MUNIHOLDINGS NEW JERSEY INSURED FUND INC
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[LOGO] Merrill Lynch Investment Managers

Annual Report

July 31, 2002

MuniHoldings
New Jersey
Insured Fund, Inc.

www.mlim.ml.com

MuniHoldings New Jersey Insured Fund, Inc.

The Benefits and Risks of Leveraging

MuniHoldings New Jersey Insured Fund, Inc. utilizes leverage to seek to enhance the yield and net asset value of its Common Stock. However, these objectives cannot be achieved in all interest rate environments. To leverage, the Fund issues Preferred Stock, which pays dividends at prevailing short-term interest rates, and invests the proceeds in long-term municipal bonds. The interest earned on these investments is paid to Common Stock shareholders in the form of dividends, and the value of these portfolio holdings is reflected in the per share net asset value of the Fund's Common Stock. However, in order to benefit Common Stock shareholders, the yield curve must be positively sloped; that is, short-term interest rates must be lower than long-term interest rates. At the same time, a period of generally declining interest rates will benefit Common Stock shareholders. If either of these conditions change, then the risks of leveraging will begin to outweigh the benefits.

To illustrate these concepts, assume a fund's Common Stock capitalization of $100 million and the issuance of Preferred Stock for an additional $50 million, creating a total value of $150 million available for investment in long-term municipal bonds. If prevailing short-term interest rates are approximately 3% and long-term interest rates are approximately 6%, the yield curve has a strongly positive slope. The fund pays dividends on the $50 million of Preferred Stock based on the lower short-term interest rates. At the same time, the fund's total portfolio of $150 million earns the income based on long-term interest rates. Of course, increases in short-term interest rates would reduce (and even eliminate) the dividends on the Common Stock.

In this case, the dividends paid to Preferred Stock shareholders are significantly lower than the income earned on the fund's long-term investments, and therefore the Common Stock shareholders are the beneficiaries of the incremental yield. However, if short-term interest rates rise, narrowing the differential between short-term and long-term interest rates, the incremental yield pickup on the Common Stock will be reduced or eliminated completely. At the same time, the market value of the fund's Common Stock (that is, its price as listed on the New York Stock Exchange) may, as a result, decline. Furthermore, if long-term interest rates rise, the Common Stock's net asset value will reflect the full decline in the price of the portfolio's investments, since the value of the fund's Preferred Stock does not fluctuate. In addition to the decline in net asset value, the market value of the fund's Common Stock may also decline.

As a part of its investment strategy, the Fund may invest in certain securities whose potential income return is inversely related to changes in a floating interest rate ("inverse floaters"). In general, income on inverse floaters will decrease when short-term interest rates increase and increase when short-term interest rates decrease. Investments in inverse floaters may be characterized as derivative securities and may subject the Fund to the risks of reduced or eliminated interest payments and losses of investment principal. In addition, inverse floaters have the effect of providing investment leverage and, as a result, the market value of such securities will generally be more volatile than that of fixed rate, tax-exempt securities. To the extent the Fund invests in inverse floaters, the market value of the Fund's portfolio and the net asset value of the Fund's shares may also be more volatile than if the Fund did not invest in these securities.

The Fund may also invest in swap agreements, which are over-the-counter contracts in which one party agrees to make periodic payments based on the change in market value of a specified bond, basket of bonds, or index in return for periodic payments based on a fixed or variable interest rate or the change in market value of a different bond, basket of bonds or index. Swap agreements may be used to obtain exposure to a bond or market without owning or taking physical custody of securities.

TO OUR SHAREHOLDERS

For the 12-month period ended July 31, 2002, the Common Stock of MuniHoldings New Jersey Insured Fund, Inc. earned $0.871 per share income dividends, which included earned and unpaid dividends, of $0.073. This represents a net annualized yield of 5.85%, based on a year-end net asset value of $14.90 per share. During the same period, the total investment return on the Fund's Common Stock was +9.16%, based on a change in per share net asset value from $14.54 to $14.90, and assuming reinvestment of $0.864 per share ordinary income dividends.

For the six-month period ended July 31, 2002, the Fund's Common Stock had a total investment return of +6.31%, based on a change in per share net asset value from $14.47 to $14.90, and assuming reinvestment of $0.438 per share ordinary income dividends.

For the six-month period ended July 31, 2002, the Fund's Auction Market Preferred Stock had an average yield as follows: Series A, 1.17%; Series B, 1.23%; Series C, 1.25%; Series D, 1.19%; and Series E, 1.27%.

The Municipal Market Environment

During the six-month period ended July 31, 2002, the direction of long-term fixed income interest rates was driven as much by volatile U.S. equity markets and continued worldwide political tensions as by economic fundamentals. In early 2002, economic indicators were mixed, signaling some strength in consumer spending and housing-related industries, but further declines in manufacturing employment. The index of leading economic indicators generally rose in late 2001 and early 2002, suggesting that economic activity was likely to expand later in the year. Furthermore, in February 2002, U.S. gross domestic product (GDP) growth for the fourth quarter of 2001 was revised higher to 1.7%, signaling significantly improving economic conditions relative to earlier in 2001. These positive economic fundamentals, however, were largely offset by U.S. equity market volatility. The initial disclosure of accounting irregularities at Enron Corporation in early February exacerbated earlier equity volatility. At the end of February 2002, long-term U.S. Treasury bond yields were approximately 5.40%.

In early March 2002, a number of economic indicators, including surging existing home sales, solid consumer spending and positive non-farm payroll growth following several months of job losses, suggested U.S. economic activity was continuing to strengthen. Also, in Congressional testimony, Federal Reserve Board Chairman Alan Greenspan was cautiously optimistic regarding future U.S. economic growth, noting that while any increase in activity was likely to be moderate, "an economic expansion (was) well underway." These factors combined to push U.S. equity prices higher and bond prices sharply lower in expectation of a reversal of the Federal Reserve Board's actions taken during the past 15 months. By the end of March 2002, long-term U.S. Treasury bond yields stood at 5.80%, their highest level in over 18 months.

During the past few months, however, bond yields reversed course to move sharply lower. Positive economic fundamentals were again overwhelmed by falling equity valuations and declines in investor confidence. U.S. GDP activity in the first quarter of 2002, while recently revised downward to 5%, was considerably above the level of economic growth seen at the end of 2001. Additionally, a number of economic indicators, such as housing activity, consumer spending and weekly unemployment claims, have pointed to at least a modest economic recovery by the end of 2002. However, steady dramatic declines in U.S. equity markets have convinced most investors to conclude recently that the Federal Reserve Board is unlikely to increase short-term interest rates for the remainder of the year. U.S. Treasury issue prices have been boosted by erupting Middle East and India/ Pakistan conflicts, as many international investors prefer the safe haven status of U.S. Treasury securities. At June 30, 2002, long-term U.S. Treasury bond yields had declined to 5.50%.

In late July, U.S. GDP growth for the second quarter of 2002 was initially estimated at 1.1%. While subject to considerable revision, this initial estimate suggested that continued declines in U.S. equity prices were negatively affecting not only consumer, but business confidence as well, and undermining the economic growth witnessed earlier this year. Some analysts have extrapolated that recent weakness will continue, if not accelerate. This brought about forecasts that the Federal Reserve Board may soon be obliged to lower short-term interest rates both to offset equity market declines and boost consumer and business spending. The possibility of lower short-term interest rates helped push longer-term bond yields lower still during late July. At July 31, 2002, U.S. Treasury bond yield levels had fallen to 5.30%, a decline of approximately 15 basis points (0.15%) during the six-month period ended July 31, 2002.

During the period, municipal bond prices also generally rose. In early 2002, tax-exempt bond yields traded in a relatively narrow range as an increasingly positive technical position supported existing municipal bond prices. In March, however, increased economic activity and associated concerns regarding near-term Federal Reserve Board actions also pushed tax-exempt bond prices lower. By late March, long-term municipal revenue bond yields, as measured by the Bond Buyer Revenue Bond Index, had risen to 5.67%, their highest level in over a year. During recent months, tax-exempt bond yields have generally declined largely in response to the positive fixed income environment engendered by falling equity valuations. The municipal bond market's recent price advances have also been bolstered by the continued improvement in the tax-exempt market's technical position. Despite sizeable advances in the rate of new municipal bond issuance, investor demand has increased in recent months, allowing tax-exempt bond prices to rise. By the end of July 2002, long-term municipal revenue bond yields stood at 5.34%, a decline of over 30 basis points from their recent highs in March.

Solid investment demand during the six-month period ended July 31, 2002 allowed the tax-exempt market to outperform its taxable counterpart in recent months. The Investment Company Institute reported that thus far in 2002, municipal bond fund net cash flows have remained very strong at over $7.7 billion, up more than 60% compared to the same period in 2001. Additionally, this past January and February, investors received nearly $50 billion in investment proceeds from coupon income, bond maturities and early redemptions. Given the recent weakness in U.S. equity markets, much of these monies were likely reinvested in tax-exempt products. Perhaps more importantly, short-term municipal interest rates have continued to move lower in response to the Federal Reserve Board's actions. In reaction to Federal Reserve Board interest rate reductions, short-term municipal rates have declined to the 1% - 1.5% range. As interest rates have declined, investors have extended maturities to take advantage of the steep municipal bond yield curve. Also, it is forecast that investors will have received from June to August approximately an additional $75 billion from bond maturities, proceeds from early bond redemptions and coupon income. Given the lack of strong investment alternatives, it is likely that these monies will continue to support the municipal bond market's currently strong technical environment.

Recent outperformance by the tax-exempt market has been even more impressive considering the increase in new bond issuance seen thus far in 2002. Throughout the past six months, more than $165 billion in new long-term municipal bonds was issued, an increase of nearly 20% compared to the same period in 2001. More than $100 billion in long-term tax-exempt securities was underwritten during the July quarter, an increase of over 33% compared to the July 2001 quarter's level. Recent months' issuance has been dominated by a number of issues each of whose size has exceeded $1 billion. While these mega-deals have caused some temporary price disruptions, imbalances have been short-lived as these underwritings have been attractively priced and in-state demand has been very strong. Apart from the mega-deals, increased issuance has been well received as investor demand for the tax-advantaged, non-equity securities has been strong.

In the coming months, we believe interest rates are likely to remain volatile with an expected upward bias. However, until equity market conditions stabilize, interest rates could stay near their present historically low levels. While recent stock market declines appear to have

negatively affected economic growth in July 2002, business activity is likely to accelerate going forward. Governmental stimulus in response to the September 11, 2001 attacks has been significant. The ongoing U.S. military response to worldwide terrorism has helped reduce a once-sizable Federal surplus to a material deficit. Further military action in early 2003 would only result in increased Federal spending, higher deficits and increased Treasury financing. Increased Federal borrowings can be expected to put upward pressure on interest rates going forward.

Equity market declines have helped push interest rates to lower levels than economic fundamentals alone would support. When U.S. equity markets stabilize and economic activity resumes, associated interest rate increases should not be extreme. Inflationary pressures have remained well contained, meaning that significant interest rate increases are unlikely. As equity valuations are likely to only gradually recover, the U.S. economic recovery is also likely to be a moderate process. Similarly, this suggests that the pace of any interest rate increases would be gradual. As the municipal bond market's strong technical position can be expected to remain supportive in the coming months, future tax-exempt interest rate increases should be more restrained than their taxable counterparts.

Portfolio Strategy

Despite further market gains during the six months ended July 31, 2002, a competitive distribution yield largely offset the Fund's more defensive investment stance that we recently adopted. In positioning the Fund for higher interest rates, some potential gains were sacrificed in exchange for a lower degree of interest rate risk and volatility. We undertook a number of measures to accomplish this goal, including a reduction in the average maturity of the Fund and the implementation of a modest hedge employing 10-year U.S. Treasury note futures. While cash reserves were minimal for the period, more than 65% of the Fund's holdings are set to mature in less than 20 years. Our decision to allocate Fund assets accordingly reflected the shape of the municipal yield curve and our recognition that approximately 90%-95% of the yield available on 30-year municipal bonds can be derived by investing in the 15-year - 20-year sector. In light of a generally cautious investment outlook, this appeared to be a reasonable tradeoff, given the lower degree of interest rate risk achieved by investing in shorter maturities.

With the foregoing strategy in mind, our efforts were also directed toward maintaining the Fund's competitive income distribution by modestly raising the credit risk profile of the Fund. This was accomplished through selective increases in exposure to low investment-grade health care bonds. Municipal credit spreads remain attractive compared to historical averages and, within the context of a recovering economy, represent a good value and should offer solid total return prospects in coming months. In addition, many of the Fund's housing bonds were subject to prepayment calls that occur when individuals holding the underlying mortgages refinance or sell their homes. These bond redemptions typically happen at an inopportune time when interest rates are low. As such, reinvestment of the proceeds generally entails accepting a reduced income stream; however, given the favorable risk/reward ratio presently in the market, the effect of these prepayments on the overall Fund was limited by reinvesting in low investment-grade municipal bonds. Nevertheless, we continued to be mindful of the relatively conservative approach mandated by the Fund's investment restrictions. At July 31, 2002, 91% of the Fund's assets were insured and were rated AAA by at least one of the major rating agencies. We implemented our strategy as a means to capture perceived value in the marketplace and as such we did not reflect a departure from past practices.

The State of New Jersey's general obligation rating has been downgraded by both Moody's Investor Service and Standard & Poor's and presently stands at Aa2 and AA, respectively. These actions, taken within the last six months, reflect a deteriorating fiscal situation brought about by declining revenue projections amidst sluggish economic growth. Balancing the budget for fiscal 2002 required a significant reduction in the state's available general fund reserves that will likely reduce fiscal flexibility in later years. While Moody's maintains a negative outlook, both rating agencies cite such underlying fundamental strengths as a highly educated workforce and a diverse economic base as reason to be optimistic about the state's economic prospects over the long term.

Caution is expected to continue to characterize the Fund's investment stance during the next six months as prospects for heavy new-issue municipal volume will put pressure on a market expected to weaken against the backdrop of a strengthening economy. Barring any major change in the stance of the Fund's benchmark, we do not anticipate any significant alteration in Fund duration. As evidenced by recent favorable performance results when interest rates rose, we believe the Fund is positioned appropriately, given our investment outlook. However, to the extent that fixed income markets remain buoyant, we expect that the Fund may not be able to provide enhanced results.

The 475 basis point decline in short-term interest rates engineered by the Federal Reserve Board in 2001 resulted in a material decrease in the Fund's borrowing cost into the 1%-1.25% range. This decline, in combination with a steep tax-exempt yield curve, has generated a material income benefit to the Fund's Common Stock shareholders from the leveraging of the Preferred Stock. While modest increases in short-term interest rates are a possibility later this year, these increases are unlikely to result in significantly higher borrowing costs for the Fund. However, should the spread between short-term and long-term interest rates narrow, the benefits of leverage will decline and, as a result, reduce the yield paid on the Common Stock. (For a more complete explanation of the benefits and risks of leveraging, see page 1 of this report to shareholders.)

In Conclusion

We appreciate your ongoing interest in MuniHoldings New Jersey Insured Fund, Inc., and we look forward to serving your investment needs in the months and years ahead.

Sincerely,

/s/ Terry K. Glenn

Terry K. Glenn
President and Director

/s/ Kenneth A. Jacob

Kenneth A. Jacob
Senior Vice President

/s/ John M. Loffredo

John M. Loffredo
Senior Vice President

/s/ Theodore R. Jaeckel Jr.

Theodore R. Jaeckel Jr.
Vice President and Portfolio Manager

August 27, 2002

We are pleased to announce that Theodore R. Jaeckel Jr. is responsible for the day-to-day management of MuniHoldings New Jersey Insured Fund, Inc. Mr. Jaeckel joined Merrill Lynch Investment Managers, L.P. in 1991 as Portfolio Manager.

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MuniHoldings New Jersey Insured Fund, Inc., July 31, 2002

SCHEDULE OF INVESTMENTS (in Thousands)

STATE	S&P Ratings	Moody's Ratings	Face Amount	Issue
New Jersey--141.4%	AAA	Aaa	$ 1,875	Atlantic Highlands, New Jersey, Highland Regional Sew Sewer Revenue Refunding Bonds, 5.50% due 1/01/2020 (b
				Camden County, New Jersey, Improvement Authority, Lea
	AAA	Aaa	1,540	5.50% due 9/01/2016

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AAA    Aaa      2,635     5.375% due 9/01/2019
-------------------------------------------------------------------------------
NR*    Aaa        430   Carteret, New Jersey, Board of Education, COP, 6% due
-------------------------------------------------------------------------------
AAA    Aaa      6,210   Casino Reinvestment Development Authority, New Jersey
                        Bonds, Series A, 5.25% due 10/01/2017 (c)
-------------------------------------------------------------------------------
AAA    Aaa      2,005   Delaware River and Bay Authority Revenue Bonds, Serie
                        5.625% due 1/01/2018 (a)
-------------------------------------------------------------------------------
                        Delaware River Port Authority of Pennsylvania and New
                        Bonds (c):
AAA    Aaa      5,000     5.50% due 1/01/2012
AAA    Aaa      6,000     5.625% due 1/01/2013
AAA    Aaa        500     5.75% due 1/01/2015
AAA    Aaa      4,865     6% due 1/01/2018
AAA    Aaa      5,525     6% due 1/01/2019
AAA    Aaa      2,425     (Port District Project), Series B, 5.625% due 1/01/
-------------------------------------------------------------------------------
AAA    Aaa      7,895   East Orange, New Jersey, Board of Education, COP,
                        5.50% due 8/01/2012 (c)
-------------------------------------------------------------------------------
NR*    Aaa      1,000   East Orange, New Jersey, Water Utility, GO, Refunding
                        5.70% due 6/15/2022 (a)
-------------------------------------------------------------------------------
                        Essex County, New Jersey, Improvement Authority, Leas
NR*    Aaa      4,000     (Correctional Facility Project), 6% due 10/01/2025
NR*    Aaa      3,100     (County Correctional Facility Project), 5.75% due 1
-------------------------------------------------------------------------------
AAA    Aaa      3,300   Essex County, New Jersey, Improvement Authority, Leas
                        Bonds (County Jail and Youth House Project), 5.35% du
-------------------------------------------------------------------------------
                        Essex County, New Jersey, Improvement Authority, Util
                        Revenue Bonds (d):
AAA    Aaa      2,705     (East Orange Franchise), 6% due 7/01/2018
AAA    Aaa      3,050     (Orange Franchise), Series A, 5.75% due 7/01/2027
-------------------------------------------------------------------------------
                        Ewing Township, New Jersey, School District, GO (b):
NR*    Aaa      1,805     5.30% due 8/01/2019
NR*    Aaa      1,780     5.30% due 8/01/2020
-------------------------------------------------------------------------------
AAA    Aaa      1,240   Freehold, New Jersey, Regional High School District,
                        5% due 3/01/2016 (b)
-------------------------------------------------------------------------------
AAA    Aaa      2,883   Freehold Township, New Jersey, Board of Education, GO
                        5.25% due 2/15/2032 (d)
-------------------------------------------------------------------------------
AAA    Aaa      1,500   Hoboken, New Jersey, Parking Authority, Parking Reven
                        5.30% due 5/01/2027 (a)
-------------------------------------------------------------------------------
AAA    Aaa      2,040   Hopewell Valley, New Jersey, Regional School District
                        5% due 8/15/2014 (b)
-------------------------------------------------------------------------------
AAA    Aaa        765   Jersey City, New Jersey, GO, Refunding, Quality Schoo
                        5.375% due 9/01/2017 (c)
-------------------------------------------------------------------------------
                        Lafayette Yard, New Jersey, Community Development Rev
                        (Hotel/Conference Center Project) (d)(e):
NR*    Aaa      5,250     6% due 4/01/2010
NR*    Aaa      1,125     6.125% due 4/01/2010
-------------------------------------------------------------------------------
AAA    Aaa        825   Lopatcong Township, New Jersey, Board of Education, G
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			5.70% due 7/15/2010 (c)(e)
AAA	Aaa	1,000	Marlboro Township, New Jersey, Board of Education, GO 5.25% due 7/15/2017 (c)
			Middlesex County, New Jersey, COP (d):
AAA	Aaa	1,375	5.50% due 8/01/2016
AAA	Aaa	1,550	5.25% due 6/15/2023
			Middlesex County, New Jersey, Improvement Authority, Bonds (Educational Services Community Projects):
AAA	Aaa	3,970	5.70% due 7/15/2020
AAA	Aaa	5,270	6% due 7/15/2025
AAA	Aaa	500	Middlesex County, New Jersey, Improvement Authority R Citizens Housing Project), AMT, 5.50% due 9/01/2030 (
			Monmouth County, New Jersey, Improvement Authority, R Bonds (a):
AAA	Aaa	1,540	5.35% due 12/01/2017
AAA	Aaa	1,470	5.375% due 12/01/2018
NR*	Aaa	1,000	Monroe Township, New Jersey, Municipal Utilities Auth County Revenue Refunding Bonds, 5.25% due 2/01/2016 (
AAA	Aaa	2,304	Mount Laurel Township, New Jersey, Board of Education 5.60% due 8/01/2019 (b)
AAA	Aaa	3,060	New Jersey EDA, Construction Revenue Bonds, GO (Schoo Series A, 5.50% due 6/15/2012 (a)
A1+	NR*	300	New Jersey EDA, Economic Development Revenue Refundin Trade Zone Project), VRDN, 1.45% due 12/01/2007 (g)
AAA	Aaa	5,000	New Jersey EDA, Lease Revenue Bonds (University of Me Dentistry--International Center for Public Health Pro 6% due 6/01/2032 (a)
			New Jersey EDA, Natural Gas Facilities Revenue Refund
AAA	Aaa	18,920	(NUI Corporation Projects), Series A, 5.70% due 6/0
NR*	Aaa	3,155	RIB, Series 161, 9.68% due 6/01/2032 (f)
			New Jersey EDA, Parking Facility Revenue Bonds (Eliza Company Project) (b):
AAA	Aaa	1,430	5.60% due 10/15/2019
AAA	Aaa	1,000	5.60% due 10/15/2026
AAA	NR*	4,580	New Jersey EDA Revenue Bonds, DRIVERS, Series 219, 10 due 5/01/2016 (c)(f)
			New Jersey EDA, School Facilities Construction Revenu
AAA	Aaa	1,100	5.125% due 6/15/2014
AAA	Aaa	7,000	5.25% due 6/15/2017
AAA	Aaa	7,200	5.25% due 6/15/2018
			New Jersey EDA, State Lease Revenue Bonds (State Offi Projects) (a):
AAA	Aaa	3,000	6% due 6/15/2015
AAA	Aaa	4,620	6.25% due 6/15/2020

Portfolio Abbreviations

To simplify the listings of MuniHoldings New Jersey Insured Fund, Inc.'s portfolio holdings in the Schedule of Investments, we have abbreviated the names of many of the securities according to the list at right.

