

CARACO PHARMACEUTICAL LABORATORIES LTD  
Form 10-K  
June 14, 2006

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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

FORM 10-K

(Mark one)

- Annual report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the Fiscal Year ended March 31, 2006
- Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

Commission File No. 0-24676

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**CARACO PHARMACEUTICAL LABORATORIES, LTD.**  
(Exact name of registrant as specified in its charter)

Michigan  
(State of Incorporation)

38-2505723  
(I.R.S. Employer Identification No.)

**1150 Elijah McCoy Drive, Detroit, MI 48202**  
(Address of principal executive office)

**(313) 871-8400**  
(Registrant's telephone number)

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**Securities Registered Pursuant to Section 12(b) of the Exchange Act:**

| Title of Each Class to be so Registered | Name of Each Exchange On which Each Class is to be Registered |
|---|---|
|---|---|

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|----------------------------|-------------------------|
| Common Stock, No Par Value | American Stock Exchange |
|----------------------------|-------------------------|

**Securities Registered Pursuant to Section 12(g) of the Exchange Act: None.**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15 (d) of the Act. Yes  No

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports),

and (2) has been subject to such filing requirements for the

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past 90 days. Yes  No

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

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

Large Accelerated Filer  Accelerated Filer  Non-Accelerated Filer

The aggregate market value of the voting common stock held by non-affiliates, based on the last sale price of the common stock as of September 30, 2005, the last day of the Registrant's most recently completed second quarter, as reported on the American Stock Exchange, was \$82,145,710.

Indicate the number of shares outstanding of each of the registrant's classes of Common Stock, as of the latest practicable date.

As of June 7, 2006, there were 26,421,994 shares of common stock outstanding.

**Documents Incorporated By Reference:**

Portions of registrant's definitive 2006 Proxy Statement in connection with its Annual Meeting to be held in September 2006 to be filed on or before July 31, 2006.

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**CARACO PHARMACEUTICAL LABORATORIES, LTD.  
FORM 10-K**

**Forward Looking Statements**

This report, other than the historical financial and business information, may contain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act. Without limitation, the words believes, plans, expects, and similar expressions are intended to identify forward-looking statements. Those statements include statements regarding our intent, belief, and current expectation. These statements are not guarantees of future performance and are subject to risks and uncertainties that cannot be predicted or quantified. Consequently, actual results could differ materially from those expressed or implied by such forward-looking statements. Such risks and uncertainties include, but are not limited to those referenced in Part I, Item 1A below. These forward-looking statements represent our judgment as of the date of this report. We disclaim, however, any intent or obligation to update our forward-looking statements.

**PART I**

**Item 1. Business**

**Introduction**

Caraco Pharmaceutical Laboratories, Ltd. ( Caraco which is also referred to as the Company, the Corporation, we, us or our corporation organized under Michigan law in 1984, engaged in the business of developing, manufacturing, marketing and distributing generic and private-label pharmaceuticals to the nation's largest wholesalers, distributors, warehousing and non- warehousing chain drugstores and managed care providers, throughout the U.S.

A generic pharmaceutical is the chemical and therapeutic equivalent of a brand-name drug as to which the patent and/or market exclusivity has expired. Generics are well accepted for substitution of brand products as they sell at lower prices than the prices of the branded products at the equivalence in quality and bioavailability.

The Company's principal executive offices are located at 1150 Elijah McCoy Drive, Detroit, Michigan 48202, and its telephone number is (313) 871-8400. The Company files annual reports, quarterly reports, current reports, proxy statements and other information with the Securities and Exchange Commission. You may read and copy any of the Company's SEC filings at the SEC's Public Reference Room at 450 Street, N.W., Washington, D.C., 20549. You may call the SEC at 1-800-SEC-0330 for further information about the Public Reference Room. Our SEC filings are also available to the public on the SEC's website at <http://www.sec.gov> and at our principal Internet address at [www.caraco.com](http://www.caraco.com). We believe that these reports are made available as soon as reasonably practicable after we electronically file with or furnish them to the SEC.

On January 27, 2005, the Board of Directors of the Company resolved to change the Company's fiscal year from December 31 to March 31 commencing in 2005. This change was made in order to make the Company's fiscal year conform to the March 31 fiscal year of its parent company, Sun Pharmaceutical Industries Limited ( Sun Pharma ). This Form 10-K covers the audited fiscal year, April 1, 2005 to March 31, 2006 ( Fiscal 2006 ). Comparative financial information to Fiscal 2006 is provided in this Form 10-K with respect to the twelve month period, April 1, 2004 to March 31, 2005, which is unaudited ( Fiscal 2005 ). Additional information is provided with respect to the transition period (January 1, 2005 through March 31, 2005) which is audited (the Transition Period ). See Item 6 and Item 7 below.

**Overview**

Our manufacturing facility and executive offices were constructed in 1991, pursuant to a \$9.1 million loan from the Economic Development Corporation of the City of Detroit (the EDC ). Since August 1997, capital infusions and loans have primarily come from Sun Pharmaceutical Industries Limited, a specialty pharmaceutical corporation organized under the laws of India ( Sun Pharma ). Among other things, Sun Pharma has acted as a guarantor on loans to Caraco, has supplied us with raw materials for certain of our products, helped us obtain machinery and equipment to enhance our production capacities at competitive prices and transferred certain generic products to us. Sun Pharma's investment in and support of Caraco has resulted in, since the second quarter of 2002, Caraco achieving the sales necessary to support its operations. As of June 7,

2006, Sun Pharma beneficially owns approximately 64% (75% including its convertible Series B Preferred Stock) of the outstanding shares of Caraco. See [Current Status](#) and [Sun Pharmaceutical Industries Limited](#).

### **Current Status**

During Fiscal 2006 we recorded net sales of \$82.8 million compared to \$64.1 million Fiscal 2005. We have generated cash from operations of \$8.9 million as compared to \$20.6 million during the relevant periods. Cash was used primarily to augment working capital. We incurred a net loss of \$10.4 million compared to net loss of \$2.3 million during the relevant periods. The higher loss was primarily due to higher non-cash research and development expense (R&D) of \$35.1 million as compared to \$26.8 million during the relevant period. This non-cash R&D expense relates to nine products passing their bio-equivalency studies during Fiscal 2006 and the related value of the preferred stock issued to Sun Pharma Global, Inc., a wholly-owned subsidiary of Sun Pharma, ( [Sun Global](#) ) pursuant to the Products Agreement as defined below, as compared to eight products during Fiscal 2005. At March 31, 2006, we had stockholders' equity of \$56.4 million as compared to stockholders' equity of \$31.7 million at March 31, 2005 and a stockholders' equity of \$25.8 million at December 31, 2004. See [Part II Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations](#).

Pursuant to our products agreement with Sun Global., we have selected, through March 31, 2005, all products out of the 25 products to be transferred to us by Sun Global. Of these, twenty products passed their bio-equivalency studies as of March 31, 2006, and one since then. Sun Global has thereby earned 544,000 preferred shares for each such product. See [Sun Pharmaceutical Industries Limited](#) and [Part II Item 7. Future Outlook](#).

We filed ten ANDAs with the FDA during Fiscal 2006. This brings our total number of ANDAs pending approval by the FDA to 14.

### **Overview of the Generic Drug Industry**

We believe that sales of generic pharmaceuticals have increased in recent years because of a number of factors including (i) increased number of formerly patented drugs which have become available to generic competition; (ii) changes in governmental and third-party payor health care reimbursement policies to encourage cost containment; (iii) increased acceptance of generic drugs by physicians, pharmacists and consumers; (iv) modification of state and federal laws to permit or require substitution of generic drugs by pharmacists; and (v) enactment of ANDA procedures for obtaining FDA approval to manufacture generic prescription drugs.

