



Napo Pharmaceuticals, Inc.
 ("Napo" or "the Company")

Final Audited Results for the year ended December 31 2006- Reduction of Non-cash Stock-Based Compensation from Previously Released Preliminary Results

South San Francisco; June 15, 2007 – Napo Pharmaceuticals, Inc. (LSE: NAPL) announces today its audited final results for the year ended 31 December 2006.

The audited results differ from the unaudited preliminary results previously issued on 30 March 2007 as a result of a reduction in the estimation of the valuation per share used in the determination of non-cash stock-based compensation expense, which resulted in a reduction of approximately \$1.2 million in non-cash stock-based compensation.

Accordingly, the loss from operations in 2006 decreased to approximately US\$10.6 million from US\$11.8 million and the net loss attributable to common stockholders decreased to approximately US\$14.0 million from \$US15.2 million.

Those parts of the financial statements affected are set out below:

	Audited results	Preliminary results
Operating expense:		
General and administrative expense (a)	\$ 4,361,064	\$ 4,912,181
Research and development expense (b)	7,469,626	8,094,224
Total operating expense	11,830,690	13,006,405
Loss from operations	(10,592,246)	(11,767,961)
Net loss	(10,070,634)	(11,246,349)
Net loss attributable to common shareholders	(14,012,641)	(15,188,356)

Included in operating expense is non-cash, stock-based compensation as follows:

(a) General and administrative expense	239,559	790,676
(b) Research and development expense	767,437	1,392,035

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Our preliminary statement contains certain statements, statistics and projections that are or may be forward-looking (within the meaning of the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995. These statements are based on the current expectations or beliefs of Napo Pharmaceuticals, Inc. management and are subject to a number of factors and uncertainties, including the risk factors identified in Part II of Napo Pharmaceuticals, Inc.'s July 2006 Prospectus, and the outcome of events may differ materially from those described in the forward-looking statements). The accuracy and completeness of all such statements, including, without limitation, statements regarding the future financial position, strategy, projected costs, plans and objectives for the management of future operations of Napo and its subsidiaries is not warranted or guaranteed. These statements typically contain words such as "intends", "expects", "anticipates", "estimates" and words of similar import. By their nature, forward looking statements involve risk and uncertainty because they relate to events and depend on circumstances that will occur in the future. Although Napo believes that the expectations reflected in such statements are reasonable, no assurance can be given that such expectations will prove to be correct. There are a number of factors, which may be beyond the control of Napo, which could cause actual results and developments to differ materially from those expressed or implied by such forward-looking statements. Other than as required by applicable law or the applicable rules of any exchange on which our securities may be listed, Napo has no intention or obligation to update forward-looking statements contained herein.

Finance Review

Summary of Results of Operations

Consolidated income statement

For the year ended 31 December 2006

	Years Ended 31 December	
	<u>2005</u>	<u>2006</u>
Revenue	8,973	1,238,444
Operating expenses:		
Cost of revenue:	37	
General & administrative (1)	2,090,909	4,361,064
Research & development (2)	1,297,076	7,469,626
Total operating expenses	<u>3,388,022</u>	<u>11,830,690</u>
Loss from operations	(3,379,049)	(10,592,246)
Other income, net	65,200	181,165
Interest (exp.) income, net	(22,758)	340,447
Net loss	<u>(3,336,607)</u>	<u>(10,070,634)</u>
Deemed dividends		(3,942,007)
Net loss attributable to common stockholders	(3,336,607)	(14,012,641)
Non-cash stock based compensation expense included in operating expenses:		
General & administrative (1)	31,949	239,559
Research & development (2)	15,762	767,437
Basic and diluted net loss per common share US\$	(\$82.42)	(\$0.83)
Basic and diluted net loss per common share GBP	(£42.09)	(£0.41)
Shares used in basic and diluted net loss per common share calculation	40,484	16,925,408

Comparison of Years Ended 31 December 2006 and 2005

Revenue. Revenue in the year ended 31 December 2006 was approximately US\$1.2 million as compared to US\$9,000 in the year ended 31 December 2005. In 2006, Napo received a US\$1 million milestone payment from Trine Pharmaceuticals, Inc., which in 2004 licensed crofelemer for the indication of diarrhoea-predominant IBS (CRO-IBS) worldwide. The milestone payment was associated with Trine's initiation of a Phase 2b trial for CRO-IBS. Additionally, Napo received a contract revenue of approximately US\$244,000 from a grant from the National Institutes of Health – National Institute of Allergy and Infectious Diseases associated with the development of a formulation of crofelemer for cholera. Milestone and contract revenue of approximately US\$1,244,000 was partially offset by the write off of another revenue item which reduced total revenue to approximately US\$1,238,000.

General and Administrative Expenses. General and administrative expenses were approximately US\$4.4 million in the year ended 31 December 2006 compared to US\$2.1 million in the year ended 31 December 2005. General and administrative expenses increased in the year ended 31 December 2006 as a result of higher employee headcount and higher compensation, employee recruiting activities as well as increased costs associated with Napo's public offering including travel, public relations and other legal

costs. Included in general and administrative expenses were non-cash compensation charges of US\$240,000 associated with the grant of incentive equity options compared to \$32,000 in the year ended 31 December 2005

Research and Development. Research and development expenses were approximately US\$7.5 million in the year ended 31 December 2006 compared to US\$1.3 million in the year ended 31 December 2005. Research and development expenses increased significantly in 2006 with the addition of additional employees and consultants in the areas of manufacturing and clinical development in preparation for the pivotal Phase 3 trial for CRO-HIV and the cholera trial which began in March 2006. In addition to personnel, there were higher costs associated with preparations for the manufacture of active pharmaceutical ingredient, formulation and related activities. Research and development employees increased to thirteen at the end of 2006 from four at the end of 2005. Included in research and development expenses were non-cash compensation charges of US\$767,000 associated with the grant of incentive equity options compared to US\$16,000 in the year ended 31 December 2005.

Other income, net. Other income in the year ended 31 December 2006 was approximately US\$181,000 compared to US\$65,200 in the year ended 31 December 2005. Other income in 2006 included a gain on a settlement with a third party regarding damages to property held in storage of US\$172,000, while the other income item of US\$65,000 in the year ended 31 December 2005 was due to an insurance recovery on damaged property.

Net Interest. Net interest *income* in the year ended 31 December 2006 was approximately US\$340,000 compared to net interest *expense* of US\$23,000 in the year ended 31 December 2005. The interest income in 2006 was due to higher net cash balances while the net interest expense in the year ended 31 December 2005 was associated with interest expense on US\$1.1 million series C convertible notes which converted to Series C Preferred Shares in July 2005.

Deemed dividends. In the year ended 31 December 2006, Napo incurred non-cash charges of approximately US\$3.9 million associated with the issuance of Series C Convertible Preferred Stock in the months prior to Napo's initial public offering.

Net loss attributable to common stockholders. The net loss attributable to common stockholders in the year ended 31 December 2006 was approximately US\$14.0 million compared to US\$3.3 million in the year ended 31 December 2005, reflecting significant increases in research and development activity and higher levels of general and administrative expenses associated with increased operating activities and as well as Napo's initial public offering and non cash compensation charges and deemed dividends.

