon the importation or exportation of our products, leading to a reduction in sales and profitability in that country.

We have experienced quarterly and annual losses in the past and may experience losses in the future.

Although we have been profitable for most of our history, we have experienced losses on a quarterly and annual basis in the past. In 2003 and in the third quarter of 2004, we incurred net losses of $1.6 million and $1.9 million, respectively. We have expended, and will continue to expend, substantial funds to pursue engineering, research and development projects, enhance sales and marketing efforts, expand our international operations and increase our manufacturing capacity, and otherwise operate our business. There can be no assurance that we will be profitable on a quarterly or annual basis in the future.

Disruption of our operations in our Santa Ana, California, manufacturing facility would substantially harm our business.

Substantially all of our manufacturing operations are located in our facilities in Santa Ana, California. Due to this geographic concentration, a disruption of our manufacturing operations, resulting from sustained process abnormalities, human error, government intervention or natural disasters, including earthquakes, power failures, fires or floods, could cause us to cease or limit our manufacturing operations and consequently harm our business, financial condition and results of operations.

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Compliance with environmental laws and regulations could harm our operating results.

We are subject to a variety of environmental laws and regulations governing, among other things, air emissions, waste water discharge, waste storage, treatment and disposal, and remediation of releases of hazardous materials. Our failure to comply with present and future requirements could harm our ability to continue manufacturing our products. Such requirements could require us to acquire costly equipment or to incur other significant expenses to comply with environmental regulations. The imposition of additional or more stringent environmental requirements, the results of future testing at our facilities, or a determination that we are potentially responsible for remediation at other sites where problems are not presently known to us, could result in expenses in excess of amounts currently estimated to be required for such matters.

Failure to comply with governmental laws and regulations could harm our business.

Our business is subject to regulation by various federal and state governmental agencies. Such regulation includes the radio frequency emission regulatory activities of the Federal Communications Commission, the anti-trust regulatory activities of the Federal Trade Commission and Department of Justice, the consumer protection laws of the Federal Trade Commission, the import/export regulatory activities of the Department of Commerce, the product safety regulatory activities of the Consumer Products Safety Commission, the regulatory activities of the Occupational Safety and Health Administration, the environmental regulatory activities of the Environmental Protection Agency, the labor regulatory activities of the Equal Employment Opportunity Commission and tax and other regulations by a variety of regulatory authorities in each of the areas in which we conduct business. We are also subject to regulation in other countries where we conduct business. In certain jurisdictions, such regulatory requirements may be more stringent than in the United States. We are also subject to a variety of federal and state employment and labors laws and regulations, including the Americans with Disabilities Act, the Federal Fair Labor Standards Act, the WARN Act and other regulations related to working conditions, wage-hour pay, over-time pay, employee benefits, anti-discrimination, and termination of employment.

Noncompliance with applicable regulations or requirements could subject us to investigations, sanctions, mandatory product recalls, enforcement actions, disgorgement of profits, fines, damages, civil and criminal penalties, or injunctions. In addition from time to time we have received, and expect to continue to receive, correspondence from former employees terminated by us who threaten to bring claims against us alleging that we have violated one or more labor and employment regulations. In certain of these instances the former employee has brought claims against us and we expect that we will encounter similar actions against us in the future. An adverse outcome in any such litigation could require us to pay contractual damages, compensatory damages, punitive damages, attorneys fees and costs.

These enforcement actions could harm our business, financial condition, results of operations and cash flows. If any governmental sanctions are imposed, or if we do not prevail in any possible civil or criminal litigation, our business, financial condition, results of operations and cash flows could be materially adversely affected. In addition, responding to any action will likely result in a significant diversion of management s attention and resources and an increase in professional fees.

Our stock price is likely to be volatile and could drop unexpectedly.

Our common stock has been publicly traded only since September 2000. The market price of our common stock has been subject to significant fluctuations since the date of our initial public offering. The stock market has from time to time experienced significant price and volume fluctuations that have affected the market prices of securities, particularly securities of technology companies. As a result, the market price of our common stock may materially decline, regardless of our operating performance. In the past, following periods of volatility in the market price of a particular company s securities, securities class action litigation has often been brought against that company. We may become involved in this type of litigation in the future. Litigation of this type is often expensive and diverts management s attention and resources.

Anti-takeover provisions in our charter documents and stock option plan could prevent or delay a change in control and, as a result, negatively impact our shareholders.

We have taken a number of actions that could have the effect of discouraging a takeover attempt. For example, provisions of our amended and restated articles of incorporation and amended and restated bylaws could make it more difficult for a third party to acquire us, even if doing so would be beneficial to our shareholders. These provisions also could limit the price that certain investors might be willing to pay in the future for shares of our common stock.

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These provisions include:

- limitations on who may call special meetings of shareholders;
- advance notice requirements for nominations for election to the board of directors or for proposing matters that can be acted upon by shareholders at shareholder meetings;
- elimination of cumulative voting in the election of directors;
- the right of a majority of directors in office to fill vacancies on the board of directors;
- the ability of our board of directors to issue, without shareholder approval, blank check preferred stock to increase the number of outstanding shares and thwart a takeover attempt.

Provisions of our 2000 Stock Incentive Plan allow for the automatic vesting of all outstanding options granted under the 2000 Stock Incentive Plan upon a change in control under certain circumstances. Such provisions may have the effect of discouraging a third party from acquiring us, even if doing so would be beneficial to our shareholders.

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

None.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

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

None.

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS

Exhibit Number	Description
10.1[(1)]	Letter, dated August 25, 2006, from Malaysian Industrial Development Authority addressed to SimpleTech, Inc. offering special incentives (filed as an exhibit to the Company s Current Report on Form 8-K filed on August 30, 2006)

10.2[2]	SimpleTech, Inc. 2000 Stock Incentive Plan (as amended and restated through April 17, 2006) (filed as an exhibit to the Company s Registration Statement on Form S-8 (File No. 333-136505) filed on August 11, 2006)
31.1	Section 302 Certification of Chief Executive Officer
31.2	Section 302 Certification of Chief Financial Officer
32.1*	Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2*	Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

* The information in Exhibits 32.1 and 32.2 shall not be deemed filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended (the Exchange Act), or otherwise subject to the liabilities of that section, nor shall they be deemed incorporated by reference in any filing under the Securities Act of 1933, as amended, or the Exchange Act (including this Report), unless SimpleTech, Inc. specifically incorporates the foregoing information into those documents by reference.

[1] Portions of this exhibit have been omitted pursuant to a report for confidential treatment filed with the Securities and Exchange Commission.

[2] Management contract or compensatory plan or arrangement.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

SIMPLETECH, INC.,

a California corporation

Date: November 14, 2006

/s/ DAN MOSES
Dan Moses

Chief Financial Officer (Principal Financial

Officer and Duly Authorized Signatory)

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SIMPLETECH, INC.

Index to Exhibits

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