The generic pharmaceutical business is highly competitive. Although generic pharmaceuticals must meet the same quality standards as branded pharmaceuticals, they could potentially be sold at prices that reflect a discount up to 90% (in some cases even more) than the price of their branded counterparts. The discount is relevant to the amount of competitors on any given product.

Companies aspiring to earn higher margins for generic drugs may have a strategy of manufacturing niche products or hard to replicate products or could include a litigious strategy of patent challenges and first to file. The developer of a generic product that is the first to have its ANDA accepted for filing by the FDA and whose filing includes a Paragraph IV Certification that the patent on the brand-name drug is invalid, unenforceable and/or not infringed may be eligible to receive a 180-day period of generic market exclusivity. During that 180-day period, the exclusive generic product would tend to earn higher margins on a higher volume of sales than in a situation in which other generic competition was also present. Recently this strategy has also seen reduced margins as authorized generics have become more prevalent. Authorized generics occur when the brand innovator has licensed its brand product to a generic manufacturer or has chosen to produce another label and provide the brand drug generically at typical generic discounts.

Products that are difficult to develop requiring difficult-to-source raw materials or representing smaller therapeutic niche markets, are generally marketed by fewer companies and may also offer margins that are higher than those where barriers to entry do not exist.

**Caraco's Products and Product Strategy**

Our present product portfolio includes 21 prescription products in 44 strengths in 99 package sizes. The products and their use for the indications are set forth in the table below:

| <b>Generic Name</b>                       | <b>Purpose</b>                                       |
|---|--|
| Metroprolol Tartrate                      | Hyper-Tension  |
| Paromomycin Sulfate                       | Antibacterial  |
| Salsalate                                 | Decongestant   |
| Choline Magnesium Trisalicylate           | Arthritis/NSAID                                      |
| Clonazepam                                | Seizure, Panic Disorders                             |
| Flurbiprofen                              | Arthritis/NSAID                                      |
| Carbamazepine Chewable                    | Anti-convulsant                                      |
| Carbamazepine IR                          | Anti-convulsant                                      |
| Oxaprozin                                 | Rheumatoid Disease                                   |
| Metformin Hydrochloride                   | Diabetes   |
| Tramadol Hydrochloride                    | Opiate Agonist/Analgesic                             |
| Tramadol Hydrochloride with Acetaminophen | Opiate Agonist/Analgesic                             |
| Meperidine Hydrochloride*                 | Analgesic  |
| Ticlopidine                               | Reduction of incidence of strokes                    |
| Tizanidine                                | Management of muscle tone associated with spasticity |
| Digoxin                                   | Heart failure  |
| Mirtazapine                               | Anti-depressant                                      |
| Citalopram Hbr                            | Anti-depressant                                      |
| Clozapine                                 | Anti-psychotic                                       |
| Midrin**                                  | Vascular & Migraine Headache suppressant             |
| Fluvoxamine                               | Anti-depressant                                      |

\* Expected to be marketed sometime in Fiscal 2007.

\*\* Product marketed on behalf of Sun Pharmaceutical Industries Inc., a wholly owned subsidiary of Sun Pharma, in one strength and one pack size.

We have submitted 34 ANDAs to the FDA for approval as of March 31, 2006, including 10 filed during Fiscal 2006. Of these 34 ANDAs filed, the FDA has approved 20 through March 31, 2006. Accordingly, we have 14 pending ANDAs.

Our strategy has been to analyze the marketplace and try to determine opportunities for products having good market potential, that are difficult to develop, that require difficult-to-source raw materials and/or products representing smaller therapeutic niche markets. Recently, we have started to develop products, which have potential patent litigation, and/or first to file opportunities. We anticipate also seeking opportunities to in-license authorized generics and other generic pharmaceuticals.

### **Sun Pharmaceutical Industries Limited**

Pursuant to a stock purchase agreement, Sun Pharma made an initial investment of \$7.5 million for the purchase of 5.3 million common shares of Caraco in 1997.

Sun Pharma and its affiliates had loaned us approximately \$10 million since August 1997. As of December 2003, we had repaid all of such loans. Sun Pharma also assisted us, by acting as guarantor, in obtaining line of credit loans from ICICI Bank Limited, The Bank of Nova Scotia and Citibank FSB in the amounts of \$5.0 million, \$12.5 million and \$10.0 million, respectively, all of which have been terminated as of December 31, 2004.

In August 1997, we entered into an agreement, whereby Sun Pharma was required to transfer to us the technology formula for 25 generic pharmaceutical products over a period of five years through August 2003. We exchanged 544,000 shares of our common stock for each technology transfer of an ANDA product (when bio-equivalency studies were successfully completed) and 181,333 shares for each technology transfer of a DESI product. The products provided to us from Sun Pharma were selected by mutual agreement. Under such agreement, we conducted, at our expense, all tests including bio-equivalency studies. Pursuant to such agreement, Sun Pharma delivered to us the technology for 13 products. This agreement has expired and as noted below, we have entered into a new agreement, with Sun Global, an affiliate of Sun Pharma.

On November 21, 2002, we entered into a products agreement with Sun Global. Under the agreement, which was approved by our independent directors, Sun Global agreed to provide us with 25 new generic drugs over a five-year period. Our rights to the products are limited to the United States and its territories or possessions, including Puerto Rico. Sun Global retains rights to the products in all other territories. The products are selected by mutual agreement. Under such agreement, we conduct, at our expense, all tests including bio-equivalency studies. We are also obligated to market the products consistent with our customary practices and to provide marketing personnel. In return for the technology transfer, Sun Global receives 544,000 shares of Series B Preferred Stock for each generic drug transferred when such drug has passed its bio-equivalency studies. The preferred shares are non-voting, do not receive dividends and are convertible into common shares after three years (or immediately upon a change in control) on a one-to-one basis. The preferred shares have a liquidation preference equal to the value attributed to them on the dates on which they were earned. While such preferred shares are outstanding, we cannot, without the consent of the holders of a majority of the outstanding shares of the preferred stock, amend or repeal our articles of incorporation or bylaws if such action would adversely affect the rights of the preferred stock. In addition, without such consent, we cannot authorize the issuance of any capital stock having any preference or priority superior to the preferred stock.

The products agreement was amended by the Independent Committee, comprised of the three independent directors, in the first quarter of 2004 to eliminate the provision requiring that the Independent Committee concur in the selection of each product, and provides instead, that each product satisfy certain objective criteria developed by management and approved by the Independent Committee. Pursuant to such objective criteria, we have selected all the 25 products, twenty of which passed bio-equivalency studies as of March 31, 2006, and one since then. See Part II Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations Future Outlook.

Sun Pharma has established Research and Development Centers in Mumbai and Vadodara, India, where the development work for products is performed.

Sun Pharma and its subsidiaries supply us with certain raw materials and formulations. In addition, Sun Pharma assists us in acquiring machinery and equipment to enhance our production capacities. During Fiscal 2006, we purchased approximately \$28.1 million in raw materials and formulations from Sun Pharma and its subsidiaries, as compared to \$5.3 million during the Transition Period and \$16.7 million during calendar 2004. We acquired \$0.2 million worth of machinery and equipment from Sun Pharma as compared to \$0.1 million during the Transition Period and \$0.6 million during calendar 2004. Such machinery and equipment are sold to us at their cost.