Cash Flow and Liquidity

In the year ended 31 December 2006, cash used in operating activities was US\$7.2 million and cash used to purchase property and equipment was US\$481,000. Net cash provided by financing activities was \$26.2 million, including:

- US\$2.7 million from the sale of Series C Convertible Preferred Stock
- US\$1.3 million from the exercise of warrants to purchase common stock
- US\$2.9 million from the issuance of the Optionally Convertible Redeemable Preference Shares
- US\$369,000 from the issuance of common stock
- US\$38,000 from the exercise of stock options
- US\$18.9 million from net IPO proceeds

On 31 July 2006, upon the initial public offering of our common stock on the Main Market of the London Stock Exchange, we issued 14,300,048 shares of our common stock at an offering price of 83 pence or US\$1.54 per share for gross proceeds of approximately \$21.9 million. Cash proceeds from the sale, net of underwriters' discount and offering expenses, totaled approximately US\$18.9 million.

In December 2006 and January 2007, Napo issued 3,150,914 shares of common stock including 124,271 shares to advisors at 94.5 pence or \$US1.85 per share for gross proceeds of US\$5.6 million and received a conditional commitment for additional funds of US\$900,000, \$300,000 of which was received in May 2007 and the remaining \$600,000 will not be received.

As of 31 December 2006 Napo had cash of US\$19.7 million and no bank borrowings.

Cash at the beginning of the year was US\$1.2 million.

There was no capitalised interest in either period.

Earnings Per Share and Dividends

The net loss per common share in the year ended 31 December 2006 was US\$0.83 or £0.41 GBP. Napo does not plan to pay any dividends in the foreseeable future, if ever.

The closing market price of the Company's shares at the end of the financial year was 94.5 pence (31 December 2006): and the range of market prices during the year was between 83 pence and 96.5 pence.

Credit Risk

Napo holds significant cash balances which are invested on a short-term basis. These deposits and other financial instruments give rise to credit risk on amounts due from counterparties. Credit risk is managed by limiting the aggregate amount and duration of the exposure to any one counterparty by reference to its credit rating. Counterparties are chosen based on yield, availability of funds, credit rating and quality of service.

The maximum maturity of the portfolio may not exceed 36 months with the average maturity not to exceed 18 months. Eligible investment includes US treasury securities, asset-backed securities with a minimum rating of AAA, and A-1 rated money market instruments.

Consolidated Balance Sheets

	2006	2005
	\$	\$
Assets		
Cash and cash equivalents	920,704	1,183,991
Short-term investments	18,803,881	—
Stock subscriptions receivable	599,998	—
Prepaid expenses and deposits	36,856	44,313
Other current assets	221,712	67,572
Total current assets	<u>20,583,151</u>	<u>1,295,876</u>
Property and equipment, net	425,961	51,865
Patent, net	111,109	138,889
Total Assets	<u><u>21,120,221</u></u>	<u><u>1,486,630</u></u>
Liabilities and Stockholders' Equity		
Accounts payable	414,060	135,447
Accrued compensation	535,415	255,299
Other current liabilities	1,350,206	3,632
Total current liabilities	<u>2,299,681</u>	<u>394,378</u>
Convertible redeemable preference shares (Optionally convertible, redeemable preference shares, 1 Indian Rupee par value, 3,529,412 shares authorized, issued and outstanding, aggregate liquidation preference of US\$5,710,830)	5,710,830	—
Commitments and Contingencies (Note 4)		
Stockholders' Equity		
Convertible preferred stock, \$0.0001 par value, 30,000,000 shares authorised:		
Series A: 6,030,000 shares designated, 5,858,350 shares issued and outstanding at 31 December 2005 and 2004, aggregate liquidation preference of \$1,756,333	—	1,759,335
Series B: 7,000,000 shares designated, 6,999,233 shares issued and outstanding at 31 December 2005 and 2004, aggregate liquidation preference of \$3,499,617	—	3,459,001
Series C: 15,000,000 shares designated, 5,260,017 shares issued and outstanding at 31 December 2005, aggregate liquidation preference of \$5,516,016	—	4,451,029
Common stock: \$0.0001 par value, 90,000,000 shares authorised; 39,910,222 shares issued and outstanding at 31 December 2006; 40,484 shares issued and outstanding at 31 December 2005 and 2004	3,991	4

Common stock subscribed	49	—
Stock subscriptions receivable	(300,000)	—
Accumulated other comprehensive loss	(7,658)	—
Additional paid-in capital	36,328,335	325,249
Deficit accumulated during the development stage	(22,915,007)	(8,902,366)
Total Stockholders' Equity	<u>13,109,710</u>	<u>1,092,252</u>
Total Liabilities and Stockholders' Equity	<u><u>21,120,221</u></u>	<u><u>1,486,630</u></u>

See summary of accounting policies and notes to consolidated financial statements.

Consolidated Statements of Operations

	Year Ended 31 December			Period from Inception (15 November 2001) through 31 December 2006
	2006	2005	2004	2006
	\$	\$	\$	\$
Revenue	1,238,444	8,973	1,088,793	2,561,838
Operating expenses:				
Cost of revenue	—	37	52,054	194,601
General and administrative expense(1)	4,361,064	2,090,909	1,370,642	9,728,355
Research and development expense(2)	7,469,626	1,297,076	1,305,405	11,772,143
Total operating expenses	11,830,690	3,388,022	2,728,101	21,695,099
Loss from operations	(10,592,246)	(3,379,049)	(1,639,308)	(19,133,261)
Gain from insurance recovery	172,051	—	—	—
Interest (expense) income, net	340,447	(22,758)	(108,972)	85,947
Other income, net	9,114	65,200	—	74,314
Net loss	(10,070,634)	(3,336,607)	(1,748,280)	(18,973,000)
Deemed dividends	(3,942,007)	—	—	(3,942,007)
Net loss attributable to common stockholders	(14,012,641)	(3,336,607)	(1,748,280)	(22,915,007)
Basic and diluted net loss per common share	0.83	82.42	49.18	
Basic and diluted net loss per common share (pounds)	0.41	42.09	25.12	
Shares used in basic and diluted net loss per common share calculation	16,925,408	40,484	35,552	
Included in operating expenses is noncash stock-based compensation as follows:				
(1) General and administrative expense	239,559	31,949	137,517	461,903
(2) Research and development expense	767,437	15,762	37,638	872,732

See summary of accounting policies and notes to consolidated financial statements.