AMT	Alternative Minimum Tax (subject to)
COP	Certificates of Participation
DRIVERS	Derivative Inverse Tax-Exempt Receipts
EDA	Economic Development Authority
GO	General Obligation Bonds
RIB	Residual Interest Bonds
VRDN	Variable Rate Demand Notes

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MuniHoldings New Jersey Insured Fund, Inc., July 31, 2002

SCHEDULE OF INVESTMENTS (continued) (in Thousands)

STATE	S&P Ratings	Moody's Ratings	Face Amount	Issue
New Jersey (continued)				New Jersey EDA, Water Facilities Revenue Refunding Bo New Jersey Inc. Project), VRDN (a)(g):
	A1+	VMIG1@	$ 890	AMT, Series C, 1.40% due 11/01/2025
	A1+	VMIG1@	600	Series A, 1.45% due 11/01/2026
				New Jersey Health Care Facilities Financing Authority
	AAA	Aaa	2,820	(Society of the Valley Hospital), 5.375% due 7/01/2
	NR*	Baa1	5,440	(South Jersey Hospital), 6% due 7/01/2026
				New Jersey Health Care Facilities Financing Authority Refunding Bonds:
	AAA	Aaa	4,000	(AHS Hospital Corporation), Series A, 6% due 7/01/2
	A-	A3	1,455	(Atlantic City Medical Center), 6.25% due 7/01/2017
	A-	A3	3,500	(Atlantic City Medical Center), 5.75% due 7/01/2025
	BBB+	NR*	1,775	(Holy Name Hospital), 6% due 7/01/2025
	AAA	Aaa	1,000	(Meridian Health System Obligation Group), 5.375% d
				New Jersey Sports and Exposition Authority, State Con Bonds (d):
	AAA	Aaa	2,400	Series A, 6% due 3/01/2013
	A1+	VMIG1@	100	VRDN, Series C, 1.30% due 9/01/2024 (g)
				New Jersey State Educational Facilities Authority Rev
	AAA	Aaa	8,905	(Capital Improvement Fund), Series A, 5.75% due 9/0
	AAA	Aaa	9,420	(Capital Improvement Fund), Series A, 5.75% due 9/0
	AAA	Aaa	2,000	(Princeton Theological), Series B, 5.90% due 7/01/2
				New Jersey State Educational Facilities Authority, Re Bonds:
	AA	NR*	2,045	(Rider University), 5.25% due 7/01/2012
	AA	NR*	1,000	(Rider University), 5.25% due 7/01/2014
	AAA	Aaa	2,375	(Rowan University), Series C, 5.25% due 7/01/2017 (
	AAA	Aaa	2,820	(Rowan University), Series C, 5.25% due 7/01/2018 (
	AAA	Aaa	2,635	(Rowan University), Series C, 5.25% due 7/01/2019 (

AAA	Aaa	4,000	(University of Medicine and Dentistry), Series B, 5.25% due 12/01/2017 (a)
			New Jersey State Highway Authority, Garden State Park Revenue Refunding Bonds:
AAA	Aaa	3,200	5.75% due 1/01/2015 (b)
AA-	A1	1,900	5.625% due 1/01/2030
			New Jersey State Highway Authority, Garden State Park Revenue Refunding Bonds, Senior Parkway (b):
AAA	Aaa	2,000	5.25% due 1/01/2018
AAA	Aaa	3,085	5.25% due 1/01/2019
			New Jersey State Housing and Mortgage Finance Agency, Revenue Bonds (d):
AAA	Aaa	8,140	AMT, Series K, 6.375% due 10/01/2026
AAA	Aaa	1,555	AMT, Series M, 6.95% due 10/01/2022
AAA	Aaa	5,310	AMT, Series M, 7% due 10/01/2026
AAA	Aaa	1,000	AMT, Series U, 5.60% due 10/01/2012
AAA	Aaa	2,820	AMT, Series U, 5.65% due 10/01/2013
AAA	Aaa	3,000	AMT, Series U, 5.75% due 4/01/2018
AAA	Aaa	2,320	AMT, Series U, 5.85% due 4/01/2029
AAA	Aaa	2,540	Series L, 6.65% due 10/01/2014
			New Jersey State Housing and Mortgage Finance Agency, Revenue Refunding Bonds, AMT, Series S (d):
AAA	Aaa	2,440	5.95% due 10/01/2017
AAA	Aaa	2,050	6.05% due 10/01/2028
			New Jersey State Transit Corporation, COP (Federal Tr Administration Grants), Series A (a)(e):
AAA	Aaa	4,000	6% due 9/15/2009
AAA	Aaa	5,000	6.125% due 9/15/2009
			New Jersey State Transportation Trust Fund Authority, Transportation System Revenue Bonds, Series A:
AA-	Aa3	7,740	6% due 6/15/2010 (e)
AA-	Aa3	7,500	6% due 6/15/2010 (e)(h)
AAA	Aaa	2,000	5% due 6/15/2015 (c)
AAA	NR*	10,000	5.25% due 6/15/2015 (d)
AAA	Aaa	3,000	5.75% due 6/15/2015 (d)
			New Jersey State Transportation Trust Fund Authority, Transportation System Revenue Refunding Bonds, Series
AAA	Aaa	2,500	6% due 12/15/2017 (d)
AAA	Aaa	6,605	6% due 12/15/2018
AAA	Aaa	7,440	6% due 12/15/2019
			New Jersey State Turnpike Authority, Turnpike Revenue Refunding Bonds (d):
AAA	Aaa	20,000	Series A, 5.75% due 1/01/2019
AAA	Aaa	5,520	Series C, 6.50% due 1/01/2016
			North Bergen Township, New Jersey, Board of Education
NR*	Aaa	1,250	5% due 12/15/2018
NR*	Aaa	1,000	6% due 12/15/2019
NR*	Aaa	1,580	6.25% due 12/15/2020
NR*	Aaa	1,680	6.25% due 12/15/2021
NR*	Aaa	3,035	Orange Township, New Jersey, Municipal Utility and Le Refunding, Series C, 5.10% due 12/01/2017 (d)

			Passaic County, New Jersey, GO, Refunding (c):
NR*	Aaa	2,170	5.25% due 6/01/2014
NR*	Aaa	2,360	5.25% due 6/01/2015
NR*	Aaa	2,350	5.25% due 6/01/2016
			Paterson, New Jersey, Public School District, COP (d)
NR*	Aaa	1,980	6.125% due 11/01/2015
NR*	Aaa	2,000	6.25% due 11/01/2019
			Salem County, New Jersey, Industrial Pollution Contro Authority, Revenue Refunding Bonds:
AAA	Aaa	5,000	(Atlantic City Electric Company), 6.15% due 6/01/20
AAA	Aaa	2,000	(Public Service Electric & Gas), Series C, 5.55% du

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MuniHoldings New Jersey Insured Fund, Inc., July 31, 2002

SCHEDULE OF INVESTMENTS (concluded) (in Thousands)

STATE	S&P Ratings	Moody's Ratings	Face Amount	Issue
New Jersey (concluded)	AAA	Aaa	$ 4,325	Trenton, New Jersey, Parking Authority, Parking Reven Bonds, DRIVERS, Series 221, 10.76% due 4/01/2010 (b)(
	AAA	Aaa	4,740	University of Medicine and Dentistry, New Jersey, Rev Bonds, Series A, 5.50% due 12/01/2027 (a)
				West Deptford Township, New Jersey, GO (b):
	NR*	Aaa	4,170	5.625% due 9/01/2026
	NR*	Aaa	4,410	5.625% due 9/01/2027
	NR*	Aaa	3,615	5.625% due 9/01/2028
	NR*	Aaa	4,940	5.625% due 9/01/2029
				West Orange, New Jersey, Board of Education, COP (d):
	NR*	Aaa	2,040	5.75% due 10/01/2014
	NR*	Aaa	3,615	6% due 10/01/2024
	AAA	Aaa	1,600	West Windsor-Plainsboro, New Jersey, Regional School 5.50% due 12/01/2013 (b)
New York--8.6%	AAA	Aaa	4,750	Port Authority of New York and New Jersey, Consolidat Refunding Bonds, AMT, 119th Series, 5.50% due 9/15/20
				Port Authority of New York and New Jersey, Special Ob Bonds, AMT (d):
	AAA	NR*	2,375	DRIVERS, Series 192, 9.79% due 12/01/2025 (f)
	NR*	Aaa	2,165	(JFK International Air Terminal LLC), RIB, Series 1 9.78% due 12/01/2022 (f)
	AAA	Aaa	13,500	(JFK International Air Terminal--Special Project), 6.25% due 12/01/2011
	AAA	Aaa	1,500	(JFK International Airport Terminal), Series 6, 6.25% due 12/01/2015

Puerto Rico--12.9%	NR*	Aaa	7,875	Puerto Rico Commonwealth, GO, RIB, Series 365, 10.36% due 7/01/2005 (d)(e)(f)
	A	Baa1	6,000	Puerto Rico Commonwealth Highway and Transportation A Transportation Revenue Bonds, Series B, 6% due 7/01/2
				Puerto Rico Electric Power Authority, Power Revenue B
	AAA	Aaa	10,000	Series HH, 5.25% due 7/01/2029 (c)
	AAA	Aaa	2,355	Series X, 5.50% due 7/01/2025 (d)
				Puerto Rico Industrial, Tourist, Educational, Medical Control Facilities Revenue Bonds, Series A:
	AAA	Aaa	1,780	(Hospital Auxilio Mutuo Obligation Group), 6.25% du
	AA	Aa2	1,750	(Hospital de la Concepcion), 6.50% due 11/15/2020
	AAA	Aaa	7,120	Puerto Rico Public Financing Corporation Revenue Bond Appropriation), Series A, 5.50% due 8/01/2019 (d)
	Total Investments (Cost--$481,495)--162.9%			
	Variation Margin on Financial Futures Contracts**--(0.1%)			
	Other Assets Less Liabilities--2.0%			
	Preferred Stock, at Redemption Value--(64.8%)			
	Net Assets Applicable to Common Stock--100.0%			

(a) AMBAC Insured.
(b) FGIC Insured.
(c) FSA Insured.
(d) MBIA Insured.
(e) Prerefunded.
(f) The interest rate is subject to change periodically and inversely based upon prevailing market rates. The interest rate shown is the rate in effect at July 31, 2002.
(g) The interest rate is subject to change periodically based upon prevailing market rates. The interest rate shown is the rate in effect at July 31, 2002.
(h) All or a portion of security held as collateral in connection with open financial futures contracts.
@ Highest short-term rating by Moody's Investors Service, Inc.
* Not Rated.
** Financial futures contracts sold as of July 31, 2002 were as follows:

(in Thousands)

Number of Contracts	Issue	Expiration Date	Value
510	U.S. Treasury Bonds	September 2002	$56,411
Total Financial Futures Contracts Sold (Total Contract Price--$54,719)			$56,411

Ratings of issues shown have not been audited by Ernst & Young LLP.

See Notes to Financial Statements.

STATEMENT OF NET ASSETS

As of July 31, 2002

Assets:	Investments, at value (identified cost--$481,495,137) ....
	Cash ....
	Interest receivable ....
	Prepaid expenses ....
	Total assets ....
Liabilities:	Payables:
	Variation margin ....
	Dividends to Common Stock shareholders ....
	Investment adviser ....
	Accrued expenses ....
	Total liabilities ....
Preferred Stock:	Preferred Stock, at redemption value, par value $.10 per share (8,120 shares of AMPS* issued and outstanding at $25,000 per share liquidation preference) ....
Net Assets Applicable to Common Stock:	Net assets applicable to Common Stock ....
Analysis of Net Assets Applicable to Common Stock:	Common Stock, par value $.10 per share (21,038,614 shares issued and outstanding) ....
	Paid-in capital in excess of par ....
	Undistributed investment income--net ....
	Accumulated realized capital losses on investments--net ....
	Unrealized appreciation on investments--net ....
	Total accumulated losses--net ....
	Total--Equivalent to $14.90 net asset value per share of Common Stock (market price--$14.24) ....

* Auction Market Preferred Stock.

See Notes to Financial Statements.

MuniHoldings New Jersey Insured Fund, Inc., July 31, 2002

STATEMENT OF OPERATIONS

For the Year Ended July 31, 2002

Investment Income:	Interest	
Expenses:	Investment advisory fees	$ 2,
	Commission fees	
	Accounting services	
	Professional fees	
	Transfer agent fees	
	Reorganization expenses	
	Printing and shareholder reports	
	Custodian fees	
	Directors' fees and expenses	
	Listing fees	
	Pricing fees	
	Other	
	Total expenses before reimbursement	3,
	Reimbursement of expenses	(
	Total expenses after reimbursement	
	Investment income--net	
Realized & Unrealized Gain On Investments--Net:	Realized gain on investments--net	
	Change in unrealized appreciation/depreciation on investments--net	
	Total realized and unrealized gain on investments--net	
Dividends to Preferred Stock Shareholders:	Investment income--net	
	Net Increase in Net Assets Resulting from Operations	

See Notes to Financial Statements.

STATEMENTS OF CHANGES IN NET ASSETS

	Increase (Decrease) in Net Assets:
Operations:	Investment income--net ....
	Realized gain (loss) on investments--net ....
	Change in unrealized appreciation/depreciation on investments--net ....
	Dividends to Preferred Stock shareholders ....
	Write-off of offering costs resulting from the initial issuance of Preferred Stock ....
	Net increase in net assets resulting from operations ....
Dividends to	Investment income--net ....

Common Stock Shareholders:	Net decrease in net assets resulting from dividends to Common Stock shareholders
Common Stock Transactions:	Proceeds from issuance of Common Stock resulting from reorganization ....
	Offering costs resulting from the initial issuance of Common Stock ....
	Net increase in net assets derived from Common Stock transactions ....
Net Assets Applicable to Common Stock:	Total increase in net assets applicable to Common Stock ....
	Beginning of year ....
	End of year* ....
	*Undistributed investment income--net ....

\+ Certain prior year amounts have been reclassified to current year presentation.

See Notes to Financial Statements.

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MuniHoldings New Jersey Insured Fund, Inc., July 31, 2002

FINANCIAL HIGHLIGHTS

	The following per share data and ratios have been derived from information provided in the financial statements. Increase (Decrease) in Net Asset Value:	For the Year July 31 2002	2001
Per Share Operating Performance:#	Net asset value, beginning of period	$ 14.54	$ 13.14
	Investment income--net	1.06++	1.08
	Realized and unrealized gain (loss) on investments--net	.31	1.39
	Dividends and distributions to Preferred Stock shareholders:		
	Investment income--net	(.15)	(.34)
	Realized gain on investments--net	--	--
	Capital write-off (charge) resulting from issuance of Preferred Stock	--	--@@
	Total from investment operations	1.22	2.13
	Less dividends and distributions to Common Stock shareholders:		
	Investment income--net	(.86)	(.73)

	Realized gain on investments--net	--	--
	In excess of realized gain on investments--net	--	--
	Total dividends and distributions to Common Stock shareholders	(.86)	(.73)
	Capital charge resulting from issuance of Common Stock	--	--@@
	Net asset value, end of period	$ 14.90	$ 14.54
	Market price per share, end of period	$ 14.24	$ 12.64
Total Investment Return:**	Based on market price per share	20.01%	14.60%
	Based on net asset value per share	9.16%	17.26%
Ratios Based on Average Net Assets of Common Stock:	Total expenses, net of reimbursement and excluding reorganization expenses***	1.19%	1.18%
	Total expenses, net of reimbursement***	1.22%	1.18%
	Total expenses***	1.29%	1.29%
	Total investment income--net***	7.32%	7.72%
	Amount of dividends to Preferred Stock shareholders	1.00%	2.43%
	Investment income--net, to Common Stock shareholders	6.32%	5.29%
Ratios Based on Average Net Assets Of Common & Preferred Stock:***	Total expenses, net of reimbursement and excluding reorganization expenses	.72%	.69%
	Total expenses, net of reimbursement	.73%	.69%
	Total expenses	.78%	.76%
	Total investment income--net	4.40%	4.53%
Ratios Based on Average Net Assets of Preferred Stock:	Dividends to Preferred Stock shareholders	1.51%	3.46%
Supplemental Data:	Net assets applicable to Common Stock, end of period (in thousands)	$313,515	$305,913
	Preferred Stock outstanding, end of period (in thousands)	$203,000	$203,000
	Portfolio turnover	20.05%	55.60%
Leverage:	Asset coverage per $1,000	$ 2,544	$ 2,507

Dividends Per Share On Preferred Stock Outstanding:+++	Series A--Investment income--net	$ 356	$ 830
	Series B--Investment income--net	$ 381	$ 872
	Series C--Investment income--net	$ 389	$ 871
	Series D--Investment income--net	$ 363	$ 901
	Series E--Investment income--net	$ 393	$ 310

* Annualized.

** Total investment returns based on market value, which can be significantly greater or lesser than the net asset value, may result in substantially different returns. Total investment returns exclude the effects of sales charges. If applicable, the Fund's Investment Adviser waived a portion of its management fee. Without such waiver, the Fund's performance would have been lower.

*** Do not reflect the effect of dividends to Preferred Stock shareholders.

\+ Commencement of operations.

++ Based on average shares outstanding.

+++ The Fund's Preferred Stock was issued on October 19, 1998 (Series A and B), March 6, 2000 (Series C and D), and March 5, 2001 (Series E).

\# Certain prior year amounts have been reclassified to conform to current year presentation.

@ Aggregate total investment return.

@@ Amount is less than $.01 per share.

See Notes to Financial Statements.

NOTES TO FINANCIAL STATEMENTS

1. Significant Accounting Policies:

MuniHoldings New Jersey Insured Fund, Inc. (the "Fund") is registered under the Investment Company Act of 1940 as a non-diversified, closed-end management investment company. The Fund's financial statements are prepared in conformity with accounting principles generally accepted in the United States of America, which may require the use of management accruals and estimates. The Fund determines and makes available for publication the net asset value of its Common Stock on a weekly basis. The Fund's Common Stock is listed on the New York Stock Exchange under the symbol MUJ. The following is a summary of significant accounting policies followed by the Fund.

(a) Valuation of investments--Municipal bonds are traded primarily in the over-the-counter markets and are valued at the most recent bid price or yield equivalent as obtained by the Fund's pricing service from dealers that make markets in such securities. Financial futures contracts and options thereon, which are traded on exchanges, are valued at their closing prices as of the close of such exchanges. Options written or purchased are valued at the last sale price in the case of exchange-traded options. In the case of options traded in the over-the-counter market, valuation is the last asked price (options written) or the last bid price (options purchased). Securities with remaining maturities of sixty days or less are valued at amortized cost, which approximates market value. Securities for which market quotations are not readily available are valued at fair value as determined in good faith by or under the direction of the Board of Directors of the Fund, including valuations furnished by a pricing service retained by the Fund, which may utilize a matrix system for valuations. The procedures of the pricing service and its valuations are reviewed by the officers of the Fund under the general supervision of the Board of Directors.

(b) Derivative financial instruments--The Fund may engage in various portfolio investment strategies to increase or decrease the level of risk to which the Fund is exposed more quickly and efficiently than transactions in other types of instruments. Losses may arise due to changes in the value of the contract or if the counterparty does not perform under the contract.

o Financial futures contracts--The Fund may purchase or sell financial futures contracts and options on such futures contracts for the purpose of hedging the market risk on existing securities or the intended purchase of securities. Futures contracts are contracts for delayed delivery of securities at a specific future date and at a specific price or yield. Upon entering into a contract, the Fund deposits and maintains as collateral such initial margin as required by the exchange on which the transaction is effected. Pursuant to the contract, the Fund agrees to receive from or pay to the broker an amount of cash equal to the daily fluctuation in value of the contract. Such receipts or payments are known as variation margin and are recorded by the Fund as unrealized gains or losses. When the contract is closed, the Fund records a realized gain or loss equal to the difference between the value of the contract at the time it was opened and the value at the time it was closed.

o Options--The Fund is authorized to write covered call options and purchase call and put options. When the Fund writes an option, an amount equal to the premium received by the Fund is reflected as an asset and an equivalent liability. The amount of the liability is subsequently marked to market to reflect the current market value of the option written.

When a security is purchased or sold through an exercise of an option, the related premium paid (or received) is added to (or deducted from) the basis of the security acquired or deducted from (or added to) the proceeds of the security sold. When an option expires (or the Fund enters into a closing transaction), the Fund realizes a gain or loss on the option to the extent of the premiums received or paid (or gain or loss to the extent the cost of the closing transaction exceeds the premium paid or received).

Written and purchased options are non-income producing investments.

(c) Income taxes--It is the Fund's policy to comply with the requirements of the Internal Revenue Code applicable to regulated investment companies and to distribute substantially all of its taxable income to its shareholders. Therefore, no Federal income tax provision is required.

(d) Security transactions and investment income--Security transactions are recorded on the dates the transactions are entered into (the trade dates). Realized gains and losses on security transactions are determined on the identified cost basis. Interest income is recognized on the accrual basis. As required, effective August 1, 2001, the Fund has adopted the provisions of the AICPA Audit and Accounting Guide for Investment Companies and began amortizing all premiums and discounts on debt securities. The cumulative effect of this accounting change had no impact on total net assets of the Fund, but resulted in a $52,416 increase in cost of securities (which, in turn, results in a corresponding $52,416 decrease in net unrealized appreciation and a corresponding $52,416 increase in undistributed net investment income), based on securities held by the Fund as of July 31, 2001.

The effect of this change for the year ended July 31, 2002 was to increase net investment income by $18,154, decrease net unrealized appreciation by $17,267 and increase net realized capital losses by $53,303. The statement of changes in net assets and financial highlights for prior periods have not been restated to reflect this change in presentation.

(e) Dividends and distributions--Dividends from net investment income are declared and paid monthly. Distributions of capital gains are recorded on the ex-dividend dates.

(f) Change in financial statement classification for Auction Market Preferred Stock ("AMPS")--In accordance with the provisions of the Financial Accounting Standards Board's Emerging Issues Task Force D-98 ("EITF D-98"), "Classification and Measurement of Redeemable Securities," effective for the current period, the Fund has reclassified its AMPS outside of permanent equity in the Net Assets section of the Statement of Net Assets. In addition, dividends to Preferred Stock shareholders are now classified as a component of the "Net Increase in Net Assets Resulting from Operations" on the Statement of Operations and Changes in Net Assets and as a component of the "Total from investment operations" in the Financial Highlights. Prior year amounts presented have been reclassified to conform to this period's presentation. The application of EITF D-98 related entirely to presentation and had no impact on net asset value or the allocation of net investment income or net realized capital gains or losses to Common Stock shareholders.

(g) Reclassification--Accounting principles generally accepted in the United States of America require that certain components of net assets be adjusted to reflect permanent differences between financial and tax reporting. Accordingly, the current year's permanent book/tax differences of $85,167 have been reclassified between accumulated net realized capital losses and undistributed net investment income and $72,137 has been reclassified between paid-in capital in excess of par and undistributed net investment income. These reclassifications have no effect on net assets or net asset values per share.

2. Investment Advisory Agreement and Transactions with Affiliates:

The Fund has entered into an Investment Advisory Agreement with Fund Asset Management, L.P. ("FAM"). The general partner of FAM is Princeton Services, Inc. ("PSI"), an indirect, wholly-owned subsidiary of Merrill Lynch & Co., Inc. ("ML & Co."), which is the limited partner.

FAM is responsible for the management of the Fund's portfolio and provides the necessary personnel, facilities, equipment and certain other services necessary to the operations of the Fund. For such services, the Fund pays a monthly fee at an annual rate of .55% of the Fund's average weekly net assets, including proceeds from the issuance of Preferred Stock. For the year ended July 31, 2002, FAM earned fees of $2,798,957 of which $231,829 was waived.

For the year ended July 31, 2002, the Fund reimbursed FAM $18,079 for certain accounting services.

Certain officers and/or directors of the Fund are officers and/or directors of FAM, PSI, and/or ML & Co.

3. Investments:

Purchases and sales of investments, excluding short-term securities, for the year ended July 31, 2002 were $101,228,975 and $100,257,580, respectively.

Net realized gains (losses) for the year ended July 31, 2002 and net unrealized gains (losses) as of July 31, 2002 were as follows:

	Realized Gains (Losses)	Unrealized Gains (Losses)
Long-term investments	$ 1,387,394	$ 29,318,238
Financial futures contracts	(474,274)	(1,691,797)
Total	$ 913,120	$ 27,626,441

NOTES TO FINANCIAL STATEMENTS (concluded)

As of July 31, 2002, net unrealized appreciation for Federal income tax purposes aggregated $29,335,505, of which $29,374,337 related to appreciated securities and $38,832 related to depreciated securities. The aggregate cost of investments at July 31, 2002 for Federal income tax purposes was $481,477,870.

4. Stock Transactions:

The Fund is authorized to issue 200,000,000 shares of stock, including Preferred Stock, par value $.10 per share, all of which were initially classified as Common Stock. The Board of Directors is authorized, however, to reclassify any unissued shares of stock without approval of holders of Common Stock.

Common Stock

Shares issued and outstanding during the year ended July 31, 2002 remained constant and during the year ended July 31, 2001 increased by 3,221,459 as a result of reorganization.

Preferred Stock

AMPS are shares of Preferred Stock of the Fund, with a par value of $.10 per share and a liquidation preference of $25,000 per share, that entitle their holders to receive cash dividends at an annual rate that may vary for the successive dividend periods. The yields in effect at July 31, 2002 were Series A, 1.00%; Series B, .91%; Series C, 1.15%; Series D, 1.05% and Series E, 1.15%.

Shares issued and outstanding during the year ended July 31, 2002 remained constant and during the year ended July 31, 2001 increased by 1,120 as a result of reorganization.

The Fund pays commissions to certain broker-dealers at the end of each auction at an annual rate ranging from .25% to .375%, calculated on the proceeds of each auction. For the year ended July 31, 2002, Merrill Lynch, Pierce, Fenner & Smith Incorporated, an affiliate of FAM, earned $281,802 as commissions.

5. Distributions to Shareholders:

On August 8, 2002, an ordinary income dividend of $.073000 was declared. The dividend was paid on August 29, 2002, to shareholders of record on August 19, 2002.