Sun Pharma also assists us by sending qualified technical professionals who work as Caraco employees.

Sun Pharma and its affiliates are using Caraco as a contract manufacturer and/or distributor for two of their products pursuant to agreements entered into in December 2004 and in January 2005, of which only one is being marketed..

During the Transition Period, SPARC Bioresearch Private Limited ( SPARC ), an affiliate of Sun Pharma,

performed certain analytical studies required as part of the bio-equivalency process for two products. The Corporation incurred approximately \$172,000 of costs during the period for the studies performed by SPARC. No similar studies were performed by SPARC during Fiscal 2006 or during the years ended December 31, 2004 and 2003.

During the first quarter of 2004, Sun Pharma acquired 3,452,291 additional shares of common stock and 1,679,066 stock options from two former directors and a significant shareholder. Sun exercised these stock options during the fourth quarter of 2004. Sun Pharma's current beneficial ownership is 64% (75% including its convertible Series B Preferred Stock).

## Marketing

We believe the primary factors driving competition in the generic pharmaceutical industry are price, product development, timely FDA approval, manufacturing capabilities, product quality, customer service and reputation.

Caraco competes effectively with respect to each of these factors; however, price is a key competitive factor in the generic pharmaceutical business. To compete effectively on the basis of price and remain profitable, a generic drug manufacturer must manufacture its products in a cost-effective manner. In addition, we must maintain an adequate level of inventories to meet customer demands in a timely manner.

Our products are effectively marketed among all classes of customers, including wholesalers, buying groups, managed care organizations, chain retail pharmacies, independent retail pharmacies, hospitals, etc. Increased competition, the emergence of large buying groups representing independent retail pharmacies, the continued growth of managed care organizations and consolidation among wholesalers, has resulted in higher discounts on pharmaceutical products. As the influence of these entities continues to grow, the Company will continue to face pricing pressure on our portfolio of products.

Our marketing objective is to compete effectively, encourage long-term relationships, and supply contracts, increase our market share on products that have not matured, gain market share on new products that are to be launched, and continue to expand our customer base.

## Sales and Customers

Our sales team effectively addressed the challenges in Fiscal 2006 of price erosion, increase market share on certain products that had room for improvement, improved the balance of sales to the trade classes we service, increased sales with a limited number of approvals, executed our plan well and improved on our capacity constraints, improved inventory levels and geared up to meet the challenges inherent in the generic industry in fiscal 2007. Every functional area has been fortified to meet the demand of our continued growth.

Certain of our end-use customers purchase our products through designated wholesalers, such as Amerisource-Bergen Corporation, McKesson Corporation and/or Cardinal Health, who act as intermediary distribution channels for our products. For example, the Veterans Administration, which has entered into the sales contract as discussed below, has selected McKesson as its designated wholesaler. Accordingly, shipments to three large wholesale customers, namely McKesson Corporation (51% and 55%), Amerisource-Bergen Corporation (9% and 11%) and Cardinal Health (17% and 12%), accounted for approximately 77% and 78% of gross sales for Fiscal 2006 and the Fiscal 2005, respectively. Balances due from these customers represented approximately 72% and 75% of gross accounts receivable at March 31, 2006 and 2005, respectively. No other single customer represented more than 10% of our gross sales during Fiscal 2006 and Fiscal 2005.

We have entered into a sales contract on June 21, 2002 with the Veterans Administration, an agency of the U.S. government. Our agreement with this customer commenced on August 5, 2002 for a one-year period, with four 1-year option periods thereafter, and is for the purchase of one product, Metformin Hydrochloride. The first three option periods were exercised. The agreement may be terminated by the purchaser without cause and in such case, we would only be entitled to a percentage of the contract price reflecting the percentage of the work performed prior to the notice of termination, plus reasonable charges that have resulted from the termination. The agreement provides that certain penalties would be incurred if we are unable to meet our sales commitment.

## Seasonality

The Company's business, taken as a whole, is not materially affected by seasonal factors.



## Research and Development

The development of new prescription ANDA products, including formulation, stability testing and the FDA approval process, averages from two to five years. A drug is bioequivalent to a brand-name drug if the rate and extent of absorption of the drug are not significantly different from those of the brand-name drug. Although we perform our own stability testing, bioequivalence is done through independent testing laboratories. The Company's research and development consists principally in conducting market research and patent research on brand name pharmaceuticals and generic pharmaceuticals in order to determine which products we may want to develop. A majority of our research and development is provided by Sun Global as a result of our technology transfer agreement and a portion is being done by Caraco. Our development list consists of both near term launches and launches that we intend to market several years in the future.

We incurred total R&D Expense for Fiscal 2006, Fiscal 2005 and calendar 2004 as set forth below:

|                         |                |
|-------------------------|----------------|
| Fiscal 2006             | \$43.5 million |
| Fiscal 2005 (Unaudited) | \$33.4 million |
| Calendar 2004           | \$30.5 million |

The non-cash R&D Expense for the Fiscal 2006, Fiscal 2005 and calendar 2004 are set forth below:

|                         |                |
|-------------------------|----------------|
| Fiscal 2006             | \$35.1 million |
| Fiscal 2005 (Unaudited) | \$26.8 million |
| Calendar 2004           | \$24.4 million |

The non-cash technology transfer charges are for research and product development provided by Sun Global. The charges are based on the fair value of the preferred shares on the date the respective product formula passes the bio-equivalency studies. The fair value of such shares is based upon an independent valuation.

## Regulation

The research and development, manufacture and marketing of our products are subject to extensive regulation by the FDA and by other federal, state and local entities, which regulate, among other things, research and development activities, testing, manufacture, labeling, storage, record keeping, advertising and promotion of pharmaceutical products.

The Federal Food, Drug and Cosmetic Act, the Public Health Services Act, the Controlled Substances Act and other federal statutes and regulations govern or influence our business. Noncompliance with applicable requirements can result in fines and other judicially imposed sanctions, including product seizures, injunction actions and criminal prosecutions. In addition, administrative remedies can involve voluntary recall of products, and the total or partial suspension of products as well as the refusal of the government to approve pending applications or supplements to approved applications. The FDA also has the authority to withdraw approval of drugs in accordance with statutory due process procedures.

FDA approval is required before any dosage form of any new unapproved drug, including a generic equivalent of a previously approved drug, can be marketed. All applications for FDA approval must contain information relating to product formulation, stability, manufacturing processes, packaging, labeling and quality control. To obtain FDA approval for an unapproved new drug, a prospective manufacturer must also demonstrate compliance with the FDA's current good manufacturing practices (cGMP) regulations as well as provide substantial evidence of safety and efficacy of the drug product. Compliance with cGMPs is required at all times during the manufacture and processing of drugs. Such compliance requires considerable Corporation time and resources in the areas of production and quality control.

Following such inspections, the FDA may issue notices on Form 483 and Warning Letters that could cause a company to modify certain activities identified during the inspection. A Form 483 notice may be issued at the conclusion of an FDA inspection and lists conditions the FDA inspectors believe may violate cGMP or other FDA regulations. FDA guidelines specify that a Warning Letter is issued only for violations of regulatory significance for which the failure to adequately and promptly achieve correction may be expected to result in an enforcement action.

The FDA routinely performs inspection of pharmaceutical companies facilities. On May 1, 2006 the FDA initiated an inspection of our facility for cGMP compliance. This inspection will be completed over the next few weeks. While there is no

assurance that the FDA will not issue observations, we believe that we are cGMP compliant.