Statement of Stockholder's Equity, Optionally Convertible Redeemable Preference Shares ("OCRPS") and Accumulated Other Comprehensive Income

	OCRPS		Common Stock		Common Stock Subscribed		Stock Subscriptions	Paid-in	Series A Preferred Stock		Series B Preferred Stock		Series C Preferred Stock		Accumulated	Accumulated Other Comprehensive	Stockholders'
	Shares	Amount	Shares	Amount	Shares	Amount	Receivable	Capital	Shares	Amount	Shares	Amount	Shares	Amount	Deficit	Income	Equity
		\$		\$		\$	\$	\$		\$		\$		\$	\$	\$	\$
Issuance of common stock in December 2001 for cash			9,378	1				277									278
Issuance of Series A preferred stock at \$0.2998 per share for cash									750,000	225,000							225,000
Issuance of Series A preferred stock to pay predecessor expenses at \$0.2998 per share, net issuance costs of \$10,150									1,932,341	569,169							569,169
Issuance of common stock warrants for services								2,503									2,503
Issuance of series A warrants for services										3,002							3,002
Issuance of common stock for cash at \$0.03 per share			11,106	1				336									337
Issuance of Series A preferred stock at \$0.2998 per share in June 2002, net issuance costs of \$3,543									3,176,009	962,164							962,164
Compensation recognized under incentive stock option plans								31,602									31,602
Net loss from inception through 31 December 2002															(1,845,358)		(1,845,358)
Balances at 31 December 2002			20,484	2				34,718	5,858,350	1,759,335					(1,845,358)		(51,303)
Compensation recognized under incentive stock option plans								67,667									67,667
Net loss															(1,972,121)		(1,972,121)
Balances at 31 December 2003			20,484	2				102,385	5,858,350	1,759,335					(3,817,479)		(1,955,757)

See summary of accounting policies and notes to financial statements.

(Continued)

	OCRPS		Common Stock		Common Stock Subscribed		Stock Subscriptions	Paid-in	Series A Preferred Stock		Series B Preferred Stock		Series C Preferred Stock		Accumulated	Accumulated Other Comprehensive	Stockholders'
	Shares	Amount	Shares	Amount	Shares	Amount	Receivable	Capital	Shares	Amount	Shares	Amount	Shares	Amount	Deficit	Income	Equity
		\$		\$		\$	\$	\$		\$		\$		\$	\$	\$	\$
Balances at 31 December 2003			20,484	2				102,385	5,858,350	1,759,335					(3,817,479)		(1,955,757)
Issuance of common stock in exchange for services			20,000	2			600										602
Issuance of common stock warrants in exchange for services in March and April 2004							4,117										4,117
Issuance of Series B preferred stock at \$0.50 per share, including conversion of short-term notes payable										6,999,233	3,459,001						3,459,001
Issuance of common stock warrants with preferred stock							115,585										115,585
Compensation recognized under incentive stock option plans							54,851										54,851
Net loss															(1,748,280)		(1,748,280)
Balances at 31 December 2004			40,484	4				277,538	5,858,350	1,759,335	6,999,233	3,459,001			(5,565,759)		(69,881)
Issuance of common stock warrants in exchange for services in February and September 2005							5,705										5,705
Issuance of Series C preferred stock from July through December 2005 at \$0.85 per share, net of issuance costs of \$24,185												5,260,017	4,451,029				4,451,029
Compensation recognized under incentive stock option plans							42,006										42,006
Net loss															(3,336,607)		(3,336,607)
Balances at 31 December 2005			40,484	4				325,249	5,858,350	1,759,335	6,999,233	3,459,001	5,260,017	4,451,029	(8,902,366)		1,092,252

See summary of accounting policies and notes to financial statements.

(Continued)

	OCRPS		Common Stock		Common Stock Subscribed		Stock Subscriptions	Paid-in	Series A Preferred Stock		Series B Preferred Stock		Series C Preferred Stock		Accumulated	Accumulated Other Comprehensive	Stockholders'
	Shares	Amount	Shares	Amount	Shares	Amount	Receivable	Capital	Shares	Amount	Shares	Amount	Shares	Amount	Deficit	Income	Equity
		\$		\$		\$	\$	\$		\$		\$		\$	\$	\$	\$
Balances at 31 December 2005			40,484	4				325,249	5,858,350	1,759,335	6,999,233	3,459,001	5,260,017	4,451,029	(8,902,366)		1,092,252
Issuance of Series C preferred stock net of issuance costs													3,135,291	2,654,110			2,654,110
Conversion of preferred stock into common stock on initial public offering			21,352,958	2,135				13,582,517	(5,958,417)	(1,789,335)	(6,999,233)	(3,459,001)	(8,395,308)	(8,336,316)			
Issuance of common stock in connection with option exercises			1,247,090	124				38,039									38,163
Issuance of common and preferred stock upon warrant exercises			2,569,036	257				1,315,761	100,067	30,000							1,346,018
Compensation recognized under incentive stock option plans								981,060									981,060
Issuance of OCRPS, net of issuance costs of \$141,979	3,529,412	2,858,021															
Deemed dividend on OCRPS		2,294,118													(2,294,118)		(2,294,118)
Accretion of OCRPS		416,712													(416,712)		(416,712)
Recognition of issuance costs on issuance of OCRPS		141,979						(141,979)									(141,979)
Preferred stock deemed dividend													1,231,177	(1,231,177)			
Issuance of common stock in 2006 for cash, net of issuance costs of \$139,981			400,606	41				368,989									369,030
Issuance of common stock for cash in connection with initial public offering, net of issuance costs of \$2,216,707			14,300,048	1,430				18,932,814									18,934,244
Common stock issuable for cash					324,727	32		599,966									599,998
Common stock issuable under subscription agreements					170,482	17	(300,000)	299,983									
Issuance of warrants								25,936									25,936
Unrealized loss on investments																(7,658)	(7,658)
Net loss															(10,070,634)		(10,070,634)
Comprehensive loss																	(10,078,292)
Balances at 31 December 2006	3,529,412	5,710,830	39,910,222	3,991	495,209	49	(300,000)	36,328,335							(22,915,007)	(7,658)	13,109,710

See summary of accounting policies and notes to financial statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS

	<i>Year Ended 31 December</i>			<i>Period from Inception (15 November 2001) through</i>
	<i>2006</i>	<i>2005</i>	<i>2004</i>	<i>2006</i>
	\$	\$	\$	\$
Operating Activities				
Net loss	(10,070,634)	(3,336,607)	(1,748,280)	(18,973,000)
Adjustments to reconcile net loss to net cash used in operating activities:				
Depreciation and amortization	134,445	49,130	36,423	277,281
Stock based compensation expense	1,006,996	47,711	175,155	1,334,635
Issuance of preferred stock to pay predecessor expenses	—	—	—	569,169
Changes in assets and liabilities:				
Prepaid expenses and deposits	7,457	8,358	(3,743)	(36,856)
Other current assets	(154,140)	(19,708)	(46,786)	(221,712)
Accounts payable	278,613	4,466	(39,692)	414,060
Accrued compensation	280,116	(187,657)	(201,423)	535,415
Other current liabilities	1,346,574	32,322	781	1,350,206
Total Cash Used in Operating Activities	<u>(7,170,573)</u>	<u>(3,401,985)</u>	<u>(1,827,565)</u>	<u>(14,750,802)</u>
Investing Activities				
Purchase of property and equipment	(480,761)	(37,863)	(38,375)	(563,750)
Purchase of short-term investments	(27,715,339)	—	—	(27,715,339)
Sale of short-term investments	8,903,800	—	—	8,903,800
Purchase of patent	—	—	—	(250,600)
Total Cash Used in Investing Activities	<u>(19,292,300)</u>	<u>(37,863)</u>	<u>(38,375)</u>	<u>(19,625,889)</u>
Financing Activities				
Proceeds from issuance of common stock on initial public offering	18,934,244	—	—	18,934,244
Proceeds from issuance of convertible redeemable preference shares, net	2,858,021	—	—	2,858,021
Proceeds from issuance of short-term notes	—	—	170,000	2,456,000
Proceeds from exercise of preferred and common stock warrants	1,346,018	—	—	1,346,018
Sale of preferred stock for cash	2,654,110	4,250,806	1,129,385	9,295,304
Sale of common stock for cash	369,030	—	—	369,645
Proceeds from stock option exercises	38,163	—	—	38,163
Total Cash Provided by Financing Activities	<u>26,199,586</u>	<u>4,250,806</u>	<u>1,299,385</u>	<u>35,297,395</u>
Net increase (decrease) in cash	(263,287)	810,958	(566,555)	920,704
Cash and cash equivalents, beginning of period	1,183,991	373,033	939,588	—
Cash and Cash Equivalents, end of period	<u>920,704</u>	<u>1,183,991</u>	<u>373,033</u>	<u>920,704</u>