The tax character of distributions paid during the fiscal years ended July 31, 2002 and July 31, 2001 was as follows:

	7/31/2002	7/31/2001
Distributions paid from:		
Tax-exempt income	$21,231,081	$20,188,269
Total distributions	$21,231,081	$20,188,269

As of July 31, 2002, the components of accumulated losses on a tax basis were as follows:

Undistributed tax-exempt income--net	$ 2,789,860
Undistributed long-term capital gains--net	--
Total undistributed earnings--net	2,789,860
Capital loss carryforward	(35,328,697)*
Unrealized gains--net	27,697,744**
Total accumulated losses--net	$ (4,841,093)

* On July 31, 2002, the Fund had a net capital loss carryforward of $35,328,697, of which $2,713,832 expires in 2006, $4,022,894 expires in 2007, $1,794,104 expires in 2008 and $26,797,867 expires in 2009. This amount will be available to offset like amounts of any future taxable gains.

** The difference between book-basis and tax-basis net unrealized gains is attributable primarily to the tax deferral of losses on straddles, the difference between book and tax amortization methods for premiums and discounts on fixed income securities, unamortized organization costs, the realization for tax purposes of unrealized gains (losses) on certain futures contracts and the deferral of post-October capital losses for tax purposes.

REPORT OF INDEPENDENT AUDITORS

To the Shareholders and Board of Directors,
MuniHoldings New Jersey Insured Fund, Inc.

We have audited the accompanying statement of net assets of MuniHoldings New Jersey Insured Fund, Inc., including the schedule of investments, as of July 31, 2002, and the related statement of operations for the year then ended, the statements of changes in net assets for each of the two years in the period then ended, and financial highlights for each of the periods indicated therein. These financial statements and financial highlights are the responsibility of the Fund's management. Our responsibility is to express an opinion on these financial statements and financial highlights based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements and financial highlights are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements and financial highlights. Our procedures included confirmation of securities owned as of July 31, 2002, by correspondence with the custodian. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements and financial highlights referred to above present fairly, in all material respects, the financial position of MuniHoldings New Jersey Insured Fund, Inc. at July 31, 2002, the results of its operations for the year then ended, the changes in its net assets for each of the two years in the period then ended and the financial highlights for each of the indicated periods in conformity with accounting principles generally accepted in the United States.

As discussed in Note 1f to the financial statements, in 2002 the Fund changed its method of classifying Preferred Stock.

/s/ Ernst & Young LLP

MetroPark, New Jersey
September 6, 2002

MANAGED DIVIDEND POLICY

The Fund's dividend policy is to distribute all or a portion of its net investment income to its shareholders on a monthly basis. In order to provide shareholders with a more consistent yield to the current trading price of shares of Common Stock of the Fund, the Fund may at times pay out less than the entire amount of net investment income earned in any particular month and may at times in any particular month pay out such accumulated but undistributed income in addition to net investment income earned in that month. As a result, the dividends paid by the Fund for any particular month may be more or less than the amount of net investment income earned by the Fund during such month. The Fund's current accumulated but undistributed net investment income, if any, is disclosed in the Statement of Net Assets, which comprises part of the financial information included in this report.

QUALITY PROFILE (unaudited)

The quality ratings of securities in the Fund as of July 31, 2002 were as follows:

S&P Rating/Moody's Rating	Percent of Total Investments
AAA/Aaa	91.0%
AA/Aa	4.9
A/A	2.3
BBB/Baa	1.4
Other*	0.4

* Temporary investments in short-term municipal securities.

IMPORTANT TAX INFORMATION (unaudited)

All of the net investment income distributions paid by MuniHoldings New Jersey

Insured Fund, Inc. during its taxable year ended July 31, 2002 qualify as tax-exempt interest dividends for Federal income tax purposes.

Please retain this information for your records.

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MuniHoldings New Jersey Insured Fund, Inc., July 31, 2002

OFFICERS AND DIRECTORS

Name	Address & Age	Position(s) Held with Fund	Length of Time Served	Principal Occupation(s During Past 5 Years
Interested Director				
Terry K. Glenn*	P.O. Box 9011 Princeton, NJ 08543-9011 Age: 61	President and Director	1999 to present and 1998 to present	Chairman, Americas Region since 2001, and Executive Vice Preside since 1983 of Fund Ass Management, L.P. ("FAM and Merrill Lynch Investment Managers, L.P. ("MLIM"); Preside of Merrill Lynch Mutua Funds since 1999; President of FAM Distributors, Inc. ("FAMD") since 1986 an Director thereof since 1991; Executive Vice President and Director of Princeton Services, Inc. ("Princeton Services") since 1993; President of Princeton Administrators, L.P. since 1988; Director o Financial Data Service Inc. since 1985.

* Mr. Glenn is a director, trustee or member of an advisory board of certa which FAM or MLIM acts as investment adviser. Mr. Glenn is an "intereste Investment Company Act, of the Fund based on his positions as Chairman (President of FAM and MLIM; President of FAMD; Executive Vice President o of Princeton Administrators, L.P. The Director's term is unlimited. Dire resignation, removal or death, or until December 31 of the year in which Mr. Glenn serves at the pleasure of the Board of Directors.

Name	Address & Age	Position(s) Held with Fund	Length of Time Served*	Principal Occupation(s During Past 5 Years
Independent Directors				
Ronald W. Forbes	P.O. Box 9011 Princeton, NJ 08543-9011 Age: 61	Director	1998 to present	Professor Emeritus of Finance, School of Business, State University of New Yor at Albany since 2000; and Professor thereof from 1989 to 2000.
Cynthia A. Montgomery	P.O. Box 9011 Princeton, NJ 08543-9011 Age: 50	Director	1998 to present	Professor, Harvard Business School since 1989.
Charles C. Reilly	P.O. Box 9011 Princeton, NJ 08543-9011 Age: 71	Director	1998 to present	Self-employed financia consultant since 1990.
Kevin A. Ryan	P.O. Box 9011 Princeton, NJ 08543-9011 Age: 69	Director	1998 to present	Founder and currently Director Emeritus of T Boston University Cent for the Advancement of Ethics and Character a Director thereof from 1989 to 1999; Professo from 1982 to 1999 at Boston University.
Roscoe S. Suddarth	P.O. Box 9011 Princeton, NJ 08543-9011 Age: 67	Director	2000 to present	Former President, Midd East Institute from 1995 to 2001.
Richard R. West	P.O. Box 9011 Princeton, NJ 08543-9011 Age: 64	Director	1998 to present	Professor of Finance since 1984, and currently Dean Emeritu of New York University Leonard N. Stern Schoo of Business Administration.
Edward D. Zinbarg	P.O. Box 9011 Princeton, NJ 08543-9011 Age: 67	Director	2000 to present	Self-employed financia consultant since 1994.

* The Director's term is unlimited. Directors serve until their resignatio December 31 of the year in which they turn 72.

Name	Address & Age	Position(s) Held with Fund	Length of Time Served*	Principal Occupat
Fund Officers				

Donald C. Burke	P.O. Box 9011 Princeton, NJ 08543-9011 Age: 42	Vice President and Treasurer	1998 to present and 1999 to present	First Vice President o Treasurer thereof sinc Treasurer of Princeton President of FAMD sinc MLIM from 1990 to 1997 since 1990.
Kenneth A. Jacob	P.O. Box 9011 Princeton, NJ 08543-9011 Age: 50	Senior Vice President	2002 to present	Managing Director of t Vice President of MLIM
John M. Loffredo	P.O. Box 9011 Princeton, NJ 08543-9011 Age: 38	Senior Vice President	2002 to present	Managing Director of t Vice President of MLIM
Theodore R. Jaeckel Jr.	P.O. Box 9011 Princeton, NJ 08543-9011 Age: 41	Vice President and Portfolio Manager	2002 to present	Director (Municipal Ta Adviser since 1997; Vi 1991.
Alice A. Pellegrino	P.O. Box 9011 Princeton, NJ 08543-9011 Age: 42	Secretary	2001 to present	Director (Legal Adviso President of MLIM sinc MLIM since 1997; Assoc LLP from 1992 to 1997.

* Officers of the Fund serve at the pleasure of the Board of Directors.

Custodian	Transfer Agents		NYSE Symbol
The Bank of New York 100 Church Street New York, NY 10286	Common Stock: The Bank of New York 101 Barclay Street New York, NY 10286	Preferred Stock: The Bank of New York 100 Church Street New York, NY 10286	MUJ

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[LOGO] Merrill Lynch Investment Managers

[GRAPHICS OMITTED]

MuniHoldings New Jersey Insured Fund, Inc. seeks to provide shareholders with current income exempt from Federal income tax and New Jersey personal income taxes by investing in a portfolio of long-term, investment-grade municipal obligations the interest on which, in the opinion of bond counsel to the issuer, is exempt from Federal income tax and New Jersey personal income taxes.

This report, including the financial information herein, is transmitted to shareholders of MuniHoldings New Jersey Insured Fund, Inc. for their information. It is not a prospectus. Past performance results shown in this report should not be considered a representation of future performance. The Fund has leveraged its Common Stock and intends to remain leveraged by issuing Preferred Stock to provide the Common Stock shareholders with a potentially higher rate of return. Leverage creates risks for Common Stock shareholders, including the likelihood of greater volatility of net asset value and market price of shares of the Common Stock, and the risk that fluctuations in the short-term dividend rates of the Preferred Stock may affect the yield to Common Stock shareholders. Statements and other information herein are as dated and are subject to change.

MuniHoldings New Jersey Insured Fund, Inc.
Box 9011
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08543-9011

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mmon stock. Factors which may affect our market price include: o progress of our relationships with strategic partners; o results of clinical studies and regulatory reviews; o technological innovations by us or our competitors; o market conditions in the pharmaceutical, drug delivery and biotechnology industries; o effect of regulatory authorities on pricing of products; o competitive products; o financings; 34 o sales or the possibility of sales of our common stock; o our results of operations and financial condition; o proprietary rights; o public concern as to the safety or commercial value of our products; and o 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. Our business will suffer if we fail to comply with recent federal regulations and proposed rules of the Securities and Exchange Commission and American Stock Exchange relating to corporate governance reform. As a public company, we are subject to certain federal regulations and the rules and regulations of the Securities and Exchange Commission and the American Stock Exchange. The Sarbanes-Oxley Act of 2002 required more stringent accounting, corporate fraud and securities laws. To implement this legislation, the Securities and Exchange Commission has adopted new rules and may adopt additional rules pertaining to, among other things, additional disclosure and reporting requirements, including requirements relating to internal control procedures. The American Stock Exchange has also adopted various rules relating to corporate governance. Our reputation and financial results could be materially harmed by any failure by us to comply with any current or future rules or regulations relating to the Sarbanes-Oxley Act or to any other federal corporate or stock exchange reform measures. 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 35 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 delaying, 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 Annual Report on Form 10-K 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 other sections in this Annual Report on Form 10-K, 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 Annual Report on Form 10-K. You are cautioned not to place undue reliance on these forward-looking statements. We undertake no obligation to publicly update or revise any forward-looking statements, whether as the result of new information, future events or otherwise. Item 2. Properties ---------- We purchased a 15,700 square foot commercial building situated on approximately 14 acres of land in Exeter, New Hampshire in January 2003 and we moved our corporate headquarters and research and development laboratory into this facility in April 2003. We are located approximately 45 minutes north of Boston, Massachusetts. We own an 80,000 square foot facility in Zaragoza, Spain, which accommodates our manufacturing plant, warehouse, research and development laboratory and office space. The facility is located in an industrial park and is situated on sufficient acreage to accommodate future expansion. 36 We lease a 10,700 square foot facility in San Sebastian de los Reyes, Spain, an area northwest of Madrid, which houses the administrative offices for our Spanish and European operations. The lease for this facility expires in 2006. We believe that each of our facilities has sufficient space for our current needs and our contemplated expansion in the near future. Our manufacturing facility is currently operating at approximately 67% of its capacity, if it were operating for three shifts per day, five days per week. Item 3. Legal Proceedings ----------------- On February 4, 2002, we were notified that a legal proceeding had been commenced against us by Merck & Co. Inc. and its Spanish subsidiary, Merck Sharp & Dohme de Espana, S.A., alleging that we violate their patents in our production of the product simvastatin and requesting an injunction ordering us not to manufacture or market the product. The case was brought against our Spanish subsidiaries in the 39th First Instance Court of the City of Madrid. After a hearing on February 18, 2002, the court refused to grant the requested injunction and dismissed the case on February 25, 2002, awarding us court costs and legal fees. Merck has appealed the award of fees. Merck re-instituted its claim against us in another proceeding brought in the 19th First Instance Court of the City of Madrid, which we received notice of on January 23, 2003. This case also alleges violation of Merck's patents in the production of the product simvastatin, requests an order that we cease manufacturing the product and demands damages during the period of manufacture. A trial with respect to this matter was held on February 19 and 20, 2004, and we are waiting for the court's decision. We are vigorously opposing this claim as we believe it is without merit. We launched our simvastatin product line in January 2002. On January 10, 2004, we were notified that a legal proceeding had been commenced against us by Smith Kline Beecham PLC, Smith Kline Beecham, S.A. and GlaxoSmithKline S.A. alleging that we violate their patents in our production of the product paroxetine and requesting an order requiring us not to manufacture or market the product. The case was brought against our Spanish subsidiaries in the 50th First Instance Court of the City of Madrid. This proceeding followed a preliminary injunction that the same plaintiff attempted to bring against us in 2003, which was dismissed. We filed a response to this suit in February 2004 that includes a counterclaim requesting that the court declare the asserted patent invalid. We intend to vigorously oppose this claim as we believe it is without merit. We launched our paroxetine product line in 2003. We are a party to various other legal actions that arose in the ordinary course of business. We do not expect that resolution of these matters will have, individually or in the aggregate, a material adverse effect on our financial position, results of operations or cash flows. Item 4. Submission of Matters to a Vote of Security Holders --- Not applicable. 37 Part II Item 5. Market for Registrant's Common Equity and Related Stockholder Matters --- 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 Year Ended December 31, 2002 First Quarter $ 11.57 $ 7.60 Second Quarter 12.08 9.91 Third Quarter 11.60 8.35 Fourth Quarter 10.00 6.40 Fiscal Year Ended

December 31, 2003 First Quarter 9.70 7.85 Second Quarter 14.05 8.20 Third Quarter 18.80 12.81 Fourth Quarter 17.15 11.34 Fiscal Year Ending December 31, 2004 First Quarter (through March 2, 2004) 14.76 10.62 As of March 2, 2004 there were 1,079 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. 38 Item 6. Selected 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, 2003 and consolidated balance sheet data as of December 31, 1999, 2000, 2001, 2002 and 2003, 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, 2003 and as of December 31, 2002 and 2003 should be read together with our consolidated financial statements and related notes appearing elsewhere in Item 15 of this Annual Report on Form 10-K and "Management's Discussion and Analysis of Financial Condition and Results of Operations." The consolidated statement of operations data for the periods ended December 31, 1999 and 2000 and the consolidated balance sheet data as of December 31, 1999, 2000 and 2001 are derived from our audited consolidated financial statements and related notes not included in Item 15 of this Annual Report on Form 10-K. Consolidated Statement of Operations Data For The Year Ended December 31, -- (in thousands, except per share data) 1999 2000 2001 2002 2003 -------- -------- -------- -------- -------- Total revenues $ 20,249 $ 18,617 $ 26,411 $ 39,136 $ 64,676 Cost of sales 8,445 7,189 11,462 16,477 26,399 -------- -------- -------- -------- -------- Gross profit 11,804 11,428 14,949 22,659 38,277 Operating expenses 11,226 11,942 16,137 19,277 26,848 Gain on sale of drug licenses - - 5,050 650 - Other income (expenses), net (887) (9) (49) 138 91 Provision for income taxes 781 222 2,452 2,534 5,423 -------- -------- -------- -------- -------- Net income (loss) $ (1,090) $ (745) $ 1,361 $ 1,636 $ 6,097 ======== ======== ======== ======== ======== Net income (loss) per common share - basic $ (0.12) $ (0.06) $ 0.10 $ 0.10 $ 0.34 ======== ======== ======== ======== ======== Net income (loss) per common share - diluted $ (0.12) $ (0.06) $ 0.08 $ 0.08 $ 0.28 ======== ======== ======== ======== ======== Weighted average common shares outstanding - basic 9,147 12,981 14,196 16,569 17,997 ======== ======== ======== ======== ======== Weighted average common shares outstanding - diluted 9,147 12,981 16,147 19,798 21,637 ======== ======== ======== ======== ======== 39 Consolidated Balance Sheet Data December 31, --- (in thousands) 1999 2000 2001 2002 2003 -------- -------- -------- -------- -------- Working capital $ 1,130 $ 3,742 $ 6,276 $ 30,703 $ 45,701 ======== ======== ======== ======== ======== Currrent assets $ 11,689 $ 13,104 $ 15,839 $ 43,972 $ 66,899 Non-current assets 10,548 15,773 16,280 20,720 33,564 -------- -------- -------- -------- -------- Total assets $ 22,237 $ 28,877 $ 32,119 $ 64,692 $100,463 ======== ======== ======== ======== ======== Current liabilities $ 10,559 $ 9,362 $ 9,563 $ 13,269 $ 21,198 Long-term debt - 908 142 345 369 Other non-current liabilities 104 791 1,990 2,327 2,731 -------- -------- -------- -------- -------- Total liabilities $ 10,663 $ 11,061 $ 11,695 $ 15,941 $ 24,298 ======== ======== ======== ======== ======== Redeemable preferred stock $ - $ - $ - $ - $ - ======== ======== ======== ======== ======== Stockholders' equity $ 11,574 $ 17,816 $ 20,424 $ 48,751 $ 76,165 ======== ======== ======== ======== ======== 40 Item 7. Management's Discussion and Analysis of Financial Condition and Results -- of Operations ------------- The following discussion and analysis should be read in conjunction with the Financial Statements and related Notes included in Item 8 of this Annual Report on Form 10-K. Except for the historical information contained herein the foregoing discussion contains forward-looking statements that involve risks and uncertainties. Our actual results could differ materially from those projected in the forward-looking statements discussed herein. Business Environment We are a specialty pharmaceutical company focused on: o research, development and licensing/commercialization of advanced drug delivery technologies and pharmaceutical products; and o development, licensing and sales of generic and branded pharmaceutical products and the manufacturing of pharmaceuticals for others. In our research and development activities, we have patents and other proprietary rights to technologies that facilitate the absorption of drugs. Our pharmaceutical product sales activities are based in Spain, where we have a significant commercial presence and we manufacture and market approximately 100 pharmaceutical products. These products represent various dosage strengths and product formulations of more than 30 chemical entities in four primary therapeutic areas: cardiovascular, gastrointestinal, neurological and infectious diseases. We also manufacture pharmaceuticals for other drug companies. We develop products which incorporate our drug delivery technologies and have licensed applications of our proprietary CPE-215(R) drug delivery technology to Auxilium Pharmaceuticals, Inc., which launched Testim(TM), the first product incorporating our drug delivery technology, in February 2003. Testim a gel indicated for testosterone replacement therapy which restores serum testosterone levels in men and thereby improves symptoms of health problems associated with low testosterone levels (hypogonadism), including loss of muscle mass and a decrease in sexual desire, sexual motivation and frequency of spontaneous erections. We are in discussions with other pharmaceutical and biotechnology companies to form additional strategic alliances to facilitate the development and commercialization of other products using our drug delivery technologies, including product candidates that deliver insulin to diabetic patients intranasally and treat nail fungus infections topically. Our generic and branded products are marketed to physicians, pharmacists and hospitals by our three separate sales and marketing organizations based in Spain: Laboratorios Belmac, Laboratorios Davur and Laboratorios Rimafar. We continually add to our product portfolio in response to increasing market demand for generic and branded therapeutic agents and divest portfolio products that we consider to be redundant or that have become non-strategic. Although most of our sales of these products are currently in the Spanish market, we have recently focused on increasing our sales in other European countries and other geographic regions through strategic alliances with companies in these countries. 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 41 151 full-time personnel located in major cities throughout Spain. In addition, our Spanish manufacturing facility produces pharmaceutical products which are marketed by pharmaceutical companies both in Spain and in other markets. Consolidated Results of Operations Fiscal Year Ended December 31, 2003 Compared To Fiscal Year Ended December 31, 2002 Revenues (in thousands) Increase ------------------ 2003 % 2002 % $ % ------------- ------------- ------- ------- Revenues: Net product sales $62,955 97% $38,718 99% $24,237 63% Licensing and collaboration revenues 1,721 3% 418 1% 1,303 312% ------------- ------------- ------- ------- Total revenues $64,676 100% $39,136 100% $25,540 65% ============= ============= ======= ======= Our total revenues increased 65% from the prior year. The increase is primarily attributed to the continuing growth of our Spanish operations and secondarily to the advancement of our proprietary drug delivery programs in the U.S., as evidenced by the launch of Testim, the first product incorporating our drug delivery technology, by our licensee in February 2003. Our revenues are generated through our five primary sales channels (branded, generic, contract manufacturing, sales outside of Spain and licensing and collaborations). See a summary of our revenues by sales channel and top-selling product lines below: For the year ended December 31, 2003 (in thousands): Sales Within Spain -------------------------------- Contract Branded Generic Manu- Other % of Total Product Line Products Products facturing Revenues Total Revenues ------------ -------- -------- --------- -------- ------- ---------- Omeprazole $ 6,099 $13,863 $ - $ - $19,962 31% Simvastatin 2,176 4,412 - - 6,588 10% Enalapril 2,610 1,878 - - 4,488 7% Codeisan 2,713 - - - 2,713 4% Pentoxifylline - 2,070 - - 2,070 3% All other products 5,463 4,744 - - 10,207 16% Contract manufacturing - - 9,536 - 9,536 15% Sales outside of Spain - - - 7,391 7,391 11% Licensing and collaborations - - - 1,721 1,721 3% ------- ------- ------- ------- ------- -------- Total Revenues $19,061 $26,967 $ 9,536 $ 9,112 $64,676 100% ======= ======= ======= ======= ======= ======== % of 2003 Revenues 29% 42% 15% 14% 100% 42 For the year ended December 31, 2002 (in thousands): Sales Within Spain -------------------------------- Contract Branded Generic Manu- Other % of Total Product Line Products Products facturing Revenues Total Revenues ------------ -------- -------- --------- -------- ------- ---------- Omeprazole $ 5,051 $ 9,813 $ - $ - $14,864 38% Simvastatin 322 1,261 - - 1,583 4% Enalapril 955 1,515 - - 2,470 6% Codeisan 1,944 - - - 1,944 5% Pentoxifylline - 1,348 - - 1,348 3% All other products 4,103 2,738 - - 6,841 18% Contract manufacturing - - 7,406 - 7,406 19% Sales outside of Spain - - - 2,262 2,262 6% Licensing and collaborations - - - 418 418 1% ------- ------- ------- ------- ------- -------- Total Revenues $12,375 $16,675 $ 7,406 $ 2,680 $39,136 100% ======= ======= ======= ======= ======= ======== % of 2002 Revenues 32% 43% 19% 6% 100% Spanish Operations. The core of our Spanish operations has been the efficient manufacturing and domestic marketing of branded and generic pharmaceutical products. Historically, our pharmaceutical products were sold only within Spain. However, the execution of our long-term strategic plan over the past eight years has created an opportunity for our Spanish operations to expand beyond the borders of Spain and into other European countries and other countries outside of Europe. The 65% growth in revenues was fueled by an increase in sales of our two major product lines, omeprazole and simvastatin. Sales of omeprazole and simvastatin increased 61% to $26,550,000 in 2003 compared to $16,447,000 in the prior year. The growth of these two product lines accounted for 40% of our growth in revenues in the current year. An increase in the weighted average value of the Euro, in relation to the U.S.