There are generally two types of applications that would be used to obtain FDA approval for pharmaceutical products:

New Drug Application ( NDA ). Generally, the NDA procedure is required for drugs with active ingredients and/or with a dosage form, dosage strength or delivery system of an active ingredient not previously approved by the FDA. We have not submitted an NDA to date.

Abbreviated New Drug Application ( ANDA ). The Hatch-Waxman Act established a statutory procedure for submission of ANDAs to the FDA covering generic equivalents of previously approved brand-name drugs. Under the ANDA procedure, an applicant is not required to submit complete reports of preclinical and clinical studies of safety and efficacy, but instead is required to provide bioavailability data illustrating that the generic drug formulation is bioequivalent to a previously approved drug. Bioavailability measures the rate and extent of absorption of a drug's active ingredient and its availability at the site of drug action, typically measured through blood levels. A generic drug is bioequivalent to the previously approved drug if the rate and extent of absorption of the generic drug are not significantly different from that of the previously approved brand-name drug.

The FDA may deny an ANDA if applicable regulatory criteria are not satisfied. The FDA may withdraw product approvals if compliance with regulatory standards is not maintained or if new evidence demonstrating that the drug is unsafe or lacks efficacy for its intended uses becomes known after the product reaches the market.

As previously disclosed, we currently manufacture several products that are regulated as Drug Efficacy Studies Implementation, or DESI, products. These products do not require the submission of an ANDA or an NDA to the FDA. These products are, however, subject to cGMP compliance. Also, while products within this DESI classification require no prior approval from the FDA before marketing, they must comply with applicable FDA monographs, which specify, among other things, required ingredients, dosage levels, label contents and permitted uses. These monographs may be changed from time to time, in which case we might be required to change the formulation, packaging or labeling of any affected product. Changes to monographs normally have a delayed effective date, so while we may have to incur costs to comply with any such changes, disruption of distribution is not likely.

FDA policy and its stringent requirements have increased the time and expense involved in obtaining ANDA approvals and in complying with FDA's cGMP standards. The ANDA filing and approval process takes approximately 12 to 18 months. The timing of final FDA approval of ANDA applications depends on a variety of factors, including whether or not the maker of the applicable branded drug is entitled to the protection of one or more statutory exclusivity periods, during which the FDA is prohibited from approving generic products. In certain circumstances, a regulatory exclusivity period can extend beyond the life of a patent, and thus block ANDAs from being approved on the patent expiration date. For example, the FDA may now extend the exclusivity of a product by six months past the date of a patent expiration if the manufacturer undertakes studies on the effect of their product in children (a so-called pediatric extension). FDA approval is required before each dosage form of any new drug can be marketed. Applications for FDA approval must contain information relating to bio-equivalency, product formulation, raw material suppliers, stability, manufacturing processes, packaging, labeling and quality control. FDA procedures require full-scale manufacturing equipment to be used to produce test batches for FDA approval. Validation of manufacturing processes by the FDA also is required before a company can market new products. The FDA conducts pre-approval and post-approval reviews and plant inspections to enforce these rules. Supplemental filings are required for approval to transfer products from one manufacturing site to another and may be under review for a year or more. In addition, certain products may only be approved for transfer once new bio-equivalency studies are conducted.

The Hatch-Waxman Act provides incentives for generic pharmaceutical manufacturers to challenge patents on branded pharmaceutical products and/or their methods of use, as well as to develop non-infringing forms of the patented subject matter. The Hatch-Waxman legislation places significant burdens on the challenger to ensure that such suits are not frivolous, but also offers the opportunity for significant financial reward if the challenge is successful.

If there is a patent listed in the FDA's Orange Book at the time of filing an ANDA with the FDA and the generic drug company intends to market the generic equivalent prior to the expiration of that patent, the generic company files with its ANDA a certification asserting that the patent is invalid, unenforceable and/or not infringed (a so-called Paragraph IV Certification). After receiving notice from the FDA that its application is acceptable for filing, the generic company sends the

patent holder and the holder of the New Drug Application ( NDA ) for the brand-name drug a notice explaining why it believes that the patents in question are invalid, unenforceable or not infringed. Upon receipt of the notice from the generic company, the patent holder has 45 days during which to bring a patent infringement suit in federal district court against the generic company. The discovery, trial and appeals process in such suits can take several years.

If a suit is commenced by the patent holder, the Hatch-Waxman Act provides for an automatic stay on the FDA's ability to grant final approval of the ANDA for the generic product. The period during which the FDA may not approve the ANDA and the patent challenger therefore may not market the generic product is 30 months, or such shorter or longer period as may be ordered by the court. The 30-month period may or may not, and often does not, coincide with the timing of the resolution of the lawsuit or the expiration of a patent, but if the patent challenge is successful or the challenged patent expires during the 30-month period, the FDA may approve the generic drug for marketing, assuming there are no other obstacles to approval such as exclusivities given to the NDA holder.

Under the Hatch-Waxman Act, the developer of a proposed generic drug which is the first to have its ANDA accepted for filing by the FDA, and whose filing includes a Paragraph IV Certification, may be eligible to receive a 180-day period of generic market exclusivity. This period of market exclusivity may provide the patent challenger with the opportunity to earn a return on the risks taken and its legal and development costs and to build its market share before competitors can enter the market.

The Generic Drug Enforcement Act of 1992 establishes penalties for wrongdoing in connection with the development or submission of an ANDA by authorizing the FDA to permanently or temporarily bar companies or individuals from submitting or assisting in the submission of an ANDA, and to temporarily deny approval and suspend applications to market off-patent drugs. The FDA has authority to withdraw approval of an ANDA under certain circumstances and to seek civil penalties. The FDA can also significantly delay the approval of a pending ANDA under certain circumstances and to seek civil penalties. The FDA can also significantly delay the approval of a pending ANDA under its Fraud, Untrue Statements of Material Facts, Bribery, and Illegal Gratuities Policy. Manufacturers of drugs must also comply with the FDA's cGMP standards or risk sanctions such as the suspension of manufacturing or the seizure of drug products and the FDA's refusal to approve additional ANDAs. The Drug Enforcement Agency ( DEA ) conducts inspections bi-annually.

Each domestic drug product-manufacturing establishment must be registered with the FDA. Establishments, like ours, handling controlled substances, must be licensed by the DEA. We are licensed by both the FDA and DEA.

We are also subject to regulation under other federal, state and local regulations regarding work place safety, environmental protection and hazardous substance controls, among others. Specifically, we are licensed by the Michigan Board of Pharmacy as a manufacturer and wholesaler of prescription drugs and as a distributor of controlled substances. We are also licensed by the Michigan Liquor Control Commission to use alcohol in the manufacture of drugs.

Reimbursement legislation, such as Medicaid, Medicare, and other programs, governs reimbursement levels. All pharmaceutical manufacturers rebate to individual states a percentage of their revenues arising from Medicaid-reimbursed drug sales. Generic drug manufacturers currently rebate an applicable percentage of calculated average manufacturer price (AMP) marketed under ANDAs. We believe that the federal and state governments may continue to enact measures in the future aimed at reducing the cost of drugs and devices to the public. We cannot predict the nature of such measures or their impact on our profitability.

## Environment

The Company is subject to federal, state, and local laws and regulations relating to the protection of the environment. These evolving laws and regulations may require expenditures over a long period of time to control environmental impacts. The Company has established procedures for the ongoing evaluation of its operations to identify potential environmental exposures and assure compliance with regulatory policy and procedures.