	Year Ended 31 December			Period from Inception (15 November 2001) through 2006
	2006	2005	2004	2006
	\$	\$	\$	\$
Supplemental Schedule of Cash Flow Information:				
Cash paid for:				
Interest	—	—	—	—
Income taxes	—	—	—	—
Supplemental Schedule of Non-Cash Investing and Financing Activities:				
Conversion of preferred stock in connection with initial public offering	13,584,652	—	—	13,584,652
Deemed dividend on optionally convertible redeemable preference shares	2,294,118	—	—	2,294,118
Accretion of optionally convertible redeemable preference shares	416,712	—	—	416,712
Deemed dividend on preferred stock	1,231,177	—	—	1,231,177
Issuance of common stock under subscription agreements	900,000	—	—	900,000
Issuance of preferred stock as repayment of short-term notes	—	170,000	2,286,000	2,456,000
Interest paid with preferred stock	—	30,224	43,616	73,840

See summary of accounting policies and notes to consolidated financial statements.

SUMMARY OF ACCOUNTING POLICIES AND NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Organization, Business and Basis of Presentation

Napo Pharmaceuticals, Inc. ("Napo", "the Company", "us", "we", or "our") was incorporated on 15 November 2001 in Delaware and is focused on licensing, developing and commercializing proprietary specialty pharmaceuticals for the global marketplace in collaboration with partners. We are currently developing our proprietary product, crofelemer, for gastrointestinal indications such as diarrhoea-predominant Irritable Bowel Syndrome (D-IBS), chronic diarrhoea in people living with HIV/AIDS (AIDS diarrhoea), pediatric diarrhoea and acute infectious diarrhoea. We operate in one segment.

We are considered to be in the development stage as, since inception, our activities have consisted primarily of acquiring the rights to crofelemer, raising capital, attracting employees, establishing facilities, performing research and development, entering into agreements with other entities for the development and commercialization rights to crofelemer and the analysis of our collection of plant samples for bioactive molecules which could result in potential new drug candidates. Revenue received from inception to date includes initial license payments as discussed below and miscellaneous sales of non-core product obtained through the purchase of certain Shaman Pharmaceutical, Inc. assets also discussed below.

The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States and include the accounts of the Company and its wholly owned subsidiaries. All significant inter-company balances and transactions have been eliminated in consolidation.

The accompanying consolidated financial statements have been prepared assuming that we will continue as a going concern. At 31 December 2006, we had an accumulated deficit of approximately US\$22.9 million and expect to incur substantial losses over the next several years while we continue in the development stage. Our operations are subject to certain risks and uncertainties frequently encountered by companies in the early stages of operations, particularly in the evolving market for small biotech and specialty pharmaceuticals companies. Such risks and uncertainties include, but are not limited to, timing and uncertainty of achieving milestones in clinical trials and in obtaining approvals by the Food and Drug Administration (the "FDA") and regulatory agencies in other countries, not only by us, but by our licensees as well. Our ability to generate revenues in the future will depend substantially on the timing and success of reaching development milestones and in obtaining regulatory approvals and market acceptance of our products, assuming the FDA and similar regulatory authorities in other countries, approves our new drug applications.

We plan to meet our future capital requirements primarily through issuances of equity securities (both in the private and public markets), payments under collaborative agreements with third parties, government grants, and license fees. We intend to seek additional funding through public or private equity or debt financing, when market conditions allow. There can be no assurance that we will be able to enter into financing arrangements on acceptable terms in the future, if at all.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires our management to make judgments, assumptions and estimates that affect the amounts reported in our consolidated financial statements and the accompanying notes. Actual results could differ materially from those estimates. Significant estimates include, but are not limited to, valuation of stock based compensation, impairment of long lived assets, impairment of intangible assets and valuation of deferred tax assets.

Concentration of Credit Risk

The financial instruments that potentially subject the Company to a concentration of credit risk are cash equivalents and short-term investments. The counterparty to the agreement relating to the Company's investment securities is a financial institution of high credit standing. We consider all highly liquid instruments with a maturity of three months or less to be cash equivalents. We place our cash with a high-credit quality financial institution. Cash is generally in excess of FDIC insurance limits. We are exposed to credit risk in the event of default by the financial institution holding the cash to the extent of the amount recorded on the balance sheet.

Cash and Cash Equivalents

The Company considers all highly liquid investments with an original maturity from date of purchase of 90 days or less to be cash equivalents for the purpose of balance sheet and statement of cash flows presentation. The carrying value of cash and cash equivalents approximates estimated market value at 31 December 2006.

Short-Term Investments

All short-term investments are classified as available-for-sale and therefore carried at estimated fair value based on quoted market prices. All investments are highly liquid (can be liquidated in less than one month) with a ready market. The Company views its available-for-sale portfolio as available for use in its current operations. Accordingly, all investments are classified as short-term, even though the stated maturity date may be one year or more beyond the current balance sheet date. Available-for-sale securities are stated at estimated fair value based upon the quoted market price of the securities. Unrealized gains and losses on such securities are reported as a separate component of stockholders' equity. Realized gains and losses on available-for-sale securities are included in interest income/expense. The cost of securities sold is based on the specific identification method. Interest and dividends on securities classified as available-for-sale are included in interest income.

The following table summarizes the maturities of the Company's investments at 31 December 2006 (US\$):

	Amortized Cost	Gross Unrealized Losses	Fair Value
Less than 1 year	6,436,963	3,721	6,433,410
Due 1-2 years	6,274,576	3,937	6,270,471
Due in 2036	3,000,000	—	3,000,000
Due in 2037	1,900,000	—	1,900,000
Due in 2038	1,200,000	—	1,200,000
Total	<u>18,811,539</u>	<u>7,658</u>	<u>18,803,881</u>

Intangible Asset

In accordance with the provisions of Statement of Financial Accounting Standards ("SFAS") No. 142, *Goodwill and Intangible Assets*, we perform an annual impairment test for the intangible asset. If the carrying amount is in excess of the fair value, an impairment loss will be recorded. No impairment has been recorded through the date of these financial statements.