Dollar over the past 12 months, had the effect of increasing revenues by approximately $10,449,000, or 27%, during the year ended December 31, 2003. Prices for prescription pharmaceutical products in Spain must be approved by the Ministry of Health. In order to help control rising healthcare costs, the Ministry of Health, in recent years, has encouraged the substitution of generic-equivalent products. In further efforts to reduce healthcare costs, the Ministry of Health had been contemplating new laws and regulations that would significantly reduce the market prices of certain pharmaceutical products, including generic-equivalent drugs. In late October 2003, the Spanish government enacted a regulation that reduced the prices that the government reimburses for six of our chemical entities, including the chemical entities omeprazole, simvastatin and enalapril, which accounted for approximately 65% to 70% of revenues in the year ended December 31, 2003. These new prices were required to take effect on December 26, 2003. However, we, and some other pharmaceutical companies in Spain, strategically implemented the new prices on December 1, 2003. Our strategy was to gain additional market share by selling to customers that wanted to buy the products at the new lower prices. We anticipated this opportunity as some of our customers delayed placing orders in November. November sales declined by approximately 19% percent from October 43 levels; however, December sales demand was very strong as we gained market share as a result of our pricing strategy. The increase in December unit volume offset the impact of the lower prices. While the adoption of the new prices did not have a material effect on our total sales in December, it did reduce our margins. Over the years, we had steadily improved our gross margins on net product sales from 57% in 2001 to 59% for the ten months ended October 31, 2003. The improved margins were the result of economies of scale. Our gross margins in November slipped to 55% as our fixed costs were absorbed by fewer units sold in that month. Upon reducing our prices in December of 2003, our gross margins remained constant at 55%, but unit volume increased by approximately 60% over November levels. We have implemented several initiatives to mitigate the decline in margins. We expect to continue to increase our future sales volume through our pipeline of approximately 100 products, consisting of approximately 20 chemical entities that are not affected by the new pricing regulations. In addition, we have modified our pricing structure in efforts to increase our sales volume and market share throughout Spain. We will continue to focus on acquiring, developing and launching new products that will improve our product mix. We will also continue our efforts to increase our sales outside of Spain through additional registration, marketing, and supply agreements. We have made significant investments in renovating and increasing capacity in our manufacturing facility, as well as investments in new high speed, high volume equipment. These investments will enable us to manufacture and package larger quantities of products more efficiently and cost effectively. We anticipate that the current gross margins will continue until the existing inventory is depleted, near the end of the first quarter of 2004 and then we expect to see margins increase by about two percentage points. Thereafter, we expect margins to gradually improve, as they have in the past, as a result of increasing volumes and economies of scale. Branded Pharmaceutical Products ------------------------------ (in thousands) Increase ------------------- 2003 % 2002 % $ % -------------- -------------- ------- -------- Branded Product Sales: Simvastatin $ 2,176 11% $ 322 2% $ 1,854 576% Enalapril 2,610 14% 955 8% 1,655 173% Omeprazole 6,099 32% 5,051 41% 1,048 21% Codeisan 2,713 14% 1,944 16% 769 40% All other branded products 5,463 29% 4,103 33% 1,360 33% -------------- -------------- ------- -------- Total branded sales $19,061 100% $12,375 100% $ 6,686 54% ============== ============== ======= ======== Sales of our branded pharmaceutical products increased by 54% compared to the prior year, although they accounted for only 29% of total revenues in 2003 compared to 32% in 2002. Sales of our branded simvastatin increased by approximately $1,854,000, or approximately 576% from the prior year. Sales of our branded enalapril increased by approximately $1,655,000, or approximately 173% from the prior year. Sales of our branded omeprazole increased by approximately $1,048,000, or 21% from the prior year. Sales of our branded codeisan increased by approximately $769,000, or approximately 40% from the prior year. While we expect to continue to develop, acquire, and launch new branded products, our focus on generics and sales outside of Spain are expected to increase at a significantly higher pace than that of our branded products. An increase in the weighted average value of the Euro, in relation to the U.S. Dollar over the past 12 months, had the effect of increasing branded net product sales by approximately $3,153,000, or 25%, during the year ended December 31, 2003. 44 Generic Pharmaceutical Products ------------------------------ (in thousands) Increase ------------------ 2003 % 2002 % $ % ------------- ------------- ------- ------- Generic Product Sales: Omeprazole $13,863 51% $ 9,813 59% $ 4,050 41% Simvastatin 4,412 16% 1,261 8% 3,151 250% Pentoxifylline 2,070 8% 1,348 8% 722 54% Enalapril 1,878 7% 1,515 9% 363 24% All other generic products 4,744 18% 2,738 16% 2,006 73% -------------- -------------- ------- -------- Total generic sales $26,967 100% $16,675 100% $10,292 62% ============== ==============

======= ======== Sales of our generic pharmaceutical products increased by 62% compared to the prior year. Sales of our generic omeprazole increased by approximately $4,050,000, or approximately 41% from the prior year. Sales of our generic simvastatin increased by approximately $3,151,000, or approximately 250% from the prior year. Sales of our generic pentoxifylline increased by approximately $722,000, or approximately 54% from the prior year. Generic products launched in 2003, such as trimetazedine and paroxetine, accounted for approximately $1,600,000 of our 2003 revenues. We expect to continue to increase our generic drug portfolio and increase our generic drug sales in Spain as products come off patent in the future. An increase in the weighted average value of the Euro, in relation to the U.S. Dollar over the past 12 months, had the effect of increasing generic net product sales by approximately $4,461,000, or 27%, during the year ended December 31, 2003. Contract Manufacturing --------------------- (in thousands) Increase ----------------- 2003 2002 $ % ------ ------ ------ --- Contract manufacturing $9,536 $7,406 $2,130 29% In addition to manufacturing our own products, our Spanish manufacturing facility supplies branded and generic products to 14 entities in Spain which market these products under their own name and with their own labeling. Revenues generated from contract manufacturing have increased by approximately 29% from the prior year, but represented only 15% of total revenues in 2003, compared to 19% of total revenues in 2002. The increase is primarily attributable to increased demand for formulations of omeprazole, our largest contract manufactured product line. Our increased capacity and high speed, high volume equipment enable us to manufacture pharmaceutical products at low costs. This competitive advantage could lead to an increase in contract manufacturing agreements in 2004 as other pharmaceutical companies in Spain search to find low cost alternatives to mitigate the new lower selling prices. An increase in the weighted average value of the Euro, in relation to the U.S. Dollar over the past 12 months, had the effect of increasing contract manufacturing sales by approximately $1,577,000, or 21%, during the year ended December 31, 2003. 45 Sales Outside of Spain --------------------- (in thousands) Increase ----------------- 2003 2002 $ % ------ ------ ------ ---- Sales outside of Spain $7,391 $2,262 $5,129 227% We have entered into license and supply agreements with more than 15 entities to sell our products outside of Spain. Sales under these supply agreements have increased 227% from 6% of total revenues in 2002 to 11% of total revenues in 2003. The $5,129,000 increase is primarily attributable to demand for formulations of omeprazole, our largest selling product outside of Spain. An increase in the weighted average value of the Euro, in relation to the U.S. Dollar over the past 12 months, had the effect of increasing sales outside of Spain by approximately $1,223,000, or 54%, during the year ended December 31, 2003. Licensing and Collaboration Revenues. Licensing and collaboration revenues now account for 3% of total revenues and increased by approximately $1,303,000, or approximately 312%, in 2003 and include milestone payments and royalties from the commercialization and continued sales of Testim, the first product incorporating our drug delivery technology, which was launched by our licensee, Auxilium, in February 2003. Testim is currently reported to capture approximately 10% of all new testosterone replacement prescriptions in the market. We have also recognized revenues totaling $203,000 during the year ended December 31, 2003, related to product licensing activities in Europe, which we have included in the Consolidated Income Statements as licensing and collaboration revenues. Gross Profit. Gross profit increased by approximately 69% from the prior year. Approximately $14,315,000, or 92% of increase, is due to the 63% increase in net product sales (and slightly improved gross margins in 2003) and $1,303,000, or 8% of the increase, is due to the increased licensing and collaboration revenues in the current year. Our gross margins on net product sales in 2003 increased slightly to 58.0% compared to 57.4% in the prior year as result of economies of scale (allocation of fixed costs over a larger number of units, reducing the per-unit cost), partially offset by lower margins of generic products, which typically have lower prices, and the sales of certain of our products in the month of December at reduced selling prices. We experienced an increase in gross profit of 42% in local currency in 2003 compared to the prior year. An increase in the weighted average value of the Euro, in relation to the U.S. Dollar over the past 12 months, had the effect of increasing gross profit by approximately $6,065,000 during the year ended December 31, 2003. Gross margins on certain of our products have decreased as a result of the recently reduced selling prices in Spain. Although we were not required to sell products at the new lower prices until December 26, 2003, we strategically implemented the new price structure beginning December 1, 2003. Our strategy was to gain additional market share by selling to customers that wanted to buy the products at the new lower prices. See discussion above in Spanish Operations. As discussed above, we have implemented several initiatives to mitigate the decline in margins. We expect to continue to increase our future sales volume through our pipeline of approximately 100 products, consisting of approximately 20 chemical entities that are not affected by the new pricing 46 regulations. In addition, we have modified our pricing structure in efforts to increase our sales volume and market share throughout Spain. We will continue to focus on acquiring, developing and launching new products that will improve our product mix. We will also continue our efforts to increase our sales outside of Spain through additional registration, marketing, and supply agreements. We have made significant investments in renovating and increasing capacity in our manufacturing facility, as well as investments in new high speed, high volume equipment. These investments will enable us to manufacture and package larger quantities of products more efficiently and cost effectively. We anticipate that the current gross margin percentages will continue until the existing inventory is depleted near the end of the first quarter of 2004 and then we expect to see margins increase by about two percentage points. Thereafter, we expect margins to gradually improve, as they have in the past, as a result of increasing volumes and economies of scale. Gross margins could decrease in the future if sales of higher priced products are replaced with sales of lower priced generic products, as a result of a change in our product mix or by additional governmental action. However, as previously discussed we have developed, and continue to implement, a broad-based growth strategy that should mitigate the impact on our margins over time. Selling and Marketing Expenses ----------------------------- (in thousands) Increase ----------------- 2003 2002 $ % ------ ------ ------ --- Selling and marketing $14,212 $10,400 $3,812 37% Selling and marketing expenses increased by approximately 37% from the prior year. The $3,812,000 increase, of which approximately 75% represented increased sales force costs and approximately 25% represented increased promotion and marketing programs, was instrumental in achieving a 63% increase in net product sales. However, the increase in the weighted average value of the Euro, in relation to the U.S. Dollar, over the past 12 months had the effect of increasing selling and marketing expenses by approximately $2,361,000 in 2003, accounting for approximately 62% of the increase. Selling and marketing expenses as a percentage of net product sales decreased to 23% in 2003 compared to 27% of net product sales in 2002. General and Administrative Expenses ---------------------------------- (in thousands) Increase ----------------- 2003 2002 $ % ------ ------ ------ --- General and administrative $7,001 $4,902 $2,099 43% General and administrative expenses increased 43% from the prior year. The $2,099,000 increase was the result of increased general and administrative activities required to support our revenue growth in 2003 and prepare for our anticipated future growth. Such expenditures included costs of additional employees, outside services, occupancy costs, corporate communications, insurance, etc. General and administrative expenses as a percent of total revenues decreased to 11% in 2003, compared to 13% of total revenues in 2002. General and administrative expenses would have been approximately $642,000 lower in 2003, absent the increase in the weighted average value of the Euro, in relation to the U.S. Dollar, over the past 12 months. We expect that our future expenditures for general and administrative expenses will continue to increase as we grow. Although we cannot reasonably estimate the costs associated with 47 implementation of the internal control provisions of the Sarbanes-Oxley Act of 2002, we do expect to incur costs not previously experienced. Research and Development Expenses -------------------------------- (in thousands) Increase ----------------- 2003 2002 $ % ------ ------ ------ --- Research and development $4,295 $2,960 $1,335 45% Research and development expenses increased approximately 45% from the prior year. The $1,335,000 increase is due to pre-clinical 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 reflect our focus on projects that are necessary for expansion of our portfolio of marketed products and clinical trials involving our drug delivery 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. We are currently in the planning stages of clinical programs to support the eventual distribution of certain of our Spanish generic pharmaceutical products in other countries, including the U.S. We have also undertaken a clinical program for the intranasal delivery of insulin and have recently completed a successful Phase I study and are in the planning stages of additional clinical trials. We expect to incur costs to conduct clinical trials and support the required regulatory submissions for these programs. Although some of our cost estimates are preliminary, and the specific timing is not known, our research and development expenses in 2004 could be $2,000,000 higher than in the year ended December 31, 2003. Provision for Income Taxes ------------------------- 2003 -------------------------------- Consol- (in thousands) Spain U.S. idated ------- ------- ------- Income (loss) before income taxes $15,091 $(3,571) $11,520 Provision (benefit) for income taxes 5,092 (1,017) 4,075 Valuation allowance - 1,348 1,348 ------- ------- ------- Net provision (benefit) for income taxes 5,092 331 5,423 ------- ------- ------- Net income (loss) $ 9,999 $(3,902) $ 6,097 ======= ======= ======= Effective tax rate 34% (9)% 47% ======= ======= ======= We recorded a provision for foreign income taxes totaling $5,092,000 (approximately 34% of the Spanish pretax income of $15,091,000) for the year ended December 31, 2003 compared to a provision for foreign income taxes of $2,534,000 (approximately 37% of the Spanish pretax income of $6,913,000) in the prior year. The 2003 provision for Spanish income taxes results from reporting taxable income from operations in Spain, whereas the 2002 Spanish provision for income taxes included approximately 48 $2,304,000 as a result of reporting taxable income from operations in Spain and approximately $230,000 as a result of capital gains taxes arising from the sale of Biolid(R), Lactoliofil(R) and other drug licenses. The 2003 provision for foreign income taxes would have been approximately $854,000 lower than reported, absent the increase in the weighted average value of the Euro, in relation to the U.S. Dollar, over the past 12 months. Our U.S. Company recorded a provision for foreign incomes taxes payable totaling $331,000 for the year ended December 31, 2003. This amount represents payments due to the Spanish tax authorities by our U.S. Company for withholding taxes on certain of our intercompany fee arrangements with our Spanish subsidiaries. No such amounts were recorded in prior years. We generated additional U.S. federal net operating loss carry-forwards in 2003 and 2002 as a result of U.S. pretax losses of ($3,571,000) and ($2,743,000), respectively. However, since we are not assured of future profitable domestic operations, we have recorded a valuation allowance for any future tax benefit of such losses in the U.S. Therefore, no tax benefit has been recognized with respect to U.S. losses reported in 2003 or 2002. Net Income ---------- (in thousands) Increase --------------- 2003 2002 $ % ------- ------- ------- ---- Net income $ 6,097 $ 1,636 $ 4,461 273% ======= ======= ======= ==== Net income per common share: Basic $ 0.34 $ 0.10 $ 0.24 243% ======= ======= ======= ==== Diluted $ 0.28 $ 0.08 $ 0.20 241% ======= ======= ======= ==== Weighted average common shares outstanding: Basic 17,997 16,569 1,428 9% ======= ======= ======= ==== Diluted 21,637 19,798 1,839 9% ======= ======= ======= ==== We reported 2003 income from operations of $11,429,000 compared to 2002 income from operations of $4,032,000 (including the $650,000 pre-tax gain on sale of the Biolid, Lactoliofil and other drug licenses). The combination of income from operations of $11,429,000 and the non-operating items, primarily the provision for income taxes of $5,423,000, resulted in 2003 net income of $6,097,000, or $.34 per basic common share ($.28 per diluted common share) on 17,997,000 weighted average basic common shares outstanding (21,637,000 weighted average diluted common shares outstanding), compared to 2002 net income of $1,636,000, or $.10 per basic common share ($.08 per diluted common share) on 16,569,000 weighted average basic common shares outstanding (19,798,000 weighted average diluted common shares outstanding). Net income in the future could be negatively impacted as a result of the lower selling prices in Spain and anticipated increases in research and development programs that are expected to benefit future periods. However, as previously discussed, our broad-based growth strategy should mitigate the impact of these developments over time. 49 Fiscal Year Ended December 31, 2002 Compared To Fiscal Year Ended December 31, 2001 Revenues -------- (in thousands) Increase -------------- ------------------ 2002 2001 $ % ------- ------- ------- ----- Revenues: Net product sales $38,718 $26,411 $12,307 47% Licensing and collaboration revenues 418 - 418 * ------- ------- ------- ----- Total revenues $39,136 $26,411 $12,725 48% ======= ======= ======= ===== * Not meaningful Net Product Sales. Net product sales increased by 47% from $26,411,000 in 2001 to $38,718,000 in 2002. The $12,307,000 increase was primarily the result of our continuing efforts to increase sales in the generic drug market in Spain. We anticipated the opportunities in the emerging generic drug market in Spain and began taking measures over four years ago to enter the Spanish generic drug market. We began to register, manufacture and market 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-equivalent 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. We experienced an increase in net sales of 42% in local currency in Spain in 2002 compared to the prior year. An increase in the weighted average value of the Euro, in relation to the U.S. Dollar had the effect of increasing revenues by approximately $2,145,000 during the year ended December 31, 2002. Prices for prescription pharmaceuticals have been established in Spain by the Ministry of Health. In order to control rising healthcare costs, substitution of generically equivalent products is often encouraged. In certain circumstances, the local governments in Spain require that prescriptions for generic medications be filled using one of the three cheapest products on the market unless the prescription specifies a particular manufacturer's product. These policies may have the effect of eroding gross margins, as sales of higher priced branded products may be replaced with sales of lower priced generic products. We are striving to maintain product sales and gross margins by concentrating our efforts on increasing sales volume, being competitive in the generic drug market, developing new products and increasing exports outside Spain. Licensing and Collaboration

Revenues. Licensing and collaboration revenues totaled $418,000 in 2002. We entered into a research collaboration whereby our collaborator agreed to fund a research and development program to combine Bentley's patented CPE-215 drug delivery technologies with certain proprietary compounds. Our collaborator advanced to us $250,000 during the fourth quarter of 2001, which we recorded as deferred income as of December 31, 2001, and we recognized it as revenue as the related costs were incurred. We also recognized revenues totaling $150,000 during the year ended December 31, 2002, related to product licensing activities, which we included in the Consolidated Income Statements as licensing and collaboration revenues. Gross Profit. Gross profit increased by 52% from $14,949,000 in 2001 to $22,659,000 in 2002. The $7,710,000 increase was the direct result of the growth in our net product sales from 2001 to 2002. Our gross margins on net product sales in 2002 increased slightly to 57.4% compared to 56.6% in the prior 50 year as result of economies of scale (allocation of fixed costs over a larger number of units, reducing the per-unit cost), partially offset by lower margins of generic products, which typically have lower prices. We experienced an increase in gross profit of 42% in local currency in 2002 compared to the prior year. An increase in the weighted average value of the Euro, in relation to the U.S. Dollar, had the effect of increasing gross profit by approximately $1,218,000 during the year ended December 31, 2002. Sales of generic products accounted for approximately 42% of our net product sales during the year ended December 31, 2002, compared to 30% in the prior year. Although we expect to continue to benefit from economies of scale in the future as we grow, gross margins may decrease as sales of generic products, with lower margins, become more significant in the future. Additionally, the Ministry of Health in Spain levies a tax on pharmaceutical companies for the purpose of funding rising healthcare costs in Spain. In 2002, this tax had the effect of reducing gross profit by approximately $551,000 and gross margins by approximately 1 percentage point. Selling and Marketing Expenses ----------------------------- (in thousands) Increase ---------------- 2002 2001 $ % -------- -------- ------- ---- Selling and marketing $ 10,400 $ 9,057 $1,343 15% Selling and marketing expenses increased by 15% from $9,057,000 in 2001 to $10,400,000 in 2002. The $1,343,000 increase was instrumental in achieving a 47% increase in net product sales during the period, as a result of our successful sales and marketing programs. The increase in the weighted average value of the Euro, in relation to the U.S. Dollar, had the effect of increasing selling and marketing expenses by $537,000 in 2002. Selling and marketing expenses as a percentage of net product sales decreased to 27% in 2002 compared to 34% of sales in 2001. General and Administrative Expenses ---------------------------------- (in thousands) Increase ---------------- 2002 2001 $ % -------- -------- ------- --- General and administrative $ 4,902 $ 4,085 $ 817 20% General and administrative expenses increased by 20% from $4,085,000 in 2001 to $4,902,000 in 2002. The $817,000 increase was the result of increased general and administrative activities required to support our revenue growth in 2002. General and administrative expenses as a percent of total revenues decreased to only 12.5% in 2002, compared to 15.5% of revenues in 2001. General and administrative expenses would have been approximately $162,000 lower in 2002, absent the increase in the weighted average value of the Euro, in relation to the U.S. Dollar. We expect that our future expenditures for general and administrative expenses will continue to increase as we grow. Although we cannot reasonably estimate the costs associated with implementation of the internal control provisions of the Sarbanes-Oxley Act of 2002, we do expect to incur costs not previously experienced; however, we do not believe that these costs will be material to our financial position, results of operations or cash flows. 51 Research and Development Expenses -------------------------------- (in thousands) Increase ---------------- 2002 2001 $ % -------- -------- ------- ---- Research and development $ 2,960 $ 2,084 $ 876 42% Research and development expenses increased by 42% from $2,084,000 in 2001 to $2,960,000 in 2002. The $876,000 increase was the result of an increase in our costs associated with our research and development collaboration as well as our Phase I/II Clinical Studies (treatment of nail fungal infections), pre-clinical 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 reflect our focus on projects that are necessary for expansion of our portfolio of marketed products and clinical trials involving our drug delivery 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 ------------------------------------ (in thousands) Increase ---------------- 2002 2001 $ % -------- -------- ------- ---- Depreciation and amortization $ 1,015 $ 911 $ 104 11% Depreciation and amortization expenses increased by 11% from $911,000 in 2001 to $1,015,000 in 2002. The $104,000 increase in 2002 was primarily the result of higher depreciation charges with respect to recent asset additions and the effect of fluctuations in foreign currency exchange rates. Depreciation and amortization charges are expected to be higher in 2003 as a result of these additions. Provision for Income Taxes ------------------------- 2002 -- (in thousands) Spain U.S. Consolidated -------- -------- ------------ Income (loss) before income taxes $ 6,913 $(2,743) $ 4,170 Provision (benefit) for income taxes 2,534 (933) 1,601 Valuation allowance - 933 933 ------- ------- ------- Net provision for income taxes 2,534 - 2,534 ------- ------- ------- Net income (loss) $ 4,379 $(2,743) $ 1,636 ======= ======= ======= Effective tax rate 37% 0% 61% ======= ======= ======= We generated additional U.S. federal net operating loss carry-forwards in 2002. However, since we are not assured of future profitable domestic operations, we have recorded a valuation allowance for any future tax benefit of such losses in the U.S. Therefore, no benefit has been recognized with respect to U.S. losses reported in 2002. We recorded a provision for foreign income taxes totaling $2,534,000 (37% of Spanish pre-tax income) for the year ended December 31, 2002 compared to a provision for foreign income taxes of $2,452,000 in the prior year. The provision for income taxes for 2002 included 52 approximately $2,304,000 as a result of reporting taxable income from operations in Spain and approximately $230,000 as a result of capital gains taxes arising from the sale of Biolid(R), Lactoliofil(R) and other drug licenses, whereas the provision for income taxes in the prior year included approximately $607,000 as a result of reporting taxable income from operations in Spain and approximately $1,845,000 as a result of capital gains taxes arising from the sale of drug licenses. The provision for income taxes would have been approximately $110,000 lower than reported, absent the increase in the weighted average value of the Euro, in relation to the U.S. Dollar. Net Income ---------- (in thousands) Increase ------------------- 2002 2001 $ % ------ ------ ======= === Net income $ 1,636 $ 1,361 $ 275 20% ======= ======= ======= === Net income per common share: Basic $ 0.10 $ 0.10 $ - - ======= ======= ======= === Diluted $ 0.08 $ 0.08 $ - - ======= ======= ======= === Weighted average common shares outstanding: Basic 16,569 14,196 2,373 17% ======= ======= ======= === Diluted 19,798 16,147 3,651 23% ======= ======= ======= === Including the $650,000 pre-tax gain on sale of the Biolid, Lactoliofil and other drug licenses, we reported income from operations of $4,032,000 for 2002 compared to income from operations of $3,862,000 (including $4,977,000 of pre-tax gain on sale of the Controlvas(R) drug license) in the prior year. Excluding the $650,000 pre-tax gain from the sale of drug licenses, income from operations for the year ended December 31, 2002 totaled $3,382,000 compared to a loss of $1,188,000 in the prior year. The combination of income from operations of $4,032,000 and the non-operating items, primarily the provision for income taxes of $2,534,000, resulted in net income of $1,636,000, or $.10 per basic common share ($.08 per diluted common share) on 16,569,000 weighted average basic common shares outstanding (19,798,000 weighted average diluted common shares outstanding) for 2002, compared to net income in the prior year 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). 53 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. Fiscal 2002 Fiscal 2003 --- -- Three Months Ended (Unaudited) --- 3/31/2002(a) 6/30/2002(a) 9/30/2002(a) 12/31/2002 3/31/2003 6/30/2003 9/30/2003 12/31/2003 -- --- (in thousands, except per share data) Total revenues $ 9,174 $ 9,867 $ 8,571 $ 11,524 $ 14,988 $ 16,754 $ 14,875 $ 18,059 Cost of sales 3,776 4,249 3,579 4,873 6,121 6,819 5,744 7,715 -------- -------- -------- -------- -------- -------- -------- -------- Gross profit 5,398 5,618 4,992 6,651 8,867 9,935 9,131 10,344 Operating expenses 4,715 4,743 4,300 5,519 6,213 6,619 6,290 7,726 Gain on sale of drug licenses 72 520 - 58 - - - - -------- -------- -------- -------- -------- -------- -------- -------- Income from operations 755 1,395 692 1,190 2,654 3,316 2,841 2,618 Other income/(expenses), net (23) 10 67 84 29 18 20 24 Provision for income taxes 597 886 468 583 1,151 1,805 1,513 954 -------- -------- -------- -------- -------- -------- -------- -------- Net income $ 135 $ 519 $ 291 $ 691 $ 1,532 $ 1,529 $ 1,348 $ 1,688 ======== ======== ======== ======== ======== ======== ======== ======== Net income per common share: Basic $ 0.01 $ 0.03 $ 0.02 $ 0.04 $ 0.09 $ 0.09 $ 0.08 $ 0.09 ======== ======== ======== ======== ======== ======== ======== ======== Diluted $ 0.01 $ 0.03 $ 0.01 $ 0.03 $ 0.08 $ 0.07 $ 0.06 $ 0.08 ======== ======== ======== ======== ======== ======== ======== ======== Weighted average common shares outstanding: Basic 14,634 16,823 17,377 17,405 17,455 17,534 17,911 19,071 ======== ======== ======== ======== ======== ======== ======== ======== Diluted 17,922 20,484 20,706 20,121 20,350 20,878 22,228 22,418 ======== ======== ======== ======== ========