The Company believes that its operations comply in all material respects with applicable laws and regulations concerning the environment. While it is impossible to accurately predict the future costs associated with environmental compliance and potential compliance with environmental laws, any compliance is not expected to require significant capital expenditures and has not had, and is not presently expected to have, a material adverse effect on the Company's earnings or competitive position.

## Suppliers and Materials

The principal components used in our business are active and inactive pharmaceutical ingredients and packaging materials. Some of these components are purchased from single sources, however, the majority of the components have an alternate source of supply. Development and approval of our pharmaceuticals are dependent upon our ability to procure components from FDA approved sources. Because the FDA approval process requires manufacturers to specify their proposed suppliers of components in their applications, FDA approval of a new supplier would be required if components were no longer available from the specified suppliers. We have been, and continue to be, actively identifying and validating alternate suppliers for our components. Our purchases of components are made from manufacturers in the U.S. and from abroad, including Sun Pharma. See Sun Pharmaceutical Industries Limited. All purchases of components are made in U.S. Dollars.

Although to date no significant difficulty has been encountered in obtaining components required for products and sources of supply are considered adequate, there can be no assurance that we will continue to be able to obtain components as required.

## Competition

The generic pharmaceutical industry is undergoing rapid and significant changes due to increasing number of generic manufacturers, introduction of authorized generics, technological advancement and consolidation among the customers. Many of our competitors have greater financial, production, and research and development resources and greater name recognition.

Competition continues to be intense which could result in further erosion of prices and profit margins. The number of generic manufacturers both domestic and from overseas is increasing resulting in increased pricing pressure. The most significant means of competition are price, innovation and development, timely FDA approval, manufacturing capabilities, product quality, marketing, customer service and reputation. Other principal competitive factors in the generic pharmaceutical market are the ability to be the first company, or among the first companies, to introduce a generic product after the related patent expires, methods of distribution, maintenance of inventories for timely delivery, and breadth of product line. Approvals for new products may have a synergistic effect on a company's entire product line since orders for new products are frequently accompanied by, or bring about, orders for other products available from the same source. We believe that price is the most significant competitive factor in the generic industry, particularly as the number of generic entrants with respect to a particular product increases. As competition from other manufacturers intensifies, selling prices typically decline. We compete by keeping our prices competitive, selecting appropriate products, based on therapeutic segments, market sizes and number of competitors manufacturing the products, by providing reliability in the timely delivery, and in the continued quality, of our products.

## Line of Credit

On November 17, 2005, the Company entered into a one-year, \$10 million Credit Agreement with JP Morgan Chase Bank, N.A. Under the Credit Agreement, the lender may make loans and issue letters of credit to the Company for the Company's working capital needs and general corporate purposes. Letters of credit, if issued, expire one year from their date of issuance, but no later than November 17, 2007. During Fiscal 2006, we utilized \$1.5 million of the available line and have repaid the

same. Borrowings are secured by the Company's receivables, inventory and all proceeds therefrom. Borrowings may be prepaid at any time by the Company. Interest is payable based on LIBOR or an alternate base rate (determined by reference to the prime rate or the federal funds effective rate), as selected by the Company. The rate of interest is LIBOR plus 75 basis points or Prime rate minus 100 basis points (effective rates of 6.0% and 6.75%, respectively at March 31, 2006.) The Credit Agreement requires that certain financial covenants be met on a quarterly basis. The Corporation is in compliance with these financial covenants at March 31, 2006. There are no borrowings under this Credit Agreement at March 31, 2006.

### **Employees**

We had a total of 272 and 205 full-time equivalent and contract employees at March 31, 2006 and 2005, respectively, engaged in research and development, quality assurance, quality control, administration, sales and marketing, materials management, facility management and manufacturing and packaging. Most of our scientific and engineering employees have had prior experience with pharmaceutical or medical products companies, including Sun Pharma. See Sun Pharmaceutical Industries Limited.

A union represents substantially all of our permanent, full-time hourly employees. In September 2004, we successfully negotiated a four-year collective bargaining agreement with the union. This agreement sets forth the wage increases which the union employees will receive in each of the next four years, and thereby giving us and the union employees, we believe, a measure of certainty and stability.

### **Product Liability and Insurance**

We currently maintain general and product liability insurance, with coverage limits of \$10 million per incident and in the aggregate. Our insurance policies provide coverage on a claims made basis and are subject to annual renewal. Such insurance may not be available in the future on acceptable terms or at all. There can be no assurance that the coverage limits of such policies will be adequate to cover our liabilities, should they occur. See Item 3. Legal Proceedings.

### **Item 1A. Risk Factors:**

#### **Risks Related to Our Business**

The following discussion highlights some of the risks related to our business and others are discussed elsewhere in this report. These and other risks could materially and adversely affect our business, financial condition, operating results or cash flows and the market value of our common stock.

#### **If we are unable to successfully develop or commercialize new products, our operating results will suffer.**

Our future results of operations depend to a significant extent upon our ability to successfully commercialize new products in a timely manner. There are numerous difficulties in developing and commercializing new products, including:

developing, testing and manufacturing products in compliance with regulatory standards in a timely fashion;

receiving the requisite regulatory approvals for such products in a timely manner;

the availability of raw materials at a competitive cost, including active pharmaceutical ingredients and other key ingredients;

development and commercializing a new products is time consuming, costly and subject to various factors, including litigation brought by our competitors, that may delay or prevent the development and commercialization of new products expected to market;

**Our gross profit may fluctuate from period to period depending upon our product sales mix including new launches, our product pricing, customer class of trade, and our costs for active ingredients.**

Some specific issues that could result in a fluctuation could include any or all of the following:

the amount of new product introductions;

the level of competition and associated pricing pressure in the marketplace for certain products;

the availability of raw materials;

The profitability of our product sales is also dependent upon the prices we are able to charge for all our products, the costs of excipients purchased from third parties, and our ability to manufacture our products in a cost effective manner.

**An unaffiliated third party may make a claim for royalties which could have a material adverse effect on our results of operations.**

In 1993, we entered into a products agreement with an unaffiliated generic drug company (the Non-Affiliate). Under the agreement, two products were to be delivered to us in exchange for royalties and options. Pursuant to the agreement, we received a formulation for one product (the Product) from the Non-Affiliate. However, we have determined that the formula provided to us by the Non-Affiliate with respect to the Product is different than the formula approved by the FDA and manufactured and introduced by us. Accordingly, since April 2003, we have discontinued to accrue royalties. The Product has been one of our top selling products. There is no assurance that the Non-Affiliate will not challenge our determination and make a claim that royalties and/or options are owed. If successful, such a claim could have a material adverse effect on our results of operations.

**If brand pharmaceutical companies are successful in limiting the use of generics through litigation, legislature and regulatory efforts, our sales of generic products may suffer.**

Many brand pharmaceutical companies increasingly have used state and federal legislative and regulatory and other litigation as means to delay generic competition. These efforts have included:

pursuing new patents for existing products which may be granted just before the expiration of one patent, which could extend patent protection for additional years or otherwise delay the launch of our generic product;

submitting for changes in U. S. Pharmacopoeia which is an organization that publishes industry wide compendia of drug standards;

using the Citizen's Petition process to request amendments to FDA standards;

attaching patent extension amendments to non-related federal legislation;

engage in state-by-state initiative to enact legislation that restricts substitution of certain generic drugs which could possibly impact products that we are developing.