The purchased intangible asset represents a composition of matter patent on crofelemer. A composition of matter patent affords patent protection on the novel chemical structure of crofelemer, previously undescribed in the scientific literature. The purchased intangible asset is carried at cost, net of accumulated amortization and is amortized over its remaining estimated useful life of nine years; being the remaining legal patent life without extensions.

Property and Equipment

Property and equipment are stated at cost, less accumulated depreciation. Depreciation is calculated using the straight-line method over the estimated useful lives of the assets; generally three years.

Impairment of Long-Lived Assets

In accordance with the provisions of Statement of Financial Accounting Standards ("SFAS") No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, we review long-lived assets, including property and equipment, for impairment whenever events or changes in business circumstances indicate that the carrying amount of the assets may not be fully recoverable. Under SFAS No. 144, an impairment loss would be recognized when estimated undiscounted future cash flows expected to result from the use of the asset and its eventual disposition are less than its carrying amount. Impairment, if any, is assessed using discounted cash flows or other appropriate measures of fair value. Through 31 December 2006, there have been no such losses.

Foreign Currency Translation

Napo translates the assets and liabilities of its foreign subsidiaries to US\$ at the rates of exchange in effect at the end of the period. Expenses are translated using rates of exchange in effect during the period.

Research and Development Expenses

Research and development expenses consist of expenses incurred in performing research and development activities including related salaries, clinical trial and related drug product costs, contract services and other outside service expenses. Research and development expenses are charged to operating expense in the period incurred.

We are currently conducting a trial for crofelemer for the indication of cholera. This trial is being conducted at the International Center for Diarrhoeal Disease in Bangladesh. Approximately 60 patients have been treated since March 2006. Additionally, we are preparing for a phase 3 trial for crofelemer for the indication of diarrhoea associated with HIV/AIDS

Income Taxes

Napo uses the liability method for income taxes as required by SFAS No. 109, *Accounting for Income Taxes*. Under this method, deferred tax assets and liabilities are determined based on differences between financial reporting and tax reporting bases of assets and liabilities and are measured using enacted tax rates and laws that are expected to be in effect when the differences are expected to reverse. Currently there is no provision for income taxes as we have incurred net losses since inception. To date, we have no history of earnings. Therefore, our net deferred tax assets are reduced by a valuation allowance to the extent that realization of the related deferred tax asset is not assured. We have recorded a valuation allowance for the full amount of our calculated deferred tax asset.

Basic and Diluted Net Loss Per Common Share

Basic net loss per common share is computed by dividing net loss by the weighted-average number of common shares outstanding during the period. The computation of basic net loss per share for all periods presented is derived from the information on the face of the statements of operations, and there are no reconciling items in either the numerator or denominator.

Diluted net loss per common share is computed as though all potential common shares that are dilutive were outstanding during the year, using the treasury stock method for the purposes of calculating the weighted-average number of dilutive common shares outstanding during the period. Potential dilutive common shares consist of shares issuable upon exercise of

stock options and warrants. We have excluded 8,724,630, 7,633,306, and 6,607,616 shares from the diluted net loss calculation for the years ended 31 December 2006, 2005 and 2004, respectively, because their inclusion would have been anti-dilutive.

Revenue Recognition

Napo has a federal government research grant which provides for the reimbursement of qualified expenses for research and development related to a cholera study, as defined under the terms of the grant agreement. Revenue under this grant agreement is recognized when the related qualified research expenses are incurred. Grant reimbursements are received on a quarterly or monthly basis and are subject to the issuing agency's right of audit. During the year ended 31 December 2006, we recognized US\$243,850 of revenue under this grant.

Milestone payments under research, partnering, or licensing agreements are recognized as revenue upon the achievement of mutually agreed upon milestones, provided that (i) the milestone event is substantive and its achievement is not reasonably assured at the inception of the agreement, and (ii) there are no performance obligations associated with the milestone payment.

Stock-Based Compensation

Effective 1 January 2002, we adopted the preferable fair value recognition provisions of SFAS No. 123, *Stock-Based Compensation*. In December 2004, the Financial Accounting Standards Board "FASB" issued SFAS No. 123(R), *Share-Based Payment*, which is a revision of SFAS No. 123. SFAS 123(R) supercedes Accounting Principles Board ("APB") Opinion No. 25, *Accounting for Stock Issued to Employees*, and amends SFAS No. 95, *Statement of Cash Flows*. SFAS 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values at the date of grant and to record that cost as compensation expense over the period during which the employee is required to perform service in exchange for the award (generally over the vesting period of the award). Excess tax benefits, as defined by SFAS 123(R), will be recognized as an addition to additional paid-in capital.

We have calculated stock-based compensation expense using the Black-Scholes option valuation model and included the portion of share-based payment awards that is ultimately expected to vest during future periods. At this time, we do not anticipate any additional forfeitures in the foreseeable future. However, in the event that there are forfeitures, estimates will be revised to reflect actual experience. Stock-based compensation expense is recognized on a straight-line basis.

Recent Accounting Pronouncements

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*, which provides guidance for using fair value to measure assets and liabilities. The pronouncement clarifies (1) the extent to which companies measure assets and liabilities at fair value; (2) the information used to measure fair value; and (3) the effect that fair value measurements have on earnings. SFAS No. 157 will apply whenever another standard requires (or permits) assets or liabilities to be measured at fair value. SFAS No. 157 is effective for the Company as of 1 January 2008. The Company is currently evaluating the impact this statement will have on our consolidated financial statements.

In June 2006, the FASB issued FASB Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes, an interpretation of SFAS No. 109, Accounting for Income Taxes*. The interpretation contains a two-step approach to recognizing and measuring uncertain tax positions accounted for in accordance with SFAS No. 109. The provisions are effective for the Company as of 1 January 2007. The Company is currently evaluating the impact this statement will have on our consolidated financial statements.

Notes to the Consolidated Financial Statements

1. Acquisition of Shaman Assets

In December 2001, we acquired certain assets of Shaman Pharmaceuticals, Inc. (“Shaman”) pursuant to a court ordered sale of such assets. Shaman Pharmaceuticals had previously filed for bankruptcy protection under Chapter 11 of the United States Bankruptcy Code. The purchase price for the Shaman assets was US\$250,000 in cash, US\$100,000 of which was loaned to us by an officer of Napo and subsequently repaid by issuing to that officer 333,555 shares of Series A preferred stock. We also incurred US\$149,559 in costs to related and unrelated parties. The assets purchased included data from clinical trials previously conducted by Shaman, in-process research and development activities and materials as well as intellectual property. We have assigned the US\$250,000 purchase price to the “composition of matter” patent for Crofelemer issued in the United States and acquired as part of the Shaman assets. We are amortizing the purchase price for the Shaman assets over the remaining 9 year life of the patent, from 1 January 2002. The patent expires in 2011.