======== ======== ======== ------------- (a) Certain prior period amounts previously reported as cost of sales have been reclassified as a reduction of revenues to conform with the current period's presentation format. Such reclassifications are not considered material to the consolidated financial statements. Liquidity and Capital Resources Total assets increased 55% from $64,692,000 at December 31, 2002 to $100,463,000 at December 31, 2003, while stockholders' equity increased 56% from $48,751,000 at December 31, 2002 to $76,165,000 at December 31, 2003. The increase in stockholders' equity reflects primarily the net proceeds from the exercise of stock options and warrants totaling $15,222,000, the positive impact of the fluctuation of the Euro/US dollar exchange rate which totaled $5,585,000 and net income of $6,097,000. Working capital increased 49% from $30,703,000 at December 31, 2002 to $45,701,000 at December 31, 2003, primarily as a result of proceeds from exercises of stock options and warrants and positive cash flow from operations, which was partially offset by additions to fixed assets. Cash, cash equivalents and marketable securities increased 51% from $26,977,000 at December 31, 2002 to $40,645,000 at December 31, 2003, primarily as a result of net proceeds received from exercises of stock options and warrants totaling $15,222,000 and cash provided by operating activities of $8,168,000, partially offset by additions to fixed assets totaling $8,076,000 and additions to drug licenses and related costs of $2,298,000. Also included in cash and cash equivalents at December 54 31, 2003 are approximately $29,156,000 of short-term liquid investments considered to be cash equivalents. Receivables increased from $10,874,000 at December 31, 2002 to $18,036,000 at December 31, 2003 as a direct result of the increase in net product sales. Trade receivables comprise 90% of total 2003 receivables, totaling $16,233,000. Receivables at December 31, 2003 also include royalties receivable totaling $884,000 and taxes receivable totaling $953,000. Receivables increased by approximately $4,119,000 in local currency, but fluctuations in foreign currency exchange rates increased receivables reported in U.S. dollars by approximately $3,043,000. We have not experienced any material delinquencies on our receivables that have had a material effect on our financial position, results of operations or cash flows. Inventories increased from $5,133,000 at December 31, 2002 to $7,106,000 at December 31, 2003 primarily as a result of raw materials purchases and strategic increases in finished goods inventories in anticipation of continuing demand for our generic products. Inventories increased by approximately $801,000 in local currency, but fluctuations in foreign currency exchange rates increased inventories reported in U.S. dollars by approximately $1,172,000. The combined total of accounts payable and accrued expenses increased from $11,265,000 at December 31, 2002 to $17,257,000 at December 31, 2003, primarily due to the effect of fluctuations in foreign currency exchange rates (approximately $2,864,000), accruals for taxes payable (approximately $1,784,000) and additions to fixed assets of $733,000. Short-term borrowings and current portion of long-term debt increased from $1,725,000 at December 31, 2002 to $1,985,000 at December 31, 2003, as a result of the effect of fluctuations in foreign currency exchange rates partially offset by net repayment of short-term borrowings. The weighted average interest rate on our short-term borrowings and current portion of long-term debt is 3.8%. Long-term debt, which totaled $345,000 at December 31, 2002, increased to $369,000 during the year ended December 31, 2003 as a result of imputed interest on certain interest-free loans in Spain. The weighted average interest rate (including imputed interest) on our long-term debt is 5.6%. 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, 2003 (in thousands): Payments Due By Period --- Less than 1 1 - 3 4 - 6 7 - 10 Total year years years years ------- ---------- ----- ----- ------ Long-term debt, including imputed interest of $83 $ 522 $ 70 $ 107 $ 194 $ 151 Capital leases - - - - - Operating leases 1,405 708 686 11 - Purchase obligations(1) - - - - - Other long-term liabilities(2) 2,731 15 1,134 1,118 464 ------ ------ ------ ------ ------ Total contractual cash obligations(3) $4,658 $ 793 $1,927 $1,323 $ 615 ====== ====== ====== ====== ====== (1) Purchase orders or contracts for the purchase of raw materials and other goods and services are not included in the table above as our purchase orders represent authorizations to purchase rather than binding agreements. For the purposes of this table, contractual obligations for purchase of goods or services are defined as agreements 55 that are enforceable and legally binding and that specify all significant terms, including: fixed or minimum quantities to be purchased; fixed, minimum or variable price provisions; and the approximate timing of the transaction. Our purchase orders are based on our current manufacturing needs and are fulfilled by our vendors within short time frame. We do not have agreements for the purchase of raw materials or other goods specifying minimum quantities. We also enter into contracts for outsourced services including payroll, information technology and maintenance; however, the obligations under these contracts are not significant and the contracts contain clauses allowing for cancellation at will, without significant penalty. (2) Other long-term liabilities represents other long-term liabilities as reflected in the Company's Consolidated Balance Sheet as of December 31, 2003. These amounts are primarily tax payments due to the Spanish Ministry of Taxes from the sale of certain drug licenses in prior years. (3) Not included in the chart above are key executive compensation agreements which have been entered into subsequent to December 31, 2003 whereby the Company is currently obligated to pay approximately $1,490,000 to its key executives in 2004 and $350,000 in 2005. Such agreements are generally for one to two years in duration. The expected timing of payments of the obligations discussed above are estimated based on current information. Timing of payments and actual amounts paid may be different depending on the time of receipt of goods or services or changes to agreed-upon amounts for obligations. Amounts disclosed as contingent or milestone-based obligations are dependent on the achievement of the milestones or the occurrence of the contingent events and can vary significantly. We do not have any significant off-balance-sheet arrangements, as defined in Item 303(a)(4)(ii) of SEC Regulation S-K. Operating activities for the year ended December 31, 2003 provided net cash of $8,168,000. Investing activities, primarily additions to machinery and equipment and capital improvements made to the manufacturing facility in Spain, the purchase of a commercial building in the U.S. and additions to drug licenses used net cash of $10,843,000 during the year ended December 31, 2003. Financing activities, consisting primarily of the proceeds received from the exercise of stock options and warrants (approximately $15,222,000), partially offset by net repayments of borrowings (approximately $21,000) provided net cash of $14,201,000 during the year ended December 31, 2003. In accordance with the terms of the license agreement whereby we granted to Auxilium an exclusive royalty-based worldwide license, to develop, market and sell a topical testosterone gel containing our CPE-215 technology, we have been earning and receiving royalty payments from Auxilium on Testim sales since the product launch in early 2003 and we expect to continue receiving royalty payments for the foreseeable future. We plan to continue making improvements to our manufacturing facility during 2004 that include the acquisition of additional manufacturing equipment and expansion of our warehouse, in order to accommodate our expected growth. We have budgeted approximately $4,600,000 for capital expenditures during 2004. 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 revenues or income from 56 operations for the periods presented. We expect to have sufficient liquidity to fund operations for at least the next twenty-four months. We continue to search both domestically and internationally for opportunities that will enable us to continue expanding our business and explore alternative financing sources for these 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. 57 Critical Accounting Policies and Estimates Our significant accounting policies are more fully described in Note 2 to our consolidated financial statements in this Annual Report on Form 10-K for the year ended December 31, 2003. However, certain of our accounting policies are particularly important to the portrayal of our financial position, and results of operations and cash flows 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 critical accounting policies and estimates include: o Revenue recognition and accounts receivable. o 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 purchase authorizations from our customers for a specified amount of product at a specified price and consider delivery to have occurred when the customer takes possession of the products and/or risk of loss has passed to the customer. We provide our customers with a right of return. Revenue is recognized upon delivery of products, at which time a reserve for sales returns is recorded. We have demonstrated the ability to make reasonable and reliable estimates of product returns in accordance with Statement of Financial Accounting Standards ("SFAS") No. 48, Revenue Recognition When Right of Return Exists, and of allowances for doubtful accounts based on significant historical experience. o Revenue from service, research and development, and licensing and supply agreements is recognized when the service procedures have been completed or as revenue recognition criteria have been met for each separate unit of accounting (as defined in Emerging Issues Task Force ("EITF") Issue No. 00-21, Accounting for Revenue Arrangements with Multiple Deliverables.) o Royalty revenue is recognized based on an estimate of sell-through of product based on prescriptions written, until such time that returns from wholesalers and pharmacies can be reasonably estimated. o 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. 58 o 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 for periods not exceeding 15 years from the dates of acquisition. Carrying values of such assets are reviewed at least annually by comparing the carrying amounts to their estimated undiscounted cash flows and adjustments are made for any diminution in value. o Provision for income taxes. We have provided for current and deferred U.S. federal, state and foreign income taxes for the current and all prior periods presented. Current and deferred income taxes have been provided with respect to jurisdictions where certain of our subsidiaries produce taxable income. We have provided a valuation allowance for the remainder of our deferred income taxes, consisting primarily of net operating loss carryforwards in the U.S., because of uncertainty regarding their realization. Should we determine that it is more likely than not that we will realize certain of our net deferred tax assets for which we have previously provided a valuation allowance, an adjustment would be required to reduce the existing valuation allowance. In addition, we operate within multiple taxing jurisdictions and are subject to audit in those jurisdictions. These audits can involve complex issues, which may require an extended period of time for resolution. Although we believe that adequate consideration has been made for such issues, there is the possibility that the ultimate resolution of such issues could have an adverse effect on our financial position, results of operations or cash flows. o Foreign currency translation. The financial position, results of operations and cash flows 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 are credited to or charged against other comprehensive income (loss) in the Consolidated Balance Sheets. Foreign currency translation gains and losses arising from cash transactions are credited to or charged against current earnings. New Accounting Standards In December 2002, the Financial Accounting Standards Board issued SFAS No. 148, Accounting for Stock-Based Compensation - Transition and Disclosure. SFAS No. 148 amends SFAS No. 123, Accounting for Stock-Based Compensation, to provide alternative methods of transition for a voluntary change to the fair value method of accounting for stock-based employee compensation. SFAS No. 148 also amends the disclosure requirements of SFAS No. 123 to require disclosure in the summary of significant accounting policies, the effects of an entity's accounting policy with respect to stock-based employee compensation on reported net income and earnings per share in annual and interim financial statements. The disclosure provision is required for all companies with stock-based employee compensation, regardless of whether the company utilizes the fair value method of accounting described in SFAS No. 123 or the intrinsic value method described in APB Opinion No. 25, Accounting For Stock Issued to Employees. SFAS No. 148's amendment of the transition and annual disclosure provisions of SFAS No. 123 were effective for fiscal years ending after December 15, 2002 and have been incorporated in the Notes to the accompanying Consolidated Financial Statements. The disclosure 59 provisions for interim financial statements were effective for interim periods beginning after December 15, 2002. We have chosen not to adopt the fair value method of accounting for stock-based employee compensation at this time. Therefore, we continue to account for stock-based compensation utilizing the intrinsic value method of accounting for stock-based employee compensation described by APB Opinion No. 25. In November 2002, the EITF issued EITF Issue No. 00-21, which addresses certain aspects of the accounting by a vendor for arrangements under which it will perform multiple revenue-generating activities. EITF Issue No. 00-21 establishes three principles: revenue arrangements with multiple deliverables should be divided into separate units of accounting; arrangement consideration should be allocated among the separate units of accounting based on their relative fair values; and revenue recognition criteria should be considered individually for each separate unit of accounting. EITF Issue No. 00-21 is effective for all revenue arrangements entered into in fiscal periods beginning after June 15, 2003, with early adoption permitted. The adoption of EITF Issue No. 00-21 in our third quarter of 2003 has not had a material effect on our financial position, results of operations or cash flows for the year ended December 31, 2003. However, the adoption of EITF Issue No. 00-21 may require the deferral and recognition over extended periods, of certain up-front fees associated with our multiple element collaboration and license agreements and of our marketing, distribution and supply agreements. 60 Item 7A. Quantitative and Qualitative Disclosures About 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. The exchange rate at December 31, 2003 and 2002 was .80 Euros and .95 Euros per U.S. Dollar, respectively. The weighted average exchange rate for the years ended December 31, 2003, 2002 and 2001 was .89 Euros, 1.06 Euros and 1.12 Euros per U.S. Dollar, respectively. The effect of foreign currency fluctuations on long lived assets for the year ended December 31, 2003 was an increase of $5,585,000 and the cumulative historical effect was an increase of $5,169,000, as reflected in our Consolidated Balance Sheets as accumulated other comprehensive income (loss). Although exchange rates fluctuated significantly in recent years, 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 functional currency as those revenues, the Euro. However, the carrying value of assets and liabilities can be materially impacted by foreign currency translation, as can the translated amounts of revenues and expenses. Nonetheless, we do not plan to modify our business practices. 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 Europe, 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 and current portion of long-term debt is 3.8% and the balance outstanding is $1,915,000 as of December 31, 2003. A portion of our long-term borrowings is non-interest bearing and the balance outstanding on these borrowings at December 31, 2003 is $369,000 including imputed interest (ranging from 4.8% to 6.0%) of $83,000. The balance of our long-term borrowings of $70,000 bears interest at the rate of 2.9%. Consequently, the weighted average interest rate on our long-term borrowings is 5.6%. The effect of an increase in the interest rate of one percentage point (one hundred basis points) to 4.8% on short-term borrowings and to 6.6% on long-term borrowings would have the effect of increasing interest expense by approximately $24,000 annually. Item 8. Financial Statements and Supplementary Data --- See Item 15 of this Annual Report on Form 10-K. Item 9. Changes in and Disagreements With Accountants on Accounting and -- Financial Disclosure -------------------- Not applicable. 61 Item 9A. Controls and Procedures ---------------------- Bentley maintains disclosure controls and procedures that are designed to ensure that information required to be disclosed in Bentley's reports that are filed with the Securities and Exchange Commission is recorded, processed and reported within the time periods required for each report and that such information is reported to Bentley's management, including its Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. Bentley carried out an evaluation, under the supervision and with the participation of Bentley's management, including the Company's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of Bentley's disclosure controls and procedures. Based on that evaluation, Bentley's Chief Executive Officer and Chief Financial Officer concluded that (i) Bentley's disclosure controls and procedures were effective as of December 31, 2003 and (ii) no change in internal control over financial reporting occurred during the quarter ended December 31, 2003 that has materially affected, or is reasonably likely to materially affect, such internal control over financial reporting. Although Bentley's management continues to evaluate the internal control structure and strengthen Bentley's control procedures, particularly in connection with the requirements of Section 404 of the Sarbanes-Oxley Act of 2002, there have been no significant changes in Bentley's internal controls or in other factors which could significantly affect internal controls since that evaluation. 62 Part III Item 10. Directors and Executive Officers of the Registrant -- Name Position ---- -------- James R. Murphy 54 Chairman, President, Chief Executive Officer and Director Michael McGovern 60 Vice Chairman and Director Robert M. Stote, M.D. 64 Senior Vice President, Chief Science Officer and Director Michael D. Price 46 Vice President, Chief Financial Officer, Treasurer, Secretary and Director Robert J. Gyurik 57 Vice President of Pharmaceutical Development and Director Jordan A. Horvath 42 Vice President and General Counsel Charles L. Bolling 80 Director Miguel Fernandez 73 Director William A. Packer 68 Director John W. Spiegel 62 Director James R. Murphy has served as one of our directors since 1993. Mr. Murphy became President of Bentley in September 1994, was named Chief Executive Officer effective January 1995 and became Chairman of the Board in June 1995. Prior to rejoining Bentley, Mr.

Murphy served as Vice President of Business Development at MacroChem Corporation, a publicly owned pharmaceutical and drug delivery company, from March 1993 through September 1994. From September 1992 until March 1993, Mr. Murphy served as a consultant in the pharmaceutical industry with his primary efforts directed toward product licensing. Prior thereto, Mr. Murphy served as Director - Worldwide Business Development and Strategic Planning of Bentley from December 1991 to September 1992. Mr. Murphy previously spent 14 years in pharmaceutical research and product development with SmithKline Corporation and in international business development with contract research and consulting laboratories. Mr. Murphy received a B.A. in Biology from Millersville University. Michael McGovern has served as one of our directors since 1997 and was named Vice Chairman of Bentley in October 1999. Mr. McGovern serves as President of McGovern Enterprises, a provider of corporate and financial consulting services, which he founded in 1975. Mr. McGovern is Chairman of the Board of Specialty Surgicenters, Inc., is Vice Chairman of the Board of Employment Technologies, Inc. and is a Director on the corporate boards of Training Solutions Interactive, Inc. and the Reynolds 63 Development Company. Mr. McGovern received a B.S. and M.S. in accounting and his Juris Doctor from the University of Illinois. Mr. McGovern is a Certified Public Accountant. Robert M. Stote, M.D. became Senior Vice President and Chief Science Officer of Bentley in March 1992 and has served as one of our directors since 1993. Prior to joining Bentley, Dr. Stote was employed for 20 years by SmithKline Beecham Corporation serving in a variety of executive clinical research positions. Dr. Stote was Chief of Nephrology at Presbyterian Medical Center of Philadelphia from 1972 to 1989 and was Clinical Professor of Medicine at the University of Pennsylvania. Dr. Stote also serves as a Director of Datatrak International, Inc. Dr. Stote received a B.S. in Pharmacy from the Albany College of Pharmacy, an M.D. from Albany Medical College and is Board Certified in Internal Medicine and Nephrology. He was a Fellow in Nephrology and Internal Medicine at the Mayo Clinic and is currently a Fellow of the American College of Physicians. Michael D. Price became Chief Financial Officer, Vice President/Treasurer and Secretary of Bentley in October 1993, April 1993 and November 1992, respectively, and has served as one of our directors since 1995. He has served Bentley in other capacities since March 1992. Prior to joining Bentley, he was employed as a financial and management consultant with Carr Financial Group from March 1990 to March 1992. Prior thereto, he was employed as Vice President of Finance with Premiere Group, Inc. from June 1988 to February 1990. Prior thereto, Mr. Price was employed by Price Waterhouse (now PriceWaterhouseCoopers) from January 1982 to June 1988 where his last position with that firm was as an Audit Manager. Mr. Price received a B.S. in Business Administration with a concentration in Accounting from Auburn University and an M.B.A. from Florida State University. Mr. Price is a Certified Public Accountant licensed by the State of Florida. Robert J. Gyurik has served as one of our directors since 1998 and became Vice President of Pharmaceutical Development of Bentley in March 1999. Before joining Bentley, Mr. Gyurik was Manager of Development and Quality Control at MacroChem Corporation, a position he held from May 1993 to February 1999. From 1971 to 1993 Mr. Gyurik worked in various research and development positions at SmithKline Beecham. Prior thereto, Mr. Gyurik worked at Schering as a Medicinal Chemist. Mr. Gyurik received a B.A. in Biology and Chemistry from Immaculata College. Mr. Gyurik is a member of the American Chemical Society, International Society for Chronobiology and the New York Academy of Sciences. Jordan A. Horvath became Vice President and General Counsel of Bentley in August 2000. Prior to joining Bentley, he was a partner at Parker Chapin LLP, the Company's legal counsel in New York City (which has since merged to become Jenkens & Gilchrist Parker Chapin LLP), since 1996. He was an associate of that firm from 1991 to 1995. Mr. Horvath received an A.B. from Princeton University and a J.D. from the University of California, Berkeley. Charles L. Bolling has served as one of our directors since 1991. Mr. Bolling served from 1968 to 1973 as Vice President of Product Management and Promotion (U.S.), from 1973 to 1977 as Vice President of Commercial Development and from 1977 to 1986 as Director of Business Development (International) at SmithKline & French Laboratories. Mr. Bolling received an A.B. from Princeton University. Mr. Bolling has been retired since 1986. Miguel Fernandez has served as one of our directors since 1999. Mr. Fernandez served from 1980 to 1996 as President of the International Division and corporate Vice President at Carter-Wallace, Inc., where he was responsible for all product lines outside of the United States. Prior 64 thereto, Mr. Fernandez was employed for approximately eight years by SmithKline & French, where his last position was President of the division that included France, Portugal and Switzerland. Before SmithKline, Mr. Fernandez served as Managing Director of Warner Lambert in Argentina for two years. From 1962 to 1970, Mr. Fernandez was employed by Merck/Frost in Canada. Mr. Fernandez attended the University of British Columbia in Canada and received an M.B.A. from the Ivey School of Business at the University of Western Ontario in London, Ontario, Canada. Mr. Fernandez has been retired since 1996. William A. Packer has served as one of our directors since 1999. Mr. Packer has been a business and industry consultant to a number of biopharmaceutical companies since 1998. From 1992 until 1998, Mr. Packer was President and Chief Financial Officer of Virus Research Institute, Inc., a publicly owned biotechnology company. Prior to this, Mr. Packer was employed by SmithKline Beecham Plc, where he held various senior management positions, the most recent as Senior Vice President, Biologicals, in which position he was responsible for the direction of SmithKline's global vaccine business. Mr. Packer is a Chartered Accountant. John W. Spiegel has served as one of our directors since June 2002. Mr. Spiegel has served as Vice Chairman and Chief Financial Officer of SunTrust Banks, Inc. since August 2000. From 1985 to August 2000, Mr. Spiegel was an Executive Vice President and Chief Financial Officer of SunTrust Banks. Mr. Spiegel also serves as Chairman of the Board of the Bank Administration Institute and on the Board of Directors of Rock-Tenn Company (RKT), the Woodruff Arts Center, the High Museum of Art, the American Cardiovascular Research Institute, and the Children's Healthcare of Atlanta. Mr. Spiegel is also a member of the Dean's Advisory Council of the Goizueta Business School at Emory University. Mr. Spiegel received an MBA from Emory University. Section 16(a) Beneficial Ownership Reporting Compliance Section 16(a) of the Securities Exchange Act of 1934, as amended, requires our executive officers and directors, and any persons who own more than 10% of any class of our equity securities, to file certain reports relating to their ownership of such securities and changes in such ownership with the Securities and Exchange Commission and the American Stock Exchange and to furnish us with copies of such reports. To the best of our knowledge during the year ended December 31, 2003, all Section 16(a) filing requirements have been satisfied. Item 11. Executive Compensation --------------------- The information called for by this item is incorporated by reference to our definitive Proxy Statement for the 2004 Annual Meeting of Stockholders to be filed pursuant to Regulation 14A. Item 12. Security Ownership of Certain Beneficial Owners and Management -- The information called for by this item is incorporated by reference to our definitive Proxy Statement for the 2004 Annual Meeting of Stockholders to be filed pursuant to Regulation 14A. 65 Item 13. Certain Relationships and Related Transactions -- The information called for by this item is incorporated by reference to our definitive Proxy Statement for the 2004 Annual Meeting of Stockholders to be filed pursuant to Regulation 14A. Item 14. Principal Accounting Fees and Services ------------------------------------- The information called for by this item is incorporated by reference to our definitive Proxy Statement for the 2004 Annual Meeting of Stockholders to be filed pursuant to Regulation 14A. 66 Part IV Item 15. Exhibits, Financial Statement Schedules and Reports on Form 8-K --- Page Herein ----------- (a) The following documents are filed as a part of this report: (1) Financial Statements: Consolidated Financial Statements of Bentley Pharmaceuticals, Inc. and subsidiaries F-1 to F-31 67 EXHIBIT INDEX (3) Exhibits filed as part of this report: Exhibit Number Description ------ ----------- 3.1 Articles of Incorporation of the Registrant, as amended and restated. (Reference is made to Appendix B to the Registrant's Definitive Proxy Statement for the Annual Meeting of Stockholders filed with the Securities and Exchange Commission on May 18, 1999, Commission File No. 1-10581,which exhibit is incorporated herein by reference.) 3.2 Bylaws of the Registrant, as amended and restated. (Reference is made to Appendix C to the Registrant's Definitive Proxy Statement for the Annual Meeting of Stockholders filed with the Securities and Exchange Commission on May 18, 1999, Commission File No. 1-10581, which exhibit is incorporated herein by reference.) 3.3 Rights Agreement, dated as of December 22, 1999, between the Registrant and American Stock Transfer and Trust Company, as Rights Agent, including the form of Rights Certificate as Exhibit B thereto. (Reference is made to Exhibit 4.1 to the Registrant's Form 8-K, filed December 27, 1999, Commission File No. 1-10581, which exhibit is incorporated herein by reference.) 4.1 Registrant's Amended and Restated 1991 Stock Option Plan. (Reference is made to Appendix D to the Registrant's Definitive Proxy Statement for the Annual Meeting of Stockholders filed with the Securities and Exchange Commission on May 18, 1999, Commission File No. 1-10581, which exhibit is incorporated herein by reference.) 4.2 Form of Non-qualified Stock Option Agreement under the Registrant's 1991 Stock Option Plan. (Reference is made to Exhibit 4.25 to the Registrant's Form 10-K for the period ended June 30, 1992, Commission File No. 1-10581, which exhibit is incorporated herein by reference.) 4.3 Form of Warrant Agreement, including form of Class A and Class B Warrant. (Reference is made to Exhibit 4.29 to the Registrant's Registration Statement on Form S-1, Commission File No. 33-65125, which exhibit is incorporated herein by reference.) 4.4 Form of Underwriter Warrant. (Reference is made to Exhibit 4.30 to the Registrant's Registration Statement on Form S-1, Commission File No. 33-65125, which exhibit is incorporated herein by reference.) 68