**Third parties may claim that we infringe their proprietary rights and may prevent us from manufacturing and selling some of our products.**

The manufacture, use and sale of new products that are the subject of conflicting patent rights have been the subject of substantial litigation in the pharmaceutical industry. These lawsuits relate to the validity and infringement of patents or proprietary rights of third parties. We may have to defend against charges that we violated patents or proprietary rights of third parties. Litigation may be costly and time-consuming, and could divert the attention of our management and technical personnel. If it is found that we infringe on the rights of others, we could lose our right to develop or manufacture products or could be required to pay monetary damages or royalties to license proprietary rights from third parties. As a result, an adverse determination in a judicial or administrative proceeding could prevent us from manufacturing and selling a product(s), which could negatively affect our financial condition and results of operations.

**Our policies regarding returns and chargebacks by wholesalers may reduce our revenues in future fiscal periods.**

Based on industry practice, generic product manufacturers including Caraco have liberal return policies and make decisions whether or not to provide shelf stock allowances (or credits) for inventories on hand on product that has already been sold to the customer. If a new competitor enters the marketplace and significantly lowers the price of any of its competing products, it is possible that we would make a decision to reduce the price of our product. As a result, we would be obligated to provide significant credits to our customers who are then holding inventories of such products, which could reduce sales revenue and gross margin for the period the credit is provided. Like our competitors, we also give credits for chargebacks to wholesale customers that have contracts with us for their sales to chain drug retail, group purchasing organizations, or other retail customers. A chargeback represents an amount payable in the future to a wholesaler for the

difference between the invoice price paid to us by our wholesale customer for a particular product and the negotiated contract price that the wholesaler's customer pays for that product. Although we establish reserves based on our historical experience and our best estimates of the potential impact that these policies may have, we cannot ensure that our reserves are adequate or that actual product returns, allowances and chargebacks will not exceed our estimates, which could adversely affect our financial condition, cash flows and market price of our stock.

**The loss of our key personnel could cause our business to suffer.**

The success of our present and future operations will depend, to a significant extent, upon the experience, abilities and continued services of key personnel. We cannot assure you that we will be able to attract and retain key personnel.

**Extensive industry regulation has had, and will continue to have, a significant impact on our business, especially our product development, manufacturing and distribution capabilities.**

All pharmaceutical companies, are subject to complex, costly regulations that continue to evolve as set forth by the federal government, principally the FDA and to a lesser extent by the DEA and state government agencies. The Federal Food, Drug and Cosmetic Act, the Controlled Substances Act and other federal statutes and regulations govern the testing, manufacturing, storage, packing, labeling, record keeping, safety, sales and marketing, promotion, and distribution of our products.

Under these regulations, we are subject to periodic routine inspection of our facilities, procedures, operations and the testing of our products by the FDA, the DEA and other authorities that regulate our business. These inspections are designed to confirm that we are in compliance with all applicable regulations. Following an inspection, the FDA may issue notices on Form 483 and /or warning letters that could cause us to modify certain activities identified during the inspection. A Form 483 notice is generally issued at the conclusion of a FDA inspection and lists conditions the FDA inspectors believe may violate cGMP or other FDA regulations. FDA guidelines specify that a warning letter is issued only for violations of regulatory significance for which the failure to promptly and adequately achieve correction may be expected to result in an enforcement action. Possible sanctions could include among others, FDA issuance of adverse publicity, fines, product recalls, total or partial suspension of production and/or distribution, suspension of the FDA's review of product applications, enforcement actions, injunctions, and civil or criminal prosecution. These sanctions, if imposed, could materially harm our operating results and financial condition. Under certain circumstances, the FDA also has the authority to revoke previously granted drug approvals. Although we have internal compliance programs in place these programs may not meet regulatory agency standards or if compliance is deemed deficient in any significant way, it could materially harm our business. Certain of our vendors that sell to us are also subject to similar regulation and periodic inspections.

**Sales of our products may continue to be adversely affected by the continuing consolidation of the distribution network and the concentration of customers.**

Our principal customers are wholesale drug distributors, major retail drug store chains and managed care. These customers comprise a significant part of the distribution network for pharmaceutical products in the U.S. This distribution network is continuing to undergo significant consolidation marked by mergers and acquisitions among wholesale distributors and the growth of large retail drug store chains and managed care companies. As a result, a small number of large wholesale distributors and large chain drug stores and managed care providers control a significant share of the market. We expect that consolidation of drug wholesalers, retailers and managed care providers will increase pricing and other competitive pressures on drug manufacturers, including Caraco.

**Even if we are able to obtain regulatory approvals for our new pharmaceutical products, the success of those products is dependent upon market acceptance. Levels of market acceptance for our new products could be impacted by several factors, including:**

- availability of alternate product from our competitors;
- the timing of our market entry;
- acceptance of our product on government and private formularies;

and the prices that we sell our products at versus our competitors' prices. These factors amongst others are beyond our control and could materially have a negative effect on operations and the market value of our common stock.

**From time to time a relatively small group of products could represent a significant portion of our sales and if the products sales of these product decline unexpectedly it could have a negative material effect on our business and could cause our market value of our common stock to decline.**

Sales of a limited number of our products often represent a significant portion of our net revenues and net earnings. If the volume or pricing of our largest selling products declines in the future, our business, financial position and results of operations could be materially adversely affected, and the market value of our common stock could decline.

**Our competitors may be able to develop products and processes competitive with or superior to our own for many reasons, including that they may have:**

- proprietary processes or product delivery systems;
- larger research and development and marketing staffs;
- larger production capacity in general or for a given product;
- more financial resources than Caraco;
- more experience in developing new drugs;

**Our reporting and payment obligations under Medicaid and other governmental programs are complex and may change periodically based upon new guidelines provided those agencies.**

Although the regulations regarding reporting and payment obligations are complex, we believe we are properly and accurately calculating and reporting the amounts owed in respect of Medicaid and other governmental pricing programs. Our calculations are subject to review and challenge by the applicable governmental agencies, and it is possible that any such review could result in material changes. Any governmental agencies may initiate an investigation of the Company and could impose, based on a claim of violation of fraud and false claims laws or otherwise, civil and/or criminal sanctions, including fines, penalties and possible exclusion from federal health care programs (including Medicaid and Medicare).

**Sun Global could determine not to assist us in our research and development and Sun Pharma could cease supplying support and raw materials**

Collectively Sun Global and Sun Pharma could determine that its own research and development takes precedent over the research and development it provides to Caraco. This could cause a gap in our research and development timelines until Caraco could increase its own capabilities. This gap could possibly cause future growth concerns until resolved. Sun Pharma which supplies us raw material could face supply issues or not be capable of supplying the raw material for certain products we manufacture. This could cause lower sales or possibly lower margins until we negotiate new suppliers and gain the requisite approvals to manufacture our product with a new raw material source.

**A significant portion of our net sales are from the sales of a limited number of customers. Should we lose a particular contract with a customer or the customer is acquired by a non-customer, our sales and operational results could face a significant decline.**

A significant portion of our net revenues are derived from sales to a limited number of customers. As such, a reduction in or loss of business with one customer, or if one customer were to experience difficulty in paying us on a timely basis, our business, financial position and results of operations could be materially adversely affected.

**Our product liability insurance may not be enough to mitigate risk associated with our products**



Though we believe we carry adequate product liability insurance it is possible that a lawsuit or lawsuits could exceed our insurance levels and have a negative impact on our financial results

**We manufacture our product line predominately from one FDA approved facility. There is a possibility that our production could be negatively impacted by a closure of this facility**

Should our facility located in Detroit incur a closure of any type it would have a negative impact on our results. We carry a limited amount of finished goods on hand and much of our inventory is either work in progress or is in bulk amounts. Should we experience an act of God that closes our facility, or production is stopped or a power outage continues for an inordinate period of time, it could have a significant negative effect on our results.

Any of these factors and others could have a material adverse effect on our business, financial position and results of operations and could cause the market value of our common stock to decline.

#### **Item 1B. Unresolved Staff Comments**

None

#### **Item 2. Properties.**

##### **The Facilities**

Our entire property, plant, equipment and intellectual property are free of any mortgages, liens or similar restrictions. Our primary facility located in Detroit, Michigan, which was designed and constructed to our specifications and completed in 1994, contains our production, research and development and corporate office. During Fiscal 2006, we added approximately 10,000 square feet of manufacturing space, giving us a total of 80,000 square feet of usable space. The manufacturing portion of the facility has a special building and systems design, with each processing area equipped with independent zone and air handling units to provide temperature and humidity control to each room. These air handling units are designed to prevent product cross contamination through the use of pre-filter and final HEPA filter banks. All processing air quarters are maintained in a negative pressure mode using laminar airflow design. This system of airflow provides a measurable control of air borne particulate entrapment in each room. Environmental segregation of individual rooms within a particular zone is accomplished by the use of duct HEPA filter booster fan units that facilitate the isolation and confinement of room activities. These special dynamics provide an added dimension and flexibility in product selection and processing techniques.

We have leased an approximately 55,000 square foot facility located near our primary facility for finished goods distribution, storage of inventory and office space. The lease expires in 2009 and includes an option to renew until 2011.

We also have leased an approximately 7,000 square foot office space for our administrative, sales and marketing and accounting offices. The lease expires in 2009.

We have invested approximately \$3.6 million during Fiscal 2006 as compared to \$3.3 million during twelve months ending March 31, 2005 to upgrade our facilities. We have invested approximately \$0.6 million during the Transition Period as compared to \$1.3 million during the corresponding period of 2004. We invested \$4.0 million in 2004 and \$2.4 million in 2003

We believe the existing facilities are suitable and adequate for our current level of operations and anticipated growth in the near future. We also believe that our facilities are adequately covered by insurance.

#### **Item 3. Legal Proceedings.**

As previously disclosed, on June 9, 2005, Novo Nordisk A/S and Novo Nordisk, Inc. ( Novo Nordisk ) filed a complaint in the United States District Court for the Eastern District of Michigan alleging that the Company's filing of an ANDA seeking approval to market its generic version of Novo Nordisk's Prandin® drug product infringed Novo Nordisk's patent, which expires June 12, 2018. Novo Nordisk seeks an order from the Court which, among other things, directs the FDA not to approve Caraco's ANDA any earlier than the claimed expiration date. The ANDA filed by Caraco contains a Paragraph IV certification challenging the Novo Nordisk patent. We believe that the Novo Nordisk patent is invalid and/or will not be infringed by Caraco's manufacture, use or sale of the product, and we intend to vigorously defend this action in order to



capitalize on potential 180 days of marketing exclusivity available for this product.

As previously disclosed, on September 22, 2004, Ortho-McNeil Pharmaceutical, Inc. ( Ortho-McNeil ) filed a complaint in the United States District Court for the Eastern District of Michigan alleging that the Company's filing of an ANDA seeking approval to market its generic version of Ortho-McNeil's Ultracet® drug product infringed Ortho-McNeil's patent, which expires on September 6, 2011. Ortho-McNeil seeks an order from the Court which, among other things, directs the FDA not to approve Caraco's ANDA any earlier than the claimed expiration date. The ANDA filed by Caraco contained a Paragraph IV Certification challenging the Ortho-McNeil patent. We believe that the Ortho-McNeil patent is invalid and/or will not be infringed by Caraco's manufacture, use or sale of the product, and we intend to vigorously defend this action. Since this action, Ortho-McNeil has entered into a license agreement with another manufacturer and has launched its product generically while another manufacturer has launched its approved generic at risk. On October 8, 2005, arguments were heard in the US District Court in the Eastern District of Michigan, on our motion for summary judgment on the issue of non-infringement. On October 19, 2005 our motion for summary judgment was granted in our favor. On December 19, 2005, the FDA approved the manufacture, use and sale of the product. Ortho-McNeil has filed an appeal of the finding of non-infringement by the Eastern District of Michigan. Additionally, the United States Patent and Trademark Office has allowed Ortho-McNeil's request for a reissue patent that, when issued, Ortho-McNeil contends will be infringed by Caraco's now-marketed product. We believe that, like its original patent, Ortho-McNeil's reissue patent will be invalid and unenforceable.

As previously disclosed, on February 12, 2003, C. Arnold Curry filed a complaint in the Wayne County Circuit Court alleging breach of a written employment agreement. Dr. Curry sought 175,000 shares of our common stock (35,000 shares for each of the first five ANDAs approved by the FDA). We and the plaintiff each filed a motion for summary disposition. Both parties' motions were denied, and the parties submitted the matter to binding arbitration. In connection with the submission to arbitration, the parties agreed that Mr. Curry would receive a minimum of 15,000 shares of common stock. On April 20, 2006, the arbitrator entered a determination of no cause of action against Mr. Curry and in favor of the Company.

From time to time, we are also involved in other legal proceedings incidental to our normal business activities, and while the outcome of any such proceedings cannot be accurately predicted, we do not believe the ultimate resolution of any existing matters would have a material adverse effect on our financial position or results of operations.

**Item 4. Submission of Matters to a Vote of Security Holders.**

We did not submit any matters to a vote of security holders in the fourth quarter of Fiscal 2006 through the solicitation of proxies or otherwise.

**PART II**

**Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer's and Affiliates' Purchases of Equity Securities.**

Our common stock is listed on the American Stock Exchange under the symbol CPD. The following table sets forth for Fiscal 2006, the Transition Period and the year ended December 31, 2004, the high and low sales prices for each of the applicable quarters.

| <b>Fiscal 2006</b> | <b>High</b> | <b>Low</b> |
|--------------------|-------------|------------|
| First Quarter      | \$ 8.97     | \$ 7.06    |
| Second Quarter     | \$ 9.29     | \$ 8.10    |
| Third Quarter      | \$ 9.81     | \$ 7.50    |
| Fourth Quarter     | \$ 13.42    | \$ 8.76    |
| <b>2005</b>        | <b>High</b> | <b>Low</b> |
| Transition Period  | \$ 9.32     | \$ 7.44    |

| 2004           | High     | Low     |
|----------------|----------|---------|
| First Quarter  | \$ 13.74 | \$ 7.31 |
| Second Quarter | \$ 11.94 | \$ 9.40 |
| Third Quarter  | \$ 10.24 | \$ 6.80 |
| Fourth Quarter | \$ 10.00 | \$ 6.82 |

As of June 7, 2006 there were 93 registered holders of our Common Stock.

During Fiscal 2006, we issued to Sun Global 4,896,000 preferred shares in exchange for the transfer of nine products. During the Transition Period, we issued to Sun Global 1,632,000 preferred shares in exchange for the transfer of three products. During 2004, we issued to Sun Global 4,352,000 preferred shares in exchange for the transfer of eight products (of which 544,000 preferred shares were earned during 2003 for one product transfer) pursuant to our current products agreement.

Pursuant to various stock and option purchase agreements between Sun Pharma and three stockholders and their affiliates, Sun Pharma acquired in January and February, 2004, 3,452,291 shares of common stock and rights to acquire options for 1,679,066 shares of common stock. The shares were acquired for \$9.00 per share and the rights to the options were acquired for \$9.00 less the exercise price of each option.

During 2004, we issued 1,679,066 shares of common stock to Sun Pharma against exercise of stock options, which Sun Pharma had acquired from two former directors during the first quarter of 2004.

All shares of preferred stock and common stock specified above that were issued by the Company were issued pursuant to exemptions from registration under Section 4(2) of the Securities Act of 1933.

#### Dividend Policy

We never have declared or paid cash dividends on our common stock. We currently intend to retain all future earnings for the operation and expansion of our business. We do not anticipate declaring or paying cash dividends on our common stock in the foreseeable future. Any payment of cash dividends on the common stock will be at the discretion of the Board of Directors and will depend upon our results of operations, earnings, capital requirements, and other factors deemed relevant by our Board of Directors.

#### Item 6. Selected Financial Data

The following selected financial data of the Company is qualified by reference to and should be read in conjunction with the financial statements and notes thereto and other financial information included elsewhere herein. The summary balance sheet data as of March 31, 2006 and 2005 and summary statements of operations data for the years ended December 31, 2003 and 2004, the three month period ended March 31, 2005 and the year ended March 31, 2006 are derived from and qualified by reference to the audited financial statements of the Company which are included elsewhere herein. The summary balance sheet data as of December 31, 2004, 2003 and 2002 and the summary of the statements of operations for the years ended December 31, 2004, 2003, 2002 and 2001 are derived from the audited financial statements of the Company which are not included herein and have been previously filed with the SEC.

In January 2005, the Company changed its fiscal year from December 31st to March 31st. The results from the twelve month period March 31, 2005 were derived from the Company's published quarterly results and are unaudited. Accordingly, this twelve month period is not disclosed in the accompanying financial statements. It is included in the selected financial data for comparative purposes only as defined below.

**Financial Data**

(In thousands, except per share data)

| Statements of operations data                     | Year ended<br>March 31, |                     |
|---|-------------------------|---------------------|
|   | 2006<br>(Audited)       | 2005<br>(Unaudited) |
| Net sales   | \$ 82,789               | \$ 64,116           |
| Cost of goods sold                                | 41,873                  | 26,930              |
| Gross profit                                      | 40,916                  | 37,185              |
| Selling, general and administrative expenses      | 8,183                   | 5,874               |
| Research and development costs affiliate non cash | 35,055                  | 26,769              |
| Research and development costs other              | 8,437                   | 6,640               |
| Operating loss                                    | (10,759)                | (2,097)             |
| Other income / (expenses)                         | 336                     | (181)               |
| Net Loss  | (10,423)                | (2,278)             |
| Net Loss per share                                |                         |                     |
| Basic   | (0.39)                  | (0.09)              |
| Diluted   | (0.39)                  | (0.09)              |
| Weighted Average Shares Outstanding:              |                         |                     |
| Basic   | 26,392                  | 26,348              |
| Diluted   | 26,392                  | 26,348              |

**Financial Data (continued)**

(In thousands, except per share data)

| Statements of operations data                     | Transition<br>Period<br>Ended<br>March 31, | Year ended<br>December 31, |           |           |          |
|---|--|----------------------------|-----------|-----------|----------|
|   |  | 2005                       | 2004      | 2003      | 2002     |
| Net sales   | \$ 17,337                                  | \$ 60,340                  | \$ 45,498 | \$ 22,381 | \$ 5,922 |
| Cost of goods sold                                | 7,879                                      | 24,441                     | 19,507    | 12,047    | 4,186    |
| Gross profit                                      | 9,457                                      | 35,899                     | 25,991    | 10,334    | 1,736    |
| Selling, general and administrative expenses      | 1,879                                      | 5,277                      | 7,363     | 3,828     | 2,680    |
| Research and development costs affiliate non cash | 10,200                                     | 24,397                     | 3,103     | 3,887     | 0        |
| Research and development costs other              | 1,720                                      | 6,053                      | 3,112     | 3,348     | 3,080    |
| Operating (loss) / income                         | (4,342)                                    | 172                        | 12,412    | (730)     | (4,024)  |
| Other income / (expense)                          | 21   | (371)                      | (1,189)   | (1,526)   | (1,734)  |
| Net (Loss) / Income                               | (4,322)                                    | (199)                      | 11,223    | (2,256)   | (5,757)  |
| Net (Loss) / Income per share                     |  |                            |           |           |          |

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|         |        |        |      |        |        |
|---------|--------|--------|------|--------|--------|
| Basic   | (0.16) | (0.01) | 0.46 | (0.10) | (0.29) |
| Diluted | (0.16) | (0.01) | 0.44 | (0.10) | (0.29) |

Weighted Average Shares Outstanding:

|         |        |        |        |        |        |
|---------|--------|--------|--------|--------|--------|
| Basic   | 26,348 | 24,734 | 24,137 | 22,031 | 21,173 |
| Diluted | 26,348 | 24,734 | 25,482 | 22,031 | 21,173 |

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## Financial Data (continued)

(In thousands)

| Balance Sheet Data                 | As at March 31, |           | As at December 31, |           |           |
|------------------------------------|-----------------|-----------|--------------------|-----------|-----------|
|                                    | 2006            | 2005      | 2004               | 2003      | 2002      |
| Current assets                     | \$ 62,282       | \$ 32,938 | \$ 24,857          | \$ 18,918 | \$ 12,106 |
| Property, plant and equipment, net | 14,960          | 12,897    | 12,546             | 9,506     | 7,747     |
| Total assets                       | 77,242          | 45,835    | 37,403             | 28,424    | 19,853    |
| Current liabilities                | 20,864          | 14,149    | 11,627             | 20,008    | 13,753    |
| Long term debt                     |                 |           |                    | 13,395    | 25,724    |
| Total liabilities                  | 20,864          | 14,149    | 11,627             | 33,404    | 39,476    |
| Stockholders' Equity (Deficit)     | 56,378          | 31,686    | 25,776             | (4,980)   | (19,623)  |
| Working Capital (Deficiency)       | 41,418          | 18,789    | 13,230             | (1,090)   | (1,647)   |

**Item 7. Management's Discussion and Analysis Of Financial Condition and Results of Operations.**

The following discussion and analysis provides information that the management believes is relevant to an understanding of our results of operations and financial condition. The discussion should be read in conjunction with the financial statements and notes thereto.

**Critical Accounting Policies and Estimates**

Our discussion and analysis of our financial condition and results of operations are based on our financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. Certain of our accounting policies are particularly important to the portrayal of our financial position and results of operations and require management's subjective judgments. As a result, these judgments are subject to an inherent degree of uncertainty. In applying these policies, management makes estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the dates of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates. Our significant estimates include our provisions for price adjustments (primarily chargebacks), valuation allowances for deferred tax assets, and valuation of overhead components in inventory.

We believe the following critical accounting policies affect our more significant judgments and estimates used in the preparation of our financial statements. There have neither been material changes to our critical accounting policies for the periods presented nor any material quantitative revisions to our critical accounting estimates for the periods presented.

## Revenue Recognition

Revenue from product sales, net of estimated provisions, is recognized when there is persuasive evidence that an arrangement exists, shipment of the goods has occurred, the selling price is fixed or determinable, and collectibility is reasonably probable. Our customers consist primarily of large pharmaceutical wholesalers who sell directly into the retail channel. Provisions for sales discounts, and estimates for chargebacks, rebates, and product returns are established as a reduction of product sales revenue at the time revenues are recognized, based on historical experience and current market trends adjusted to reflect known changes in the factors that impact these reserves. These revenue reductions are reflected as a direct reduction to accounts receivable through an allowance.

### *Chargebacks*

Chargebacks