2. License and Other Agreements

Milestone Revenue

In June 2004, we entered into an agreement with Trine Pharmaceuticals, Inc. (“Trine”) regarding certain development responsibilities and commercialization rights of crofelemer, including worldwide development and commercialization rights for IBS and HIV. In accordance with this agreement, Trine was required to make a US\$1,000,000 cash milestone payment at the earlier of six months from the final study report or the initiation of the enrollment of a Phase 2b study. Trine initiated such enrollment in October 2006 and subsequently paid us US\$1,000,000. This amount has been recorded as revenue in these consolidated financial statements.

Revenue from the License or Assignment of Intellectual Property Rights

We recognize revenue from the license or assignment of intellectual property rights to third parties, including development milestone payments associated with such agreements if we have received the funds, we have delivered the rights to the property, and have no further obligations under the agreements in accordance with the date(s) when the payment has been received. In June 2004, we recognized US\$950,000 of license revenue from the grant of a license to Trine Pharmaceuticals, Inc. for the worldwide development and commercialization rights to Crofelemer for the indication of D-IBS.

Royalty Revenue

We entered into licensing agreements with AsiaPharm Group Ltd, based in the Peoples Republic of China and Glenmark Pharmaceuticals Limited, based in Mumbai, India, for the license of Crofelemer for the indications of AIDS-related diarrhoea, acute infectious diarrhoea and pediatric diarrhoea in their respective territories. AsiaPharm Group, through its subsidiary, AsiaPharm Investments Ltd., invested in our Series C preferred stock as did Glenmark Pharmaceuticals. We have recognized no royalty revenue from these licenses.

3. Property and Equipment

Property and equipment consists of the following (US\$):

	31 December	
	2006	2005
Lab equipment	513,186	42,530
Office equipment	49,265	39,160
Furniture and fixtures	1,299	1,299
	<u>563,750</u>	<u>82,989</u>
Less accumulated depreciation	(137,789)	(31,124)
Property and equipment, net	<u>425,961</u>	<u>51,865</u>

4. Leases and Commitments

The Company entered into a lease agreement in November 2004 for office space under a noncancelable operating lease. This noncancelable operating lease expired in November 2006. The Company currently rents office space on a month to month basis.

Rent expense under the operating lease for the years ended 31 December 2006, 2005 and 2004 amounted to US\$188,790, US\$161,935, and US\$15,091, respectively.

We have at-will employment agreements with certain of our employees that provide severance payments, including healthcare benefits to be paid in the event of a change of control of Napo, defined in the agreements as a transaction where more than 50 *per cent* of the total combined voting power of our outstanding securities changes ownership, whereby pursuant to a change of control any of the following occur: (i) the employment of these employees is not maintained; (ii) their compensation is changed; (iii) their job title is changed; or (iv) the geographic location of their workplace is changed.

The severance payments vary in length from 6 months to 12 months of the employee's then current level of compensation, including healthcare benefits, as set by the board of directors. As of 31 December 2006, the cost of such severance would equal approximately, US\$1.1 million.

Our licensing agreements with licensees provide for indemnification and hold harmless from all claims or damages arising from its licensing of Napo patent or sales of related products except for negligent acts by the licensee.

License Agreement with Michael Tempesta

The Company has entered into a license agreement dated 16 October 2002 with Michael Tempesta. This agreement settled disputes with Dr. Tempesta relating to previous license arrangements between Shaman or the Company and Dr. Tempesta. The agreement provides for the payment of a royalty to Dr. Tempesta of between 2 *per cent* and 4 *per cent* of net sales of products containing Crofelemer or any derivative thereof obtained from any species of the Croton plant. "Product" for the purposes of calculating royalties is defined as all products for the treatment, maintenance or improvement of human health which are prescription medicines, botanicals, dietary supplements sold for the treatment of diarrhoea, Irritable Bowel Syndrome ("IBS") or herpes. This excludes cosmetic products, non-medicinal agricultural products and products for non-human animal health.

Healing Forest Conservancy

The Company has entered into an agreement with the Healing Forest Conservancy (“HFC”) pursuant to which the Company has issued to HFC 30,000 common shares in Napo at a purchase price of \$0.0001 each and has agreed to pay 2 *per cent* of the net profit derived from the sale of all of its products to HFC once Napo has achieved net profits after tax over a consecutive period of 6 months. The aim of Napo’s arrangement with HFC is, amongst other things, (i) to promote the conservation of the biological diversity of tropical forests, particularly medicinal plants (ii) to promote the survival of cultural diversity of tropical forest peoples, and in particular, their traditional knowledge of medicinal plants, (iii) to develop and implement a process to return financial benefits from net profits made on certain products to collaborating countries and cultural groups, (iv) to promote initiatives addressing total community health for developing and emerging communities; and (v) to lead efforts to encourage sustainable global communication and participation from other organizations, including corporate, non-governmental organizations, governmental agencies, and others.

5. Stockholders’ Equity

Initial Public Offering

On 31 July 2006, upon the initial public offering of our common stock on the Main Market of the London Stock Exchange, we issued 14,300,048 shares of our common stock at an offering price of US\$1.54 per share. At that time, all of our Series A, B and C Convertible Preferred Stock automatically converted into 21,352,958 shares of common stock. Cash proceeds from the sale, net of underwriters’ discount and offering expenses, totalled approximately US\$18.9 million. Total shares of Napo common stock outstanding under accounting principles generally accepted in the United States immediately subsequent to the IPO were 39,536,282.

Common Stock

90,000,000 shares of Common Stock are authorized, with a par value of US\$0.0001 per share. We have reserved shares of our common stock for future issuance as follows:

	<i>31 December 2006</i>
Stock options outstanding	7,683,225
Stock options available for future grant	5,569,685
Warrants to purchase common stock	99,104
	<u>13,352,014</u>

In December 2006, we entered into subscription agreements to sell 757,707 shares of common stock to various investors at approximately US\$1.85 per share, for aggregate consideration of approximately US\$1,260,019, net of issuance costs of US\$139,981. Of the approximate total of US\$1,400,000 cash proceeds received or to be received from the investors, approximately US\$500,000 was received in December 2006, approximately US\$600,000 was received in January 2007 and approximately US\$300,000 had yet to be received as of 31 December 2006. As of 31 December 2006, no common stock has been issued under these subscription agreements, the conditions of which had not been fulfilled.

Preferred Stock

Series A

On 14 December 2001 we sold 2,682,341 shares of Series A Preferred Stock to a group of investors at US\$0.2998 per share for cash and to pay predecessor expenses.

During 2002 we sold an additional 3,176,009 shares of Series A Preferred Stock to a group of investors at US\$0.2998 per share for cash.

During 2002, we issued warrants to purchase 100,067 shares of Series A Preferred Stock at US\$0.2998, valued at US\$3,002, to our outside counsel for legal fees. These warrants were exercised at the time of the Company's initial public offering.

Series B

In March 2004 we sold 4,659,233 shares of Series B Convertible Preferred Stock to investors, including 87,233 shares issued in lieu of interest incurred of US\$43,616. In connection with this investment, we issued the investors warrants to purchase 2,329,616 shares of common stock at US\$0.50 per share, valued at US\$107,508. These warrants were exercised at the time of the Company's initial public offering.

In September 2004 an additional 2,340,000 shares of Series B Convertible Preferred Stock were sold to investors. In connection with this investment, we issued the investors warrants to purchase 175,000 shares of common stock at US\$0.50 per share, valued at US\$8,077. These warrants were exercised at the time of the Company's initial public offering.