Exhibit Number Description ------ ----------- 4.5 Warrant issued by the Registrant for the benefit of Hsu, dated February 11, 1999. (Reference is made to exhibit 7.4 to the Registrant's Form 8-K filed February 26, 1999, Commission File No. 1-10581, which exhibit is incorporated herein by reference.) 4.6 Registrant's 2001 Employee Stock Option Plan. (Reference is made to Appendix B to the Registrant's Definitive Proxy Statement for the Annual Meeting of Stockholders filed with the SEC on April 9, 2001, Commission File No. 1-10581, which exhibit is incorporated herein by reference.) 4.7 Registrant's 2001 Directors' Stock Option Plan. (Reference is made to Appendix C to the Registrant's Definitive Proxy Statement for the Annual Meeting of Stockholders filed with the SEC on April 9, 2001, Commission File No. 1-10581, which exhibit is incorporated herein by reference.) 4.8 Form of Stock Option contract under the Registrant's 2001 Employee Stock Option Plan. (Reference is made to Exhibit 4.8 to the Registrant's Form 10-K for the year ended December 31, 2001, Commission File No. 1-10581, which exhibit is incorporated herein by reference.) 4.9 Form of Stock Option contract under the Registrant's 2001 Directors' Stock Option Plan. (Reference is made to Exhibit 4.9 to the Registrant's Form 10-K for the year ended December 31, 2001, Commission File No. 1-10581, which exhibit is incorporated herein by reference.) 4.10* Amendment No. 1 to the Registrant's 2001 Employee Stock Option Plan. 4.11* Amendment No. 2 to the Registrant's 2001 Employee Stock Option Plan. 4.12* Amendment No. 1 to the Registrant's 2001 Directors' Stock Option Plan. 4.13* Amendment No. 2 to the Registrant's 2001 Directors' Stock Option Plan. ---------- * Filed herewith. 69 Exhibit Number Description ------ ----------- 10.1 Employment Agreement dated as of January 1, 2002 between the Registrant and James R. Murphy. (Reference is made to Exhibit 10.1 to the Registrant's Form 10-K for the year ended December 31, 2001, Commission File No. 1-10581, which exhibit is incorporated herein by reference.) 10.2* Employment Agreement dated as of January 1, 2004 between the Registrant and Robert M. Stote, M.D. 10.3 Employment Agreement dated as of January 1, 2002 between the Registrant and Michael D. Price. (Reference is made to Exhibit 10.3 to the Registrant's Form 10-K for the year ended December 31, 2001, Commission File No. 1-10581, which exhibit is incorporated herein by reference.) 10.4 Employment Agreement dated as of January 1, 2002 between the Registrant and Robert J. Gyurik. (Reference is made to Exhibit 10.4 to the Registrant's Form 10-K for the year ended December 31, 2001, Commission File No. 1-10581, which exhibit is incorporated herein by reference.) 10.5 Agreement between the Registrant and Hsu dated February 1, 1999, effective as of December 31, 1998. (Reference is made to Exhibit 7.1 to the Registrant's Form 8-K filed February 26, 1999, Commission File No. 1-10581, which exhibit is incorporated herein by reference.) 10.6 License Agreement between the Registrant and Auxilium A2, Inc. dated May 31, 2000, including Amendment No. 1 thereto dated October 2000 and Amendment No. 2 dated May 31, 2001. (Reference is made to Exhibit 10.10 to the Registrant's Form 10-K for the year ended December 31, 2001, Commission File No. 1-10581, which exhibit is incorporated herein by reference.) 10.7 Agreement between the Registrant and Pfizer Inc dated October 25, 2001. (Reference is made to Exhibit 10.11 to the Registrant's Form 10-K for the year ended December 31, 2001, Commission File No. 1-10581, which exhibit is incorporated herein by reference.) 10.8 Supply Agreement, License Agreement and Rights Agreement between Laboratorios Belmac, S.A., Laboratorios Davur, S.L. and Teva Pharmaceutical Industries Ltd. dated July 18, 2000. (Reference is made to Exhibit 10.12 to the Registrant's Form 10-K for the year ended December 31, 2001, Commission File No. 1-10581, which exhibit is incorporated herein by reference.) ---------- * Filed herewith. 70 Exhibit Number Description ------ ----------- 10.9 Amendment No. 3 dated September 6, 2002 to License Agreement between the Registrant and Auxilium Pharmaceuticals, Inc. dated May 31, 2000. (Reference is made to Exhibit 10.10 to the Registrant's Form 10-K for the year ended December 31, 2002, Commission File No. 1-10581, which exhibit is incorporated herein by reference.) 10.10 License Agreement between the Registrant and Auxilium Pharmaceuticals, Inc. dated May 31, 2001 relating to products using Dihydrotestosterone. (Reference is made to Exhibit 10.12 to the Registrant's Form 10-K for the year ended December 31, 2002, Commission File No. 1-10581, which exhibit is incorporated herein by reference.) 10.11 Amendment No. 1 dated September 6, 2002 to License Agreement between the Registrant and Auxilium Pharmaceuticals, Inc. dated May 31, 2001 related to products using Dihydrotestosterone. (Reference is made to Exhibit 10.13 to the Registrant's Form 10-K for the year ended December 31, 2002, Commission File No. 1-10581, which exhibit is incorporated herein by reference.) 10.12* Amendment dated October 14, 2003 to the Agreement between the Registrant and Pfizer Inc dated October 25, 2001. 21.1* Subsidiaries of the Registrant. 23.1* Independent Auditors' Consent. 31.1* Certification of the Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. 31.2* Certification of the Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. 32.1* Certification of the Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. 32.2* Certification of the Chief

Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. ---------- * Filed herewith. 71 (b) Reports on Form 8-K filed during the fiscal quarter ended December 31, 2003: On October 29, 2003, a Report on Form 8-K was filed under Items 7 and 12 which disclosed the press release dated October 29, 2003 reporting financial results of the Registrant for the three and nine months ended September 30, 2003. 72 SIGNATURES Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized. BENTLEY PHARMACEUTICALS, INC. By: /s/ James R. Murphy ------------------------------------ James R. Murphy Chairman, President and Chief Executive Officer Date: March 4, 2004 Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated. Signature Title Date --------- ----- ---- /s/ James R. Murphy Chairman, President, March 4, 2004 ---------------------------------- Chief Executive Officer James R. Murphy and Director (principal executive officer) /s/ Michael McGovern Vice Chairman and Director March 4, 2004 ---------------------------------- Michael McGovern /s/ Robert M. Stote Senior Vice President, March 4, 2004 ---------------------------------- Chief Science Officer and Robert M. Stote, M.D. Director /s/ Michael D. Price Vice-President, March 4, 2004 ---------------------------------- Chief Financial Officer, Michael D. Price Treasurer, Secretary and Director (principal financial and accounting officer) /s/ Robert J. Gyurik Vice President of March 4, 2004 ---------------------------------- Pharmaceutical Development Robert J. Gyurik and Director /s/ Charles L. Bolling Director March 4, 2004 ---------------------------------- Charles L. Bolling /s/ Miguel Fernandez Director March 4, 2004 ---------------------------------- Miguel Fernandez /s/ William A. Packer Director March 4, 2004 ---------------------------------- William A. Packer /s/ John W. Spiegel Director March 4, 2004 ---------------------------------- John W. Spiegel CONSOLIDATED FINANCIAL STATEMENTS OF BENTLEY PHARMACEUTICALS, INC. AND SUBSIDIARIES Page ---- F-1 INDEPENDENT AUDITORS' REPORT To the Board of Directors and Stockholders of Bentley Pharmaceuticals, Inc. Exeter, New Hampshire We have audited the accompanying consolidated balance sheets of Bentley Pharmaceuticals, Inc. and subsidiaries (the "Company") as of December 31, 2003 and 2002, and the related consolidated income statements and statements of comprehensive income, changes in stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2003. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion. In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of the Company at December 31, 2003 and 2002, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2003 in conformity with accounting principles generally accepted in the United States of America. /s/ Deloitte & Touche LLP Boston, Massachusetts March 4, 2004 F-2 BENTLEY PHARMACEUTICALS, INC. AND SUBSIDIARIES CONSOLIDATED BALANCE SHEETS (in thousands, except per share data) December 31, December 31, 2003 2002 ------------ ------------ ASSETS ------ Current assets: Cash and cash equivalents $ 39,393 $ 26,581 Marketable securities 1,252 396 Receivables, net 18,036 10,874 Inventories, net 7,106 5,133 Deferred taxes 213 123 Prepaid expenses and other 899 865 --------- --------- Total current assets 66,899 43,972 --------- --------- Non-current assets: Fixed assets, net 18,566 9,565 Drug licenses and related costs, net 13,818 10,975 Restricted cash 1,000 - Other 180 180 --------- --------- Total non-current assets 33,564 20,720 --------- --------- $ 100,463 $ 64,692 ========= ========= LIABILITIES AND STOCKHOLDERS' EQUITY ------------------------------------- Current liabilities: Accounts payable $ 10,154 $ 7,206 Accrued expenses 7,103 4,059 Short-term borrowings 1,915 1,598 Current portion of long-term debt 70 127 Deferred income 1,956 279 --------- --------- Total current liabilities

21,198 13,269 --------- --------- Non-current liabilities: Deferred taxes 2,555 2,141 Long-term debt 369 345 Other 176 186 --------- --------- Total non-current liabilities 3,100 2,672 --------- --------- Commitments and contingencies Stockholders' equity: Preferred stock, $1.00 par value, authorized 2,000 shares, issued and outstanding, none - - Common stock, $.02 par value, authorized 100,000 shares, issued and outstanding, 20,573 and 17,404 shares 412 348 Stock purchase warrants (to purchase 420 and 3,292 shares of common stock) 333 431 Additional paid-in capital 136,850 121,084 Accumulated deficit (66,599) (72,696) Accumulated other comprehensive income (loss) 5,169 (416) --------- --------- Total stockholders' equity 76,165 48,751 --------- --------- $ 100,463 $ 64,692 ========= ========= The accompanying Notes to Consolidated Financial Statements are an integral part of these financial statements. F-3 BENTLEY PHARMACEUTICALS, INC. AND SUBSIDIARIES CONSOLIDATED INCOME STATEMENTS AND STATEMENTS OF COMPREHENSIVE INCOME (in thousands, except per share data) For the Year Ended December 31, ------------------------------ 2003 2002 2001 -------- -------- -------- Revenues: Net product sales $ 62,955 $ 38,718 $ 26,411 Licensing and collaboration revenues 1,721 418 - -------- -------- -------- Total revenues 64,676 39,136 26,411 Cost of net product sales 26,399 16,477 11,462 -------- -------- -------- Gross profit 38,277 22,659 14,949 -------- -------- -------- Operating expenses: Selling and marketing 14,212 10,400 9,057 General and administrative 7,001 4,902 4,085 Research and development 4,295 2,960 2,084 Depreciation and amortization 1,340 1,015 911 -------- -------- -------- Total operating expenses 26,848 19,277 16,137 -------- -------- -------- Income (loss) from operations before sale of drug licenses 11,429 3,382 (1,188) Gain on sale of drug licenses - 650 5,050 -------- -------- -------- Income from operations 11,429 4,032 3,862 -------- -------- -------- Other income (expenses): Interest income 332 279 168 Interest expense (228) (209) (244) Other, net (13) 68 27 -------- -------- -------- Income before income taxes 11,520 4,170 3,813 Provision for income taxes 5,423 2,534 2,452 -------- -------- -------- Net income $ 6,097 $ 1,636 $ 1,361 ======== ======== ======== Net income per common share: Basic $ 0.34 $ 0.10 $ 0.10 ======== ======== ======== Diluted $ 0.28 $ 0.08 $ 0.08 ======== ======== ======== Weighted average common shares outstanding: Basic 17,997 16,569 14,196 ======== ======== ======== Diluted 21,637 19,798 16,147 ======== ======== ======== Net income $ 6,097 $ 1,636 $ 1,361 Other comprehensive income (loss): Foreign currency translation gains (losses) 5,585 3,054 (842) -------- -------- -------- Comprehensive income $ 11,682 $ 4,690 $ 519 ======== ======== ======== The accompanying Notes to Consolidated Financial Statements are an integral part of these financial statements. F-4 BENTLEY PHARMACEUTICALS, INC. AND SUBSIDIARIES CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY (in thousands, except per share data) $.02 Par Value Accumulated Common Stock Stock Additional Other ------------------- Purchase Paid-In Accumulated Comprehensive Shares Amount Warrants Capital Deficit Income (Loss) Total -------- -------- -------- ---------- -------- ------------ -------- Balance at December 31, 2000 13,914 $ 278 $ 632 $ 95,227 $(75,693) $ (2,628) $ 17,816 Exercise of stock options and warrants 171 4 - 443 - - 447 Exercise of underwriter's Class A warrants 460 9 (199) 1,570 - - 1,380 Equity based compensation 40 1 - 261 - - 262 Foreign currency translation adjustment - - - - - (842) (842) Net income - - - - 1,361 - 1,361 -------- -------- -------- -------- -------- -------- -------- Balance at December 31, 2001 14,585 292 433 97,501 (74,332) (3,470) 20,424 Offering of common stock, net 2,500 50 - 22,058 - - 22,108 Exercise of stock options and warrants 304 6 (2) 1,369 - - 1,373 Equity based compensation 15 - - 156 - - 156 Foreign currency translation adjustment - - - - - 3,054 3,054 Net income - - - - 1,636 - 1,636 -------- -------- -------- -------- -------- -------- -------- Balance at December 31, 2002 17,404 348 431 121,084 (72,696) (416) 48,751 Exercise of stock options and warrants 3,111 62 (98) 15,258 - - 15,222 Equity based compensation 58 2 - 508 - - 510 Foreign currency translation adjustment - - - - - 5,585 5,585 Net income - - - - 6,097 - 6,097 -------- -------- -------- -------- -------- -------- -------- Balance at December 31, 2003 20,573 $ 412 $ 333 $136,850 $(66,599) $ 5,169 $ 76,165 ======== ======== ======== ======== ======== ======== ======== The accompanying Notes to Consolidated Financial Statements are an integral part of these financial statements. F-5 BENTLEY PHARMACEUTICALS, INC. AND SUBSIDIARIES CONSOLIDATED STATEMENTS OF CASH FLOWS (in thousands) For the Year Ended December 31, ---------------------------------- 2003 2002 2001 --------- --------- --------- Cash flows from operating activities: Net income $ 6,097 $ 1,636 $ 1,361 Adjustments to reconcile net income to net cash provided by operating activities: Gain on sale of drug licenses - (650) (5,050) Depreciation and amortization 2,479 1,584 1,235 Foregiveness of related party loans 302 98 98 Equity-based compensation expense 510 156 262 Other non-cash items (163) 597 (286) (Increase) decrease in assets and increase (decrease) in liabilities: Receivables (3,673) (1,949) (2,060) Inventories (801) (1,796) (864) Deferred foreign taxes (55) 45 1,629 Prepaid expenses and other current assets (362) (357) 100 Other assets (18) 24 (11) Accounts payable and accrued expenses

2,682 1,855 3,306 Deferred income 1,180 (217) 496 Other liabilities (10) 23 (77) --------- --------- --------- Net cash provided by operating activities 8,168 1,049 139 --------- --------- --------- Cash flows from investing activities: Proceeds from sale of investments 225,750 56,190 31,645 Purchase of investments (226,219) (56,314) (31,567) Proceeds from sale of drug licenses - 656 2,698 Additions to fixed assets (8,076) (3,432) (1,595) Additions to drug licenses and related costs (2,298) (796) (437) --------- --------- --------- Net cash (used in) provided by investing activities (10,843) (3,696) 744 --------- --------- --------- (Continued on following page) The accompanying Notes to Consolidated Financial Statements are an integral part of these financial statements. F-6 BENTLEY PHARMACEUTICALS, INC. AND SUBSIDIARIES CONSOLIDATED STATEMENTS OF CASH FLOWS (concluded) (in thousands) For the Year Ended December 31, ------------------------------ 2003 2002 2001 -------- -------- -------- Cash flows from financing activities: Proceeds from exercise of stock options/warrants $ 15,222 $ 1,375 $ 1,827 Proceeds from offering of common stock, net - 22,108 - Repayment of borrowings (3,577) (3,039) (4,219) Proceeds from borrowings 3,556 2,841 2,514 Increase in restricted cash (1,000) - - -------- -------- -------- Net cash provided by financing activities 14,201 23,285 122 -------- -------- -------- Effect of exchange rate changes on cash 1,286 207 (85) -------- -------- -------- Net increase in cash and cash equivalents 12,812 20,845 920 Cash and cash equivalents at beginning of year 26,581 5,736 4,816 -------- -------- -------- Cash and cash equivalents at end of year $ 39,393 $ 26,581 $ 5,736 ======== ======== ======== Supplemental Disclosures of Cash Flow Information The Company paid cash during the year for: Interest $ 203 $ 202 $ 247 ======== ======== ======== Taxes $ 4,862 $ 2,164 $ 317 ======== ======== ======== Supplemental Disclosures of Non-Cash Financing and Investing Activities The Company has issued or is obligated to issue Common Stock in exchange for services as follows: Shares 58 15 40 ======== ======== ======== Amount $ 505 $ 151 $ 233 ======== ======== ======== Included in year-end accounts payable are fixed asset and drug license purchases totaling: $ 1,721 $ 922 $ 514 ======== ======== ======== The accompanying Notes to Consolidated Financial Statements are an integral part of these financial statements. F-7 BENTLEY PHARMACEUTICALS, INC. AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS NOTE 1 - HISTORY AND OPERATIONS Bentley Pharmaceuticals, Inc. and Subsidiaries (which may be referred to as Bentley Pharmaceuticals, Bentley or the Company) is a U.S.-based international specialty pharmaceutical company, incorporated in the State of Delaware, operating in two business segments: research, development and licensing/commercialization of advanced drug delivery technologies and pharmaceutical products; and development, licensing and sales of generic and branded pharmaceutical products and the manufacturing of pharmaceuticals for others. In the research and development segment based in the U.S., the Company owns U.S. and international patent and other proprietary rights to technologies that enhance or facilitate the absorption of drugs across biological membranes. The Company is developing products incorporating these technologies and seeks to form strategic alliances with other pharmaceutical and biotechnology companies to facilitate the development and commercialization of its products. The Company currently has strategic alliances with various companies in the pharmaceutical industry and is in preliminary discussions to form additional alliances with several others. In the pharmaceutical product sales segment based in Spain, the Company manufactures and markets branded and generic pharmaceutical products within four primary therapeutic areas: cardiovascular, gastrointestinal, infectious and neurological diseases. In addition, the Company licenses the right to register and market its pharmaceutical products in other foreign countries. The Company also provides contract manufacturing services for pharmaceutical products to be sold both within Spain and in other foreign countries in connection with its international license agreements. The Company has also recently developed a strategy to introduce certain of its generic pharmaceutical products into the U.S. marketplace. The Company anticipated the opportunities that the emerging generic drug market in Spain presented and began taking measures over four years ago to enter the Spanish generic drug market. The Company created Laboratorios Davur and Laboratorios Rimafar, wholly-owned subsidiaries of its Spanish entity, Laboratorios Belmac, to register, market and distribute generic pharmaceutical products in Spain and began aligning its business model to be competitive, including hiring and training a new generic sales force, submission of generic-equivalent products to the Spanish Ministry of Health for approval and a marketing campaign designed to position its Spanish generic subsidiaries as leaders in the Spanish generic drug market. In July 2000, the Company entered into a strategic alliance with Teva Pharmaceutical Industries, Ltd. (Teva), whereby the Company has received the right to register and market in Spain certain of Teva's pharmaceutical products, representing more than 25 different chemical entities. Teva also entered into a supply agreement with the Company pursuant to which Teva will manufacture the products and supply them to the Company for marketing and sale in Spain. Teva was also granted a right of first refusal to acquire Laboratorios Davur in the event that the Company decides to sell that subsidiary or its direct parent, Laboratorios Belmac. The Company also granted Teva the right to bid for Laboratorios Belmac in the event the Company intends to sell that subsidiary. NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES Principles of consolidation and foreign currency translation The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries: Pharma de Espana, Inc. and its wholly-owned subsidiary, Laboratorios Belmac S.A. and its wholly-owned subsidiaries, Laboratorios Davur S.L. and Laboratorios Rimafar S.L.; F-8 BENTLEY PHARMACEUTICALS, INC. AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) Bentley Park, L.L.C.; Bentley Healthcare Corporation and its wholly-owned subsidiary, Belmac Hygiene, Inc.; Belmac Health Corporation; Belmac Holdings, Inc. and its wholly-owned subsidiary, Belmac A.I., Inc.; B.O.G. International Finance, Inc.; and Belmac Jamaica, Ltd. All inter-company balances have been eliminated in consolidation. The financial position and results of operations of the Company's 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 are credited to or charged against other comprehensive income (loss) in the Consolidated Balance Sheets. Foreign currency translation gains and losses arising from cash transactions are credited to or charged against current earnings. Use of estimates The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Cash and cash equivalents and restricted cash The Company considers all highly liquid investments with remaining maturities of three months or less when purchased to be cash equivalents for purposes of classification in the Consolidated Balance Sheets and the Consolidated Statements of Cash Flows. Investments in securities that do not meet the definition of cash equivalents are classified as marketable securities in the Consolidated Balance Sheets. Included in cash and cash equivalents at December 31, 2003 and 2002 are approximately $29,156,000 and $23,360,000, respectively, of short-term investments considered to be cash equivalents, as the remaining maturity dates of such investments were three months or less when purchased. The Company acquired intellectual property during the year ended December 31, 2003 for $1,000,000 plus future royalties on sales and licensing income. In connection with the acquisition, the Company obtained a renewable, irrevocable letter of credit in the amount of $1,000,000 in favor of the assignor to guarantee future royalty payments. The $1,000,000 used to secure the letter of credit has been classified as restricted cash in the Consolidated Balance Sheets as of December 31, 2003. Marketable securities The Company has investments in securities, with maturities of greater than three months when purchased, totaling $1,252,000, which are classified as available-for-sale as of December 31, 2003, compared to $396,000 as of December 31, 2002. The Company's investments are carried at amortized cost which approximates fair value due to the short-term nature of these investments. Accordingly, no unrealized gains or losses have been recognized on these investments. Should the fair values differ significantly from the amortized costs, unrealized gains or losses would be included as a component of other comprehensive income (loss). F-9 BENTLEY PHARMACEUTICALS, INC. AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) Inventories Inventories are stated at the lower of cost or market, cost being determined on the first-in, first-out (FIFO) method. Reserves for slow moving and obsolete inventories are provided based on historical experience and current product demand. Fixed assets Fixed assets are stated at cost. Depreciation is computed using the straight-line method over the following estimated economic lives of the assets: Years ----- Buildings and improvements... 30 Equipment... 3-7 Furniture and fixtures.. 5-7 Other... 5 Leasehold improvements are amortized over the life of the respective lease. Expenditures for replacements and improvements that significantly add to productive capacity or extend the useful life of an asset are capitalized, while expenditures for maintenance and repairs are charged to operations as incurred. When assets are sold or retired, the cost of the asset and the related accumulated depreciation are removed from the accounts and any gain or loss is recognized currently. Drug licenses and related costs Drug licenses and related costs incurred in connection with acquiring licenses, patents, and other proprietary rights related to the Company's commercially developed products are capitalized. Capitalized drug licenses and related costs are amortized on a straight-line basis for periods not exceeding fifteen years from the dates of acquisition. Carrying values of such assets are reviewed at least annually by the Company, by comparing the carrying amounts to their estimated undiscounted cash flows, and adjustments are made for any diminution in value. In accordance with the guidelines in Statement of Financial Accounting Standards ("SFAS") No. 142, Goodwill and Other Intangible Assets, the Company determined it has one reporting unit. The Company performed a review for diminution in value and has concluded that no diminution in value has occurred. The Company has also reassessed the useful lives of its drug licenses and related costs and determined the useful lives are appropriate in determining amortization expense. Fair value of financial instruments The carrying amounts of cash, cash equivalents, marketable securities, receivables, accounts payable, accrued expenses and short-term borrowings approximate fair value because of their short-term nature. The carrying amount of the Company's long-term obligations approximates fair value given the amounts outstanding at December 31, 2003 and 2002. The fair value information presented herein is based on information available to management as of December 31, 2003. Although management is not aware of any factors that would significantly affect the estimated fair value amounts, such amounts have not been comprehensively revalued for purposes of these financial statements since that date and, therefore the current estimates of fair value may differ significantly from the amounts presented herein. F-10 BENTLEY PHARMACEUTICALS, INC. AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) Revenue recognition 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. The Company generally obtains purchase authorizations from its customers for a specified amount of product at a specified price and considers delivery to have occurred when the customer takes possession of the products. The Company provides its customers with a limited right of return. Revenue is recognized upon delivery and a reserve for sales returns is recorded. The Company has demonstrated the ability to make reasonable and reliable estimates of product returns in accordance with SFAS No. 48, Revenue Recognition When Right of Return Exists, and of allowances for doubtful accounts based on significant historical experience. Revenue from service, research and development, and licensing and supply agreements is recognized when the service procedures have been completed or as revenue recognition criteria have been met for each separate unit of accounting as defined in Emerging Issues Task Force ("EITF") Issue No. 00-21, Accounting for Revenue Arrangements with Multiple Deliverables. At December 31, 2003, the Company has deferred the recognition of approximately $634,000 in royalties and $1,322,000 of licensing, collaboration or other revenues which currently do not meet the requirements for revenue recognition. Research and development Research and development costs are expensed when incurred. Income taxes The Company accounts for income taxes under SFAS No. 109, Accounting for Income Taxes, which requires the recognition of deferred tax assets and liabilities relating to the expected future tax consequences of events that have been recognized in the Company's consolidated financial statements and tax returns. As permitted by APB Opinion No. 23, Accounting for Income Taxes - Special Areas, provisions for income taxes on undistributed earnings of foreign subsidiaries that are considered permanently invested are not recognized in the Company's consolidated financial statements. Basic and diluted net income per common share Basic and diluted net income per common share is based on the weighted average number of shares of Common Stock outstanding during each period. The effect of the Company's outstanding stock options and stock purchase warrants were considered in the diluted net income per share calculation for the years ended December 31, 2003, 2002 and 2001. The following is a reconciliation between basic and diluted net income per common share for the years ended December 31, 2003, 2002 and 2001. Dilutive securities issuable for the years ended December 31, 2003, 2002 and 2001 include approximately 1,441,000, 1,309,000 and 663,000 shares, respectively, issuable as a result of Class B Warrants, and approximately 2,199,000, 1,920,000 and 1,288,000 shares, respectively, issuable as a result of various stock options and warrants outstanding. F-11 BENTLEY PHARMACEUTICALS, INC. AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) For The Year Ended December 31, 2003 ---------------------------------- Effect of Basic Dilutive Diluted EPS Securities EPS ------ ---------- ------- (In Thousands, Except Per Share Data) Net income... $ 6,097 $ - $ 6,097 Weighted average common shares outstanding................................... 17,997 3,640 21,637 Net income per common share.. $ 0.34 $ (0.06) $ 0.28 For The Year Ended December 31, 2002 ---------------------------------- Effect of Basic Dilutive Diluted EPS Securities EPS ------ ---------- ------- (In Thousands, Except Per Share Data) Net income... $ 1,636 $ - $ 1,636 Weighted average common shares outstanding................................... 16,569 3,229 19,798 Net income per common share.. $ 0.10 $ (0.02) $ 0.08 For The Year Ended December 31, 2001 ---------------------------------- Effect of Basic Dilutive Diluted EPS Securities EPS ------ ---------- ------- (In Thousands, Except Per Share Data) Net income... $ 1,361 $ - $ 1,361 Weighted average common shares outstanding................................... 14,196 1,951 16,147 Net income per common share.. $ 0.10 $ (0.02) $ 0.08 For the years ended December 31, 2003, 2002 and 2001, warrants and options to purchase 237,000, 324,000 and 467,000 shares of Common Stock, respectively, were excluded from the diluted EPS presentation because their exercise prices were greater than the average fair value of the Common Stock. Comprehensive income The Company applies SFAS No. 130, Reporting Comprehensive Income, which requires disclosure of all components of comprehensive income on an annual and interim basis. Comprehensive income is defined as the change in equity of a business enterprise during a period from transactions and other events and circumstances from non-owner sources. The Company's comprehensive income includes foreign currency translation gains (losses) and unrealized gains (losses) on its investments that are considered available-for-sale. Stock-based compensation plans The Company has stock-based employee compensation plans that are described more fully in Note 11. The Company accounts for these plans under the recognition and measurement principles of APB Opinion No. 25, Accounting for Stock Issued to Employees, and related Interpretations. Options granted under these plans have exercise prices equal to or greater than the market value of the underlying F-12 BENTLEY PHARMACEUTICALS, INC. AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) common stock on the dates of grant, which is generally the date on which compensation is measured. In addition to these plans, the Company also sponsors a 401(k) Plan for eligible employees and matches eligible contributions with shares of the Company's Common Stock. From time to time, at the discretion of the Corporate Governance and Compensation Committee of the Board of Directors (the Compensation Committee), the Company grants shares of its Common Stock to employees in lieu of cash compensation. Related stock-based employee compensation costs are reflected in the Consolidated Income Statements and Statements of Cash Flows. The following table illustrates the effect on net income and earnings per share as if the Company had applied the fair value recognition provisions of SFAS No. 123, Accounting for Stock-Based Compensation, to stock-based employee compensation: Year Ended December 31, ---------------------- 2003 2002 2001 ---- ---- ---- (In Thousands, Except Per Share Data) Net income, as reported.................................... $ 6,097 $ 1,636 $ 1,361 Add: Stock-based employee compensation expense included in reported net income................................... 510 156 262 Deduct: Total stock-based employee compensation expense determined under fair value method for all awards......... (3,232) (3,829) (2,302) -------- ---------- ----------- Pro forma net income (loss)................................ $ 3,375 $ (2,037) $ (679) ======== ========== =========== Net income (loss) per share: Basic - as reported................................... $ 0.34 $ 0.10 $ 0.10 ======== ========== =========== Basic - pro forma..................................... $ 0.19 $ (0.12) $ (0.05) ======== ========== =========== Diluted - as reported................................. $ 0.28 $ 0.08 $ 0.08 ======== ========== =========== Diluted - pro forma................................... $ 0.16 $ (0.12) $ (0.05) ======== ========== =========== F-13 BENTLEY PHARMACEUTICALS, INC. AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) The preceding pro forma results were calculated using the Black-Scholes option pricing model with the following weighted average assumptions (results may vary depending on the assumptions applied within the model): Year Ended December 31, ---------------------- 2003 2002 2001 ---- ---- ---- (In Thousands, Except Per Share Data) Risk free interest rate............ 3.86% 5.08% 5.18% Dividend yield.................... 0.00% 0.00% 0.00% Expected life..................... 5 years 5 years 10 years Volatility........................ 54.12% 57.61% 140.81% Fair value of options granted...... $5.03 $5.58 $3.72 Stock or other equity-based compensation for non-employees is accounted for under the fair value method as required by SFAS No. 123 and EITF Issue No. 96-18, Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services and other related interpretations. Segments of an enterprise and related information SFAS No. 131, Disclosures About Segments of an Enterprise and Related Information, redefines how operating segments are determined and requires disclosure of certain financial and descriptive information about a company's operating segments. The Company operates in two business segments that are in two geographical locations. See Note 14 for the disclosures required by SFAS No. 131. Recently issued accounting pronouncements In December 2002, the Financial Accounting Standards Board issued SFAS No. 148, Accounting for Stock-Based Compensation - Transition and Disclosure. SFAS No. 148 amends SFAS No. 123, to provide alternative methods of transition for a voluntary change to the fair value method of accounting for stock-based employee compensation.

SFAS No. 148 also amends the disclosure requirements of SFAS No. 123 to require disclosure in the summary of significant accounting policies, the effects of an entity's accounting policy with respect to stock-based employee compensation on reported net income and earnings per share in annual and interim financial statements. The disclosure provision is required for all companies with stock-based employee compensation, regardless of whether the company utilizes the fair value method of accounting described in SFAS No. 123 or the intrinsic value method described in APB Opinion No. 25. SFAS No. 148's amendment of the transition and annual disclosure provisions of SFAS No. 123 were effective for fiscal years ending after December 15, 2002 and have been incorporated in the Notes to the accompanying Consolidated Financial Statements. The disclosure provisions for interim financial statements were effective for interim periods beginning after December 15, 2002. We have chosen not to adopt the fair value method of accounting for stock-based employee compensation at this time. Accordingly, we continue to account for stock-based compensation utilizing the intrinsic value method of accounting for stock-based employee compensation described by APB Opinion No. 25. F-14 BENTLEY PHARMACEUTICALS, INC. AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) In November 2002, the EITF released Issue No. 00-21, which addresses certain aspects of the accounting by a vendor for arrangements under which it will perform multiple revenue-generating activities. EITF Issue No. 00-21 establishes three principles: revenue arrangements with multiple deliverables should be divided into separate units of accounting; arrangement consideration should be allocated among the separate units of accounting based on their relative fair values; and revenue recognition criteria should be considered individually for each separate unit of accounting. EITF Issue No. 00-21 is effective for all revenue arrangements entered into in fiscal periods beginning after June 15, 2003, with early adoption permitted. The adoption of EITF Issue No. 00-21 in our third quarter of 2003 has not had a material effect on our financial position, results of operations or cash flows for the year ended December 31, 2003. However, the adoption of EITF Issue No. 00-21 may require the deferral and recognition over extended periods, of certain up-front fees associated with our multiple element collaboration and license agreements and of our marketing, distribution and supply agreements. Reclassifications Certain prior year amounts have been reclassified to conform with the current year's presentation format. Such reclassifications did not have a material effect on the Company's financial position, results of operations or cash flows. NOTE 3 - RECEIVABLES Receivables consist of the following: December 31, --------------------- 2003 2002 -------- -------- (In Thousands) Trade receivables (of which $1,914 and $1,340, respectively, collateralize short-term borrowings with Spanish financial institutions) .... $ 16,233 $ 9,829 VAT, income and social security taxes receivable .... 953 1,033 Royalties receivable .... 884 - Other .... 126 112 -------- -------- 18,196 10,974 Less-allowance for doubtful accounts .... (160) (100) -------- -------- $ 18,036 $ 10,874 ======== ======== The following is a summary of the activity related to our allowance for doubtful accounts: Year Ended Year Ended Year Ended December 31, 2003 December 31, 2002 December 31, 2001 ---------------- ---------------- ---------------- (In Thousands) Balance at beginning of year .... $ 100 $ 66 $ 13 Provisions charged to costs and expenses 102 64 54 Write-offs reducing provisions .... (64) (45) - Effect of foreign currency .... 22 15 (1) ----- ----- ----- Balance at end of year .... $ 160 $ 100 $ 66 ===== ===== ===== F-15 BENTLEY PHARMACEUTICALS, INC. AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) NOTE 4 - INVENTORIES Inventories consist of the following: December 31, ---------------- 2003 2002 ---- ---- (In Thousands) Raw materials....................................... $ 5,351 $ 3,518 Finished goods...................................... 1,829 1,677 ------- -------- 7,180 5,195 Less-allowance for slow moving inventory............. (74) (62) ------- -------- $ 7,106 $ 5,133 ======= ======== The following is a summary of the activity related to our allowance for slow moving inventory: Year Ended Year Ended Year Ended December 31, 2003 December 31, 2002 December 31, 2001 ---------------- ---------------- ---------------- (In Thousands) Balance at beginning of year............................... $ 62 $ 54 $ 61 Provisions charged to costs and expenses.................. - - - Write-offs reducing provisions............................ - (1) (4) Effect of foreign currency................................ 12 9 (3) ------ ------ ------ Balance at end of year.................................... $ 74 $ 62 $ 54 ====== ====== ====== NOTE 5 - FIXED ASSETS Fixed assets consist of the following: December 31, ----------------- 2003 2002 ---- ---- (In Thousands) Land.. $ 1,900 $ 930 Buildings and improvements......................... 9,085 5,576 Equipment... 10,953 5,197 Furniture and fixtures............................ 1,497 1,006 Leasehold improvements............................ 43 52 ----------- ----------- 23,478 12,761 Less-accumulated depreciation...................... (4,912) (3,196) ------------ ------------ $ 18,566 $ 9,565 =========== =========== In order to support the

Company's growth in Europe, it is adding additional capacity to its manufacturing facility through a series of improvements. During the year ended December 31, 2003, the Company invested approximately $1,239,000 renovating the facility and approximately $4,136,000 for machinery and equipment including new high speed manufacturing and packaging equipment. The Company also purchased a 15,700 square foot commercial building located on approximately 14 acres of land in Exeter, New Hampshire for approximately $1,800,000 in January 2003. The purchase included furniture and fixtures in the building and the purchase price was allocated to the following components in accordance with their relative fair market values: land - $786,000, buildings - $911,000, and furniture and fixtures - $103,000. The Company moved its corporate headquarters into the purchased building in April 2003. As a result of the move, the Company abandoned its former office space. F-16 BENTLEY PHARMACEUTICALS, INC. AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) The remaining lease costs and costs for the abandonment of leasehold improvements totaling $44,000 were charged to general and administrative expenses in the Consolidated Income Statements for the year ended December 31, 2003. The lease agreement for the former office space ended in February 2004. Depreciation expense of approximately $368,000, $212,000 and $139,000 has been charged to operations as a component of depreciation and amortization expense in the Consolidated Income Statements for the years ended December 31, 2003, 2002 and 2001, respectively. The Company has included depreciation totaling approximately $1,139,000, $569,000 and $324,000 in cost of net product sales during the years ended December 31, 2003, 2002 and 2001, respectively. NOTE 6 - DRUG LICENSES AND RELATED COSTS Drug licenses and related costs consist of the following: December 31, ----------------- 2003 2002 ---- ---- (In Thousands) Drug licenses and related costs................ $ 18,102 $ 13,908 Less-accumulated amortization................. (4,284) (2,933) ---------- ---------- $ 13,818 $ 10,975 ========== ========== The Company acquired intellectual property during the year ended December 31, 2003 for $1,000,000 plus future royalties on sales and licensing income (See Notes 2 and 15). In November 2000, Laboratorios Belmac entered into an agreement to sell the trademark, registration rights and dossier for its branded pharmaceutical product, Controlvas(R), for approximately $5,148,000. Laboratorios Belmac received a 50% deposit from the purchaser in November 2000, which was reflected as deferred income in the Consolidated Balance Sheet as of December 31, 2000. The transaction was completed in February 2001, resulting in a gain of approximately $4,977,000 being recognized in the year ended December 31, 2001. In June 2001, Laboratorios Belmac agreed to sell the trademark, registration rights and dossier for its pharmaceutical product, Amantadine(R), to a third party for approximately $153,000. A deposit of approximately $56,000 was received from the purchaser in June 2001 and a second payment of the same amount was received upon approval of the transfer of the rights to the purchaser by the Spanish Ministry of Health, which occurred during the quarter ended September 30, 2001, resulting in recognition of a pre-tax gain of approximately $73,000. The remaining amount of approximately $41,000 is payable over the five subsequent years, in the form of a royalty arrangement. Amortization expense for drug licenses and related costs was approximately $972,000, $803,000 and $772,000 for the years ended December 31, 2003, 2002 and 2001, respectively, and has been recorded in depreciation and amortization expense in the accompanying Consolidated Income Statements. Amortization expense for existing drug licenses and related costs for each of the five years ending December 31, 2008 and for all remaining years thereafter is estimated to be approximately $1,047,000 and $8,583,000, respectively. F-17 BENTLEY PHARMACEUTICALS, INC. AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) NOTE 7 - RELATED PARTY NOTES There are no Related Party Receivables from executive officers or directors at December 31, 2003. In March 2000, the Company provided loans to each of Messrs. Murphy, Price and Gyurik, who are executive officers of the Company, in the amounts of $250,000, $50,000 and $140,000, respectively, which Messrs. Murphy, Price and Gyurik used to pay income taxes on equity-based compensation received in the prior year. In December 2001, the Compensation Committee of the Company's Board of Directors agreed to amend the loan agreements resulting in the forgiveness of principal and accrued interest totaling approximately $56,000, $11,000 and $31,000, due from Messrs. Murphy, Price and Gyurik, respectively. The amounts forgiven were applied first to unpaid accrued interest and then to principal. These amounts were recorded as compensation expense during the year ended December 31, 2001 and treated as taxable income to the respective executives. In January 2002, the Compensation Committee agreed to amend the loan agreements, resulting in the forgiveness of principal and accrued interest totaling approximately the same amounts as in December 2001 and the reduction in the number of shares collateralizing the remaining loan amounts to 18,700, 4,000 and 10,700 shares of the Company's Common Stock owned by Messrs. Murphy, Price and Gyurik, respectively. These amounts were recorded as compensation expense during the year ended December 31, 2002 and treated as taxable income to the respective executives. In March 2003, the Compensation Committee agreed to amend the loan agreements, resulting in the forgiveness of the remaining aggregate principal of $294,000 and accrued interest on the loan balances of $8,000. As of March 31, 2003, the balance outstanding related to these loans was reduced to zero. These amounts were recorded as compensation expense during the year ended December 31, 2003 and treated as taxable income to the respective executives. Of the balances outstanding at December 31, 2002 approximately $301,000 was included in prepaid expenses and other current assets in the Consolidated Balance Sheets. Accrued interest on such loans totaled approximately $7,000 at December 31, 2002. NOTE 8 - ACCRUED EXPENSES Accrued expenses consist of the following: December 31, ----------------- 2003 2002 ---- ---- (In Thousands) Foreign income taxes payable...................... $ 1,940 $ 1,177 Allowance for sales returns....................... 446 349 Accrued payroll.................................. 952 756 Spanish pharmaceutical taxes payable.............. 1,586 565 Other accrued expenses............................ 2,179 1,212 -------- -------- $ 7,103 $ 4,059 ======== ======== F-18 BENTLEY PHARMACEUTICALS, INC. AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) The following is a summary of the activity related to our allowance for sales returns: Year Ended Year Ended Year Ended December 31, 2003 December 31, 2002 December 31, 2001 ---------------- ---------------- ---------------- (In Thousands) Balance at beginning of year.............................. $ 349 $ 402 $ 56 Provisions charged to costs and expenses.................. 640 311 351 Write-offs reducing provisions............................ (615) (423) - Effect of foreign currency................................ 72 59 (5) ------ ------ ------ Balance at end of year.................................... $ 446 $ 349 $ 402 ====== ====== ====== NOTE 9 - DEBT Short-term borrowings consist of the following: December 31, ----------------- 2003 2002 ---- ---- (In Thousands) Trade receivables discounted with a Spanish financial institution, with recourse, effective interest rate is 3.9% and 5.2%, respectively... $ 1,914 $ 1,340 Revolving lines of credit payable to Spanish financial institutions, weighted average interest rate is 3.3% and 4.5%, respectively... 1 258 --------- -------- $ 1,915 $ 1,598 ========= ======== The weighted average stated interest rate on short-term borrowings outstanding at December 31, 2003 and 2002 was 3.8% and 5.1%, respectively. The Company has revolving lines of credit with Spanish financial institutions, which entitle the Company to borrow up to $6,617,000 at December 31, 2003. The lines are scheduled to mature on various dates through November 30, 2004 and are renewable. At December 31, 2003, advances outstanding under the lines of credit totaled approximately $1,000. The weighted average interest rate at December 31, 2003 and 2002 was 3.3% and 4.5%, respectively, and interest is payable quarterly. Long-term debt consists of the following: December 31, -------------- 2003 2002 ---- ---- (In Thousands) Loans payable to Spanish government, net of unamortized discount of $83 and $105, respectively......... $ 369 $ 282 Loans payable for equipment financing..................... 70 190 ----- ------ 439 472 Less-current portion..................................... (70) (127) ---- ----- Total long-term debt................................... $ 369 $ 345 ===== ====== In March 2002, the Company entered into a loan agreement to finance the acquisition of manufacturing equipment. The terms of the loan require repayment over a two-year period at an average interest rate of 2.9%. As of December 31, 2003, approximately $70,000 of the original balance remains outstanding. F-19 BENTLEY PHARMACEUTICALS, INC. AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) In November 2002, the Company entered into a loan agreement with the Spanish government as part of a research-funding program. The loan is non-interest bearing and is payable in equal annual installments of approximately $17,000 beginning in 2006. Accordingly, the Company imputed interest at the market rate in Spain (4.8%), recorded a discount on the obligation of $33,000 and has classified the obligation at December 31, 2003 and 2002 as non-current. The discount is being amortized over the ten-year term of the loan. In December 2001, the Company entered into a loan agreement with the Spanish government as part of a research-funding program. The loan is non-interest bearing and is payable in equal annual installments of approximately $31,000 beginning in 2005. Accordingly, the Company imputed interest at the market rate in Spain (6%), recorded a discount on the obligation of $72,000 and has classified the obligation at December 31, 2003 and 2002 as non-current. The discount is being amortized over the ten-year term of the loan. NOTE 10 - PREFERRED STOCK The Company has 2,000,000 shares of $1.00 Preferred Stock authorized for issuance. As of December 31, 2003 and 2002, no shares of Preferred Stock were outstanding. NOTE 11 - STOCKHOLDERS' EQUITY At December 31, 2003 the Company had the following Common Stock reserved for issuance under various plans and agreements (in thousands): Common Shares ------------- For exercise of stock purchase warrants........................ 420 For exercise of outstanding stock options...................... 3,920 For future stock option grants................................ 1,578 ----- 5,918 ===== The

Company has never paid any dividends on its Common Stock. The current policy of the Board of Directors is to retain earnings to finance the operation of the Company's business. Accordingly, it is anticipated that no cash dividends will be paid to the holders of the Common Stock in the foreseeable future. Common stock transactions During the year ended December 31, 2003, the Company issued approximately 2,870,000 shares of Common Stock upon exercise of Class B Warrants, approximately 240,000 shares of Common Stock upon exercise of stock purchase options, and approximately 58,000 shares of Common Stock as equity-based compensation in lieu of cash. During the year ended December 31, 2002, the Company issued approximately 2,500,000 shares of Common Stock in a Common Stock Offering which raised gross proceeds of $24,500,000, approximately 132,000 shares of Common Stock upon exercise of Class B Warrants, approximately 172,000 shares of Common Stock upon exercise of stock purchase options, and approximately 15,000 shares of Common Stock as equity-based compensation in lieu of cash. During the year ended December 31, 2001, the Company issued approximately 460,000 shares of Common Stock as a result of the exercise of underwriter's Class A Warrants, approximately 4,200 shares of F-20 BENTLEY PHARMACEUTICALS, INC. AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) Common Stock upon exercise of Class B Warrants, approximately 150,000 shares of Common Stock upon exercise of 150,000 other stock purchase warrants, approximately 16,900 shares of Common Stock upon exercise of stock purchase options, and approximately 40,000 shares of Common Stock as equity-based compensation in lieu of cash. General and administrative expenses for the years ended December 31, 2003, 2002 and 2001 include $248,000, $100,000 and $160,000, respectively, of non-cash equity-based compensation. Research and development expenses for the years ended December 31, 2003, 2002 and 2001 include $262,000, $56,000 and $102,000, respectively, of non-cash equity-based compensation. Stock purchase warrants At December 31, 2003, warrants to purchase an aggregate of approximately 420,000 shares of Common Stock were outstanding, which were exercisable at prices ranging from $1.50 to $20.00 per share, of which 400,000 warrants have an exercise price of $1.50 per share and 20,000 warrants have an exercise price of $20.00 per share. The warrants expire on various dates from June 2004 through February 2009. During the year ended December 31, 2003, approximately 5,740,000 Class B Warrants were exercised to acquire an aggregate of 2,870,000 shares of Common Stock. The Company received net cash proceeds of approximately $14,349,000 from all such exercises during the year ended December 31, 2003. Approximately 3,600 Class B Warrants which were not exercised by December 31, 2003 expired unexercised. At December 31, 2002, warrants to purchase an aggregate of approximately 3,292,000 shares of Common Stock were outstanding, which were exercisable at prices ranging from $1.50 to $20.00 per share, of which 400,000 warrants had an exercise price of $1.50 per share, approximately 5,744,000 Class B Warrants to purchase approximately 2,872,000 shares of common stock had an exercise price of $5.00 per share and 20,000 warrants had an exercise price of $20.00 per share. During the year ended December 31, 2002, approximately 263,800 Class B Warrants were exercised to acquire an aggregate of 131,900 shares of Common Stock. The Company received net cash proceeds of approximately $660,000 from all such exercises during the year ended December 31, 2002. During the year ended December 31, 2001, underwriter's Class A Warrants were exercised to acquire 460,000 shares of Common Stock and 460,000 underwriter's Class B Warrants. Approximately 8,400 Class B Warrants and 150,000 other stock purchase warrants were exercised during 2001 to acquire an aggregate of 154,200 shares of Common Stock. The Company received net cash proceeds of approximately $1,776,000 from all such exercises during the year ended December 31, 2001. F-21 BENTLEY PHARMACEUTICALS, INC. AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) The table below summarizes warrant activity for the years ended December 31, 2001, 2002 and 2003. Weighted Number of Average Exercise Common Shares Price Per Share ------------ -------------- (In Thousands, Except Per Share Data) Outstanding at December 31, 2000 .... 4,038 $ 4.41 Exercised .... (614) $ 2.89 ----- Outstanding at December 31, 2001 .... 3,424 $ 4.68 Exercised .... (132) $ 5.00 ----- Outstanding at December 31, 2002 .... 3,292 $ 4.67 Exercised .... (2,870) $ 5.00 Expired .... (2) $ 5.00 ----- Outstanding at December 31, 2003 .... 420 $ 2.38 ===== Stock option plans The Company has in effect Stock Option Plans (the "Plans"), pursuant to which directors, officers and employees of the Company are eligible to receive grants of options for the Company's Common Stock. Approximately 5,498,000 shares of Common Stock have been reserved for issuance under the Plans, of which approximately 605,000 are outstanding under the 1991 Plan, approximately 1,881,000 are outstanding under the 2001 Employee and Director Plans and

1,434,000 are outstanding under the Executive Plan as of December 31, 2003. Options may be granted for terms not exceeding ten years from the date of grant except for incentive stock options which are granted to persons owning more than 10% of the total combined voting power of all classes of stock of the Company. For these individuals, incentive stock options may be granted for terms not exceeding five years from the date of grant. Options may not be granted at a price that is less than 100% of the fair market value on the date the options are granted (110% in the case of incentive stock options for persons owning more than 10% of the total combined voting power of the Company). Options granted under the Plans generally vest over one or two years. Options to purchase 240,500, 172,300 and 16,900 shares of Common Stock were exercised during the years ended December 31, 2003, 2002 and 2001, respectively, resulting in net cash proceeds to the Company of approximately $962,000, $715,000 and $51,000, respectively. F-22 BENTLEY PHARMACEUTICALS, INC. AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) The table below summarizes activity in the Company's Plans for the years ended December 31, 2001, 2002 and 2003. Number of Weighted Average Common Shares Exercise Price -------------- -------------- (In Thousands, Except Per Share Data) Outstanding at December 31, 2000 2,457 $ 4.87 Granted .... 553 6.04 Exercised .... (17) 3.00 Canceled .... (56) 9.66 ----- Outstanding at December 31, 2001 2,937 5.00 Granted .... 699 10.28 Exercised .... (172) 4.15 Canceled .... (5) 29.40 ----- Outstanding at December 31, 2002 3,459 6.07 Granted .... 731 9.62 Exercised .... (240) 4.00 Canceled .... (30) 20.08 ----- Outstanding at December 31, 2003 3,920 $ 6.75 ===== The table below summarizes options outstanding and exercisable at December 31, 2003 (number of options in thousands): Options Currently ---------------------- Options Outstanding Exercisable ------------------- ----------- Weighted Weighted Weighted Range of Number Average Average Number Average Exercise Of Exercise Remaining Life Of Exercise Prices Options Price (Years) Options Price ------ ------- -------- ------------- -------- --------- $2.00-2.89 476 $ 2.86 2.5 476 $ 2.86 3.00-3.75 579 3.62 2.5 579 3.62 4.73 500 4.73 2.3 500 4.73 5.70-5.88 147 5.84 6.4 147 5.84 6.00-6.38 410 6.01 7.3 410 6.01 7.10-7.90 262 7.53 6.7 262 7.53 8.00-8.93 311 8.16 7.9 52 8.50 9.00-9.80 534 9.68 8.0 250 9.70 10.04-10.75 385 10.10 9.2 30 10.73 11.13-11.81 266 11.49 8.3 133 11.54 13.48-15.83 50 14.03 9.8 - - ---------- ----- ------- --- ----- ------- $2.00-15.83 3,920 $ 6.75 5.8 2,839 $ 5.58 ========== ===== ======= === ===== ======= Options and warrants outstanding at December 31, 2003 include approximately 420,000 warrants, all of which are exercisable, and approximately 3,920,000 options, of which approximately 2,839,000 are vested and exercisable at December 31, 2003. Options and warrants outstanding at December 31, 2002 included warrants to purchase approximately 3,292,000 shares of common stock, all of which were exercisable, and approximately 3,459,000 options, of which approximately 2,710,000 were vested and exercisable at December 31, 2002. F-23 BENTLEY PHARMACEUTICALS, INC. AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) Subsequent to December 31, 2003, the Company granted options to certain employees of the Company to purchase an aggregate of approximately 403,000 shares of Common Stock at a weighted average exercise price of $13.27, which options are scheduled to expire on various dates between January 1, 2014 and March 1, 2014. 401(k) Retirement Plan The Company sponsors a 401(k) retirement savings plan (the "401(k) Plan") under which eligible employees may contribute, on a pre-tax basis, up to 100% of their respective total annual income from the Company, subject to a maximum aggregate annual contribution imposed by the Internal Revenue Code of 1986, as amended. All employees who work for the Company in the U.S. are eligible to participate in the 401(k) Plan. All employee contributions are allocated to the employee's individual account and are invested in various investment options as directed by the employee. Employees' cash contributions are fully vested and nonforfeitable. The Company made matching contributions to the 401(k) Plan during the years ended December 31, 2003, 2002 and 2001 in the form of approximately 11,500, 9,300 and 13,700 shares, respectively, of the Company's Common Stock valued at approximately $117,000, $92,000 and $83,000, respectively. All Company matching contributions vest 25% each year for the first four years of each employee's employment, in which the employee works for the Company at least 1,000 hours. Stockholder Rights Plan On December 22, 1999, the Board of Directors of the Company adopted a stockholder rights plan pursuant to which a dividend of one right for each outstanding share of the Company's Common Stock on the record date of December 27, 1999 was declared. The plan is designed to prevent a potential acquirer from gaining control of the Company without fairly compensating all of the Company's stockholders and to protect the Company from coercive takeover attempts. Each of the rights, which are not currently exercisable, entitles the holder to purchase one one-thousandth of a share of Series A Junior Participating Preferred Stock at an exercise price of $16.50. The rights will become exercisable only if a person or group of affiliated persons beneficially acquire(s) 15% or more of the Company's Common Stock. Under certain circumstances, each holder of a right (other than the person or group who acquired 15% or more of the Company's Common Stock) is entitled to purchase a defined number of shares of the Company's Common Stock at 50% of the market price of the Common Stock at the time that the right becomes exercisable. NOTE 12 - PROVISION FOR INCOME TAXES For all periods presented the income before income taxes as shown in the Consolidated Income Statements consists of losses generated in the United States and income derived from foreign operations. See Note 14 for information regarding the components of income before taxes. F-24 BENTLEY PHARMACEUTICALS, INC. AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) The provision for income taxes consists of the following: Year Ended December 31, -- 2003 2002 2001 ---- ---- ---- (In Thousands) Current: State.. $ - $ - $ - Federal.. - - - Foreign.. 5,417 2,524 2,446 Deferred: State.. (54) 1,477 (123) Federal.. (329) 9,073 (757) Foreign.. 6 8 5 Effect of tax benefit from exercise of stock options: State.. (61) - (3) Federal.. (375) - (18) --------- -------- ------- Tax benefit from operating loss carryforwards: State.. (158) (144) (133) Federal.. (973) (884) (818) Foreign.. - - - Valuation allowance.................................... 1,950 (9,520) 1,852 --------- -------- ------- Total provision for income taxes $ 5,423 $ 2,534 $ 2,451 ========= ======== ======= A reconciliation between the federal statutory rate and the Company's effective income tax rate is as follows: Year Ended December 31, ------------------------------- 2003 2002 2001 ---- ---- ---- (In Thousands) Statutory federal income tax...................................... $ 3,917 $ 1,418 $ 1,296 Permanent differences from foreign subsidiary...................... 489 183 202 Foreign withholding taxes.. (331) - - Valuation allowance.. 1,348 933 954 ------- ------- ------- $ 5,423 $ 2,534 $ 2,452 ======= ======= ======= The components of the Company's deferred taxes are as follows: December 31, ------------------------ 2003 2002 ---- ---- (In Thousands) Deferred tax assets: NOL carryforwards.. $ 16,685 $ 15,118 Disposition of subsidiary.. 6,912 6,912 Foreign tax on deferred income... 213 123 Tax credit carryforwards.. 415 415 Other, net... 1,100 719 ---------- ---------- Total deferred tax assets... 25,325 23,287 Deferred tax liabilities... (217) (217) Valuation allowance... (24,895) (22,947) ---------- ---------- Deferred tax asset, net... $ 213 $ 123 ========== ========== The Company has established a valuation allowance equal to the full amount of the domestic deferred tax asset, as future domestic operating profits cannot be assured. The Company has a current deferred tax asset of $213,000 and a non-current tax liability of $2,555,000 due to temporary differences arising as a result of the Company's Spanish subsidiary recording the gain on the sale of drug licenses and the corresponding taxes for Spanish statutory purposes during the years ended December 31, 2001 and 2002. The deferred tax asset is a result of taxes that related to deferred income and the tax liability results from taxes that will be payable in Spain beginning in 2005. F-25 BENTLEY PHARMACEUTICALS, INC. AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) Should the Company determine that it is more likely than not that it will realize certain of its net deferred tax assets for which it had previously provided a valuation allowance, an adjustment would be required to reduce the existing valuation allowance. In addition, the Company operates within multiple taxing jurisdictions and is subject to audit in those jurisdictions. These audits can involve complex issues, which may require an extended period of time for resolution. Although the Company believes that adequate consideration has been made for such issues, there is the possibility that the ultimate resolution of such issues could have an adverse effect on the Company's results of operations. Under the provisions of the Internal Revenue Code, certain substantial changes in the Company's ownership may have limited, or may limit in the future, the amount of net operating loss (the "NOL") carryforwards that could be utilized annually to offset future taxable income and income tax liabilities. The amount of any annual limitation is determined based upon the Company's value prior to an ownership change. At December 31, 2003, the Company has NOL carryforwards of approximately $42,331,000 available to offset U.S. taxable income. The NOL carryforwards include the benefit of disqualifying dispositions of $1,156,000, the tax effect of which $457,000 will be credited to additonal paid-in capital if and when realized. The Company calculates that use of its NOLs may be limited each year as a result of stock option and warrant issuances resulting in an ownership change of more than 50% of the Company's outstanding equity. If not offset against future taxable income, the NOL carryforwards will expire in tax years 2007 through 2023. Capital loss carryforwards totaling approximately $27,562,000 expired unused during the year ended December 31, 2002. The valuation allowance increased (decreased) by approximately $1,950,000, ($9,520,000) and $1,852,000 for each of the years ended December 31, 2003, 2002 and 2001, respectively. NOTE 13 - SELECTED QUARTERLY FINANCIAL INFORMATION (Unaudited) The following tables contain condensed information from the Company's income statements for each quarter of the years ended December 31, 2003, 2002 and 2001. The Company believes that the following information reflects all normal recurring adjustments necessary for a fair presentation of the information for the periods presented. The operating results for any quarter are not necessarily indicative of results for any future period. F-26 BENTLEY PHARMACEUTICALS, INC. AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) Fiscal 2003 -- For the Three Months Ended --- 3/31/2003 6/30/2003 9/30/2003 12/31/2003 -- (In Thousands, Except Per Share Data) Total revenues $ 14,988 $ 16,754 $ 14,875 $ 18,059 Cost of sales 6,121 6,819 5,744 7,715 -------- -------- -------- -------- Gross profit 8,867 9,935 9,131 10,344 Operating expenses 6,213 6,619 6,290 7,726 Gain on sale of drug licenses - - - - -------- -------- -------- -------- Income from operations 2,654 3,316 2,841 2,618 Other income/(expenses), net 29 18 20 24 Provision for income taxes 1,151 1,805 1,513 954 -------- -------- -------- -------- Net income $ 1,532 $ 1,529 $ 1,348 $ 1,688 ======== ======== ======== ======== Net income per common share: Basic $ 0.09 $ 0.09 $ 0.08 $ 0.09 ======== ======== ======== ======== Diluted $ 0.08 $ 0.07 $ 0.06 $ 0.08 ======== ======== ======== ======== Weighted average common shares outstanding: Basic 17,455 17,534 17,911 19,071 ======== ======== ======== ======== Diluted 20,350 20,878 22,228 22,418 ======== ======== ======== ======== Fiscal 2002 --- For the Three Months Ended -- 3/31/2002(a) 6/30/2002(a) 9/30/2002(a) 12/31/2002 -- (In Thousands, Except Per Share Data) Total revenues $ 9,174 $ 9,867 $ 8,571 $ 11,524 Cost of sales 3,776 4,249 3,579 4,873 -------- -------- -------- -------- Gross profit 5,398 5,618 4,992 6,651 Operating expenses 4,715 4,743 4,300 5,519 Gain on sale of drug licenses 72 520 - 58 -------- -------- -------- -------- Income from operations 755 1,395 692 1,190 Other income/(expenses), net (23) 10 67 84 Provision for income taxes 597 886 468 583 -------- -------- -------- -------- Net income $ 135 $ 519 $ 291 $ 691 ======== ======== ======== ======== Net income per common share: Basic $ 0.01 $ 0.03 $ 0.02 $ 0.04 ======== ======== ======== ======== Diluted $ 0.01 $ 0.03 $ 0.01 $ 0.03 ======== ======== ======== ======== Weighted average common shares outstanding: Basic 14,634 16,823 17,377 17,405 ======== ======== ======== ======== Diluted 17,922 20,484 20,706 20,121 ======== ======== ======== ======== (a) Certain prior period amounts previously reported as cost of sales have been reclassified as a reduction of revenues to conform with the current period's presentation format. Such reclassifications are not considered material to the consolidated financial statements. F-27 BENTLEY PHARMACEUTICALS, INC. AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) Fiscal 2001 -- For the Three Months Ended -- 3/31/2001 6/30/2001 9/30/2001 12/31/2001 -- (In Thousands, Except Per Share Data) Total revenues $ 5,814 $ 6,125 $ 6,316 $ 8,156 Cost of sales 2,449 2,687 2,708 3,618 -------- -------- -------- -------- Gross profit 3,365 3,438 3,608 4,538 Operating expenses 3,730 3,906 3,601 4,900 Gain on sale of drug licenses 4,977 - 113 (40) -------- -------- -------- -------- Income from operations 4,612 (468) 120 (402) Other income/(expenses), net (11) (7) (24) (7) Provision for income taxes 1,959 94 245 154 -------- -------- -------- -------- Net income $ 2,642 $ (569) $ (149) $ (563) ======== ======== ======== ======== Net income per common share: Basic $ 0.19 $ (0.04) $ (0.01) $ (0.04) ======== ======== ======== ======== Diluted $ 0.17 $ (0.04) $ (0.01) $ (0.04) ======== ======== ======== ======== Weighted average common shares outstanding: Basic 13,915 13,952 14,308 14,585 ======== ======== ======== ======== Diluted 15,882 13,952 14,308 14,585 ======== ======== ======== ======== NOTE 14 - BUSINESS SEGMENT INFORMATION The Company is a U.S.-based international specialty pharmaceutical company focused on advanced drug delivery technologies and pharmaceutical products. The Company also has a commercial presence in Europe. The Company's Spanish subsidiaries, Laboratorios

Belmac, Laboratorios Davur and Laboratorios Rimafar, develop, license and sell generic and branded pharmaceutical products and manufacture pharmaceuticals for others. In the U.S., the Company's activities consist primarily of licensing, product research and development, business development activities, corporate management and administration. Laboratorios Belmac and its subsidiaries derive its revenues from the development, licensing and sales of its own products as well as from product manufacturing for others, within four primary therapeutic categories of cardiovascular, gastrointestinal, infectious and neurological diseases. Set forth in the tables below is certain financial information with respect to the Company's business and geographical segments for the years ended December 31, 2003, 2002 and 2001. The segments use the same accounting policies as those described in the summary of significant accounting policies in Note 2. F-28 BENTLEY PHARMACEUTICALS, INC. AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) Year Ended December 31, 2003 ---------------------------- (In thousands) Product R/D/ Sales Collaborations/ Spain U.S. Consolidated ----- --------------- ------------ Total revenues .... $ 63,158 $ 1,518 $ 64,676 Interest income .... 136 196 332 Interest expense .... 215 13 228 Depreciation and amortization expense .... 863 477 1,340 Income (loss) before income taxes .... 15,091 (3,571) 11,520 Provision for income taxes .... 5,092 331 5,423 Net income (loss) .... 9,999 (3,902) 6,097 Fixed assets .... 16,428 2,138 18,566 Drug licenses and related costs .... 9,441 4,377 13,818 Total assets .... 62,564 37,899 100,463 Total liabilities .... 22,619 1,679 24,298 Expenditures for drug licenses/delivery technology...... 1,075 1,223 2,298 Expenditures for fixed assets .... 5,970 2,106 8,076 Year Ended December 31, 2002 ---------------------------- (In thousands) Product R/D/ Sales Collaborations/ Spain U.S. Consolidated ----- --------------- ------------ Total revenues .... $ 38,718 $ 418 $ 39,136 Interest income .... - 279 279 Interest expense .... 200 9 209 Depreciation and amortization expense .... 655 360 1,015 Income (loss) before income taxes .... 6,913 (2,743) 4,170 Provision for income taxes .... 2,534 - 2,534 Net income (loss) .... 4,379 (2,743) 1,636 Fixed assets .... 9,417 148 9,565 Drug licenses and related costs .... 7,463 3,512 10,975 Total assets .... 38,199 26,493 64,692 Total liabilities .... 15,417 524 15,941 Expenditures for drug licenses/delivery technology...... 615 181 796 Expenditures for fixed assets .... 3,408 24 3,432 F-29 BENTLEY PHARMACEUTICALS, INC. AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) Year Ended December 31, 2001 ---------------------------- (In thousands) Product R/D/ Sales Collaborations/ Spain U.S. Consolidated ----- --------------- ------------ Total revenues .... $ 26,411 $ - $ 26,411 Interest income .... 27 141 168 Interest expense .... 244 - 244 Depreciation and amortization expense .... 523 388 911 Income (loss) before income taxes .... 6,618 (2,805) 3,813 Provision for income taxes .... 2,452 - 2,452 Net income (loss) .... 4,166 (2,805) 1,361 Fixed assets .... 5,427 168 5,595 Drug licenses and related costs .... 6,663 3,613 10,276 Total assets .... 24,890 7,229 32,119 Total liabilities .... 10,974 721 11,695 Expenditures for drug licenses/delivery technology...... 412 72 484 Expenditures for fixed assets .... 2,029 40 2,069 Interest income and interest expense are based upon the actual results of each operating segment's assets and borrowings. The principal component of the inter-segment amounts is related to inter-segment advances. Revenues from one customer exceeded 10% of consolidated total revenues during the year ended December 31, 2003, accounting for 14% of 2003 consolidated total revenues and 16% of the consolidated accounts receivable balance at December 31, 2003. Revenues from one customer exceeded 10% of consolidated total revenues during the year ended December 31, 2002, accounting for 14% of 2002 consolidated total revenues and 8% of the consolidated receivables balance at December 31, 2002. Revenues from one customer exceeded 10% of consolidated total revenues during the year ended December 31, 2001, accounting for 15% of 2001 consolidated total revenues. NOTE 15 - COMMITMENTS AND CONTINGENCIES The Company is obligated to pay certain royalty payments upon commercialization of products using its CPE-215 technology acquired in 1999 and on intellectual property acquired in 2003 (See Notes 2 and 6). The Company has entered into various renewable, employment agreements with its key executive officers, which agreements provide for salaries, potential bonuses and other benefits in exchange for services provided by the key executive officers. The employment agreements also provide for certain compensation in the event of termination or change in control of the Company. The Company is currently obligated to pay approximately $1,490,000 to its key executives in 2004 and $350,000 in 2005 under such agreements, which are scheduled to expire on December 31, 2004 and 2005 The Company is currently undergoing a tax review of its Spanish subsidiary, Laboratorios, Belmac, S.A., by the Spanish tax authorities. Certain tax contingencies exist and when probable and reasonably estimable, are provided F-30 BENTLEY PHARMACEUTICALS, INC. AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued) for in the Consolidated Financial Statements. Accordingly, as of December 31, 2003, since these contingencies are not probable or reasonably estimable, no amounts have been provided for related to these contingencies. The Company leases certain equipment and facilities under non-cancelable operating leases, which expire through the year 2008. Total charges to operations under operating leases were approximately $911,000, $785,000 and $705,000 for the years ended December 31, 2003, 2002 and 2001, respectively. Future minimum lease payments under operating leases are as follows: Year Ending December 31, ----------------------- (In Thousands) 2004.. $ 708 2005.. 492 2006.. 175 2007.. 19 2008 and beyond............................. 11 On February 4, 2002, the Company was notified that a legal proceeding had been commenced against it by Merck & Co. Inc. and its Spanish subsidiary, Merck Sharp & Dohme de Espana, S.A., alleging that the Company violates their patents in its production of the product simvastatin and requesting an injunction ordering the Company not to manufacture or market the product. The case was brought against the Company's Spanish subsidiaries in the 39th First Instance Court of the City of Madrid. After a hearing on February 18, 2002, the court refused to grant the requested injunction and dismissed the case on February 25, 2002, awarding court costs and legal fees to the Company. Merck has appealed the award of fees. Merck re-instituted its claim against the Company in another proceeding brought in the 19th First Instance Court of the City of Madrid, of which the Company received notice on January 23, 2003. This case also alleges violation of Merck's patents in the production of the product simvastatin, requests an order that the Company cease manufacturing the product and demands damages during the period of manufacture. A trial with respect to this matter was held on February 19 and 20, 2004, and the Company is waiting for the court's decision. The Company is vigorously opposing this claim as the Company believes the claim is without merit. The Company's simvastatin product line was launched in January 2002. On January 10, 2004, the Company was notified that a legal proceeding had been commenced against the Company by Smith Kline Beecham PLC, Smith Kline Beecham, S.A. and GlaxoSmithKline S.A. alleging that the Company violates their patents in the Company's production of the product paroxetine and requesting an order requiring that the Company not manufacture or market the product. The case was brought against the Company's Spanish subsidiaries in the 50th First Instance Court of the City of Madrid. This proceeding followed a preliminary injunction that the same plaintiffs attempted to bring against the Company in 2003, which was dismissed. The Company filed a response to this suit in February 2004 that includes a counterclaim requesting that the court declare the asserted patent invalid. The Company intends to vigorously oppose this claim as the Company believes the claim is without merit. The Company's paroxetine product line was launched in 2003. The Company is a party to various other legal actions that arose in the ordinary course of business. The Company does not expect that resolution of these matters will have, individually or in the aggregate, a material adverse effect on the Company's financial position, results of operations or cash flows. F-31