Series C

In a series of transactions beginning in December 2004 and ending in June 2005, we raised US\$1,090,000 through the issuance of convertible notes to a group of investors. These notes bore interest at 5 *per cent* with interest payable in the form of Series C Convertible Preferred Stock.

In September 2005, all of the convertible notes converted to 1,317,911 shares of Series C Convertible Preferred Stock at US\$0.85 per share, including 35,558 shares of Series C Convertible Preferred Stock issued in lieu of cash interest.

Additionally, we issued 2,973,557 shares of Series C Convertible Preferred Stock at US\$0.85 per share in September 2005 to a group of investors for cash. In addition, as per our agreement with a finder, we issued fully vested and immediately exercisable warrants, valued at US\$5,705, to purchase 90,000 shares of common stock at US\$0.85 per share. These warrants expire in 2010. As of 30 June 2006, none of these warrants have been exercised. Subsequently, by 31 December 2005, we sold an additional 968,549 shares of Series C Convertible Preferred Stock at US\$0.85 per share. These warrants were exercised at the time of the Company's initial public offering.

In February 2006, we issued 1,241,174 shares of Series C Convertible Preferred Stock at US\$0.85 per share in February 2006 for aggregate consideration of US\$1,055,000.

In April 2006, we issued 1,894,117 shares of Series C Preferred Stock at US\$0.85 per share to third-parties for consideration of US\$1,550,000 in cash and services which the Company valued at US\$60,000, for total aggregate consideration of US\$1,610,000. In connection with this issuance, Napo recorded a deemed dividend to those preferred shareholders that purchased Series C Preferred Stock in April 2006 of US\$1,231,177.

Optionally Convertible, Redeemable, Non-Cumulative, Non-Participating Preference Shares

On 19 April 2006, IL&FS Investment Managers Limited ("IL&FS"), invested US\$3 million in Napo India Private Limited ("Napo India"), a company organized by us for the purpose of this investment and our ongoing activity in India, in exchange for 100 shares of Napo India and 3,529,412 optionally convertible, redeemable, non-cumulative, non-participating preference shares of Napo India having a par value of Rupee One ("OCRPS"). Napo India subsequently invested the US\$3 million invested by IL&FS in our Series C Preferred Stock at US\$0.85 per share pursuant to a subscription

agreement dated 19 April 2006.

Subsequent to Napo India's investment in our Series C Preferred stock, we bought 10,000 Shares of Napo India from the existing shareholders of Napo India, and Napo India became an approximately 99 *per cent* owned subsidiary of ours. These consolidated financial statements include the accounts of Napo India at 31 December 2006.

The OCRPSs held by IL&FS have a term of four (4) years from the completion of the subscription as set forth in the Subscription Agreement or the earliest to occur of (x) the due date of the OCRPSs (y) IL&FS receiving the Liquidity Amount (being the net proceeds received by Napo India from the sale of shares of our Common Stock) and (z) the occurrence of a change in Indian law permitting, under applicable law, IL&FS to own and hold shares of Series C Preferred Stock, and after which Napo India sells our Series C Preferred Stock to IL&FS.

The OCRPSs have a redemption premium that yields for IL&FS an internal rate of return of 20 *per cent* per annum on their US\$3,000,000 investment, calculated from the date of the investment in Napo India until the date of actual receipt by IL&FS of the redemption of the OCRPSs. This redemption premium resulted in deemed dividends of \$416,712 during the year ended 31 December 2006. In addition, it was determined that there was a beneficial conversion feature associated with the OCRPS due to the fair value of the company's common stock being more than the price per share paid by the investor for the OCRPS. As such, we recorded a deemed dividend of \$2,294,118.

Warrants

In September 2006, we issued fully vested and immediately exercisable warrants to a consultant to purchase 15,625 shares of common stock at US\$1.80, valued at \$25,936, and recorded as additional paid-in capital. These warrants are exercisable for three years from 15 September 2006. As of 31 December 2006, none of these warrants have been exercised.

Stock Options

The Napo Pharmaceuticals, Inc. 2001 Equity Incentive Plan (the "2001 Plan"), provides for grants of incentive and nonqualified stock options, restricted stock awards, and stock bonuses to our employees, directors and consultants. Under the 2001 Plan, the total number of shares originally reserved and available for grant was 2,600,000. As a result of a series of amendments which were approved by the stockholders, the number of shares reserved and either granted or available for grant as of 31 December 2006 is 8,500,000. Under the 2001 Plan, incentive stock options may be granted at a price per share not less than the fair market value at the date of grant, and nonqualified stock options may be granted at a price per share not less than 85 *per cent* of the fair market value at the date of grant. If, at the time we grant an option, the optionee owns stock possessing more than 10 *per cent* of the total combined voting power of all classes of stock of the Company, the option price shall be 110 *per cent* of the fair market value of the shares of the date of grant. Options granted generally have a maximum term of ten years from the grant date and become exercisable over two to three years. As of 31 December 2006, there were options to purchase 6,868,225 shares outstanding under the 2001 Plan and 1,631,775 shares available for future grant.

The Napo Pharmaceuticals, Inc. 2006 Equity Incentive Plan (the "2006 Plan"), provides for grants of incentive and nonqualified stock options, restricted stock awards, and stock bonuses to our employees, directors and consultants. Under the 2006 Plan, the total number of shares reserved and available for grant is 6,000,000, not to exceed 10% of the outstanding common stock of the Company. Under the 2006 Plan, incentive and nonqualified stock options may be granted at a price per share not less than the fair market value at the date of grant. If, at the time we grant an option, the optionee owns stock possessing more than 10 *per cent* of the total combined voting power of all classes of stock of the Company, the option price shall be 110 *per cent* of the fair market value of the shares of the date of grant. Options granted generally have a maximum term of ten years from the grant date and become exercisable over two to three years. As of 31 December 2006, there were options to purchase 815,000 shares outstanding under the 2006 Plan and 5,185,000 shares available for future grant.

The application of the Black-Scholes option valuation model (see Summary of accounting policies) involves the use of assumptions that are judgmental and sensitive in the determination of stock-based compensation expense. Expected price volatility is based on historical data and industry experience. The key assumptions used in determining the fair value of options granted during the years ended 31 December 2006, 2005 and 2004 are as follows:

	<i>Years ended 31 December</i>		
	<i>2006</i>	<i>2005</i>	<i>2004</i>
Expected price volatility	267%	267%	267%
Risk-free interest rate	4.52%	4.42%	4.22%
Weighted average expected life in years	10	10	10
Dividend yield	—	—	—

A summary of activity under the Plans is as follows:

	<i>Outstanding Options</i>		
	<i>Shares Available for Grant</i>	<i>Number of Shares</i>	<i>Weighted-Average Price Per Share</i>
Balances at 31 December 2002	902,316	1,697,684	\$0.043
Additional shares authorized	1,700,000	—	—
Options granted	(2,550,251)	2,550,251	\$0.045
Balances at 31 December 2003	52,065	4,247,935	\$0.044
Additional shares authorized	1,600,000	—	—
Options granted	(480,212)	480,212	\$0.059
Balances at 31 December 2004	1,171,853	4,728,147	\$0.046
Options granted	(443,924)	443,924	\$0.085
Balances at 31 December 2005	727,929	5,172,071	\$0.049
Additional shares authorized	8,600,000	—	—
Options granted	(4,033,349)	4,033,349	\$0.594
Options exercised	—	(1,247,090)	\$0.031
Options forfeited	275,105	(275,105)	\$0.180
Balances at 31 December 2006	5,569,685	7,683,225	\$0.333

The following table summarizes information about stock options outstanding at 31 December 2006:

<i>Exercise Prices</i>	<i>Outstanding Options</i>		
	<i>Number Outstanding at 31 December 2006</i>	<i>Weighted-Average Remaining Contract Life</i>	<i>Options Vested at 31 December 2006</i>
\$0.030	1,026,156	5.69	1,026,156
\$0.050	2,153,425	7.03	2,136,530
\$0.085	574,136	8.42	432,252
\$0.170	1,044,685	9.01	493,218
\$0.300	83,478	5.35	83,478
\$0.340	1,886,345	9.31	981,682
\$0.850	100,000	9.46	100,000
\$1.730	300,000	9.59	58,185
\$1.800	515,000	9.76	74,950
	<u>7,683,225</u>	8.08	<u>5,386,451</u>

The following table summarizes information about stock options outstanding at 31 December 2005:

<i>Exercise Prices</i>	<i>Outstanding Options</i>		
	<i>Number Outstanding at 31 December 2005</i>	<i>Weighted-Average Remaining Contract Life</i>	<i>Options Vested at 31 December 2005</i>
\$0.030	2,235,746	6.60	2,232,274
\$0.050	2,278,711	8.05	1,569,844
\$0.085	574,136	9.42	174,552
\$0.300	83,478	6.35	83,478
	<u>5,172,071</u>	7.55	<u>4,060,148</u>

The following table summarizes information about nonvested stock options at 31 December 2006 and changes during the year ended 31 December 2006:

<i>Nonvested Shares</i>	<i>Shares</i>	<i>Weighted Average Grant Date Fair Value</i>
Balance at 31 December 2005	1,111,923	\$0.063
Granted	4,033,349	\$0.291
Vested	(2,573,393)	\$0.213
Forfeited	(275,105)	\$0.180
Balance at 31 December 2006	<u>2,296,774</u>	\$0.281

The weighted-average fair value of options granted during the years ended 31 December 2006, 2005 and 2004 was US\$0.586, US\$0.085, US\$0.059, respectively. The weighted average grant date fair value of options vested at 31

December 2006 was US\$0.174. The weighted-average fair value of options granted during the period from inception (15 November 2001) through 31 December 2006 was US\$0.285. The weighted average exercise price of options vested at 31 December 2006 was US\$0.174. There was no aggregate intrinsic value of options vested at 31 December 2006. There was no aggregate intrinsic value of options exercised as of the date of exercise during the year ended 31 December 2006. Cash received from the exercises was \$38,163.

As of 31 December 2006, there was US\$1,746,927 of total unrecognized compensation cost related to nonvested options granted under the Plans. That cost is expected to be recognized over a weighted average period of 2.3 years.

6. 401(k) Plan

In April 2005, we adopted a Tax Deferred Savings Plan under Section 401(k) of the Internal Revenue Code (the "Plan") for all full-time employees. Under the Plan, our eligible employees can contribute amounts to the Plan via payroll withholding, subject to certain limitations. Our matching contributions to the Plan are discretionary and can only be made in cash. To date, we have made no employer contributions to the plan.

7. Income Taxes

The Company's provision for income taxes is comprised of the following:

	<i>For the year ended 31 December,</i>		
	<i>2006</i>	<i>2005</i>	<i>2004</i>
	<i>\$</i>	<i>\$</i>	<i>\$</i>
Current:			
Federal	—	—	—
State	800	800	800
Foreign	—	—	—
Total current income taxes	<u>800</u>	<u>800</u>	<u>800</u>
Deferred:			
Federal	(4,032,077)	(1,130,829)	(621,798)
State	(794,267)	(194,004)	(132,320)
Total deferred income taxes	<u>(4,826,344)</u>	<u>(1,324,833)</u>	<u>(754,118)</u>
Valuation Allowance	(4,826,344)	(1,324,833)	(754,118)
Provision for income taxes	<u>800</u>	<u>800</u>	<u>800</u>

The provision for income taxes differs from the amount of income tax determined by applying the applicable statutory federal income tax rate to pretax loss as a result of the following:

	<i>For the year ended 31 December,</i>		
	<i>2006</i>	<i>2005</i>	<i>2004</i>
	<i>%</i>	<i>%</i>	<i>%</i>
Statutory federal tax rate	(34.0)	(34.0)	(34.0)
State taxes	(7.9)	(5.8)	(7.6)
Research credits	(2.2)	—	(1.7)
Change in valuation allowance	47.9	39.7	43.2
Non-cash compensation	(3.1)	—	—
Other	(.7)	0.1	0.1
Total provision for income taxes	<u>0.0</u>	<u>0.0</u>	<u>0.0</u>

Deferred tax assets are comprised of the following:

	<i>31 December,</i>	
	<i>2006</i>	<i>2005</i>
	\$	\$
Capitalized research and patents	87,103	89,173
Non deductible reserves and accruals	179,021	—
Credit carryforwards	433,888	59,825
Loss carryforwards	6,722,375	3,301,957
Deferred compensation	906,834	131,595
Other	95,324	15,650
Gross deferred tax assets	<u>8,424,545</u>	<u>3,598,200</u>
Valuation allowance	(8,424,545)	(3,598,200)
Net deferred tax assets	<u>—</u>	<u>—</u>

Based on the available objective evidence, including cumulative losses since inception and expected future losses, the Company has determined that it is more likely than not that the entire deferred tax asset amount will not be realized, and therefore, a valuation allowance has been provided on all net deferred tax assets.

The increase in the valuation allowance for deferred tax assets of approximately \$3.5 million in 2006 is primarily attributable to increases in net operating loss and increase to research tax credits.

At 31 December 2006, the Company had \$17.1 million and \$15.4 million of federal and state net operating loss carryforwards, respectively, available to offset future taxable income. The federal and state net operating loss carryforwards will expire between 2012 and 2022, if not utilized.

At 31 December 2006, the Company had approximately \$247,000 and \$283,000 of federal and state research credit carryovers, respectively, available to offset future taxable income. The federal credits begin to expire in 2022 and state research credits carry forward indefinitely.

Utilization of the Company's net operating loss and tax credit carryforwards may be subject to a substantial annual limitation due to the ownership change limitations provided by the United States Internal Revenue Code and similar state provisions. Such an annual limitation could result in the expiration or elimination of the net operating loss and tax credit carryforwards before utilization.

8. Subsequent Events

In January 2007, we sold 2,431,300 shares of common stock to an investor at US\$1.85 per share. Total cash proceeds were approximately US\$4,266,000, net of issuance costs of approximately US\$232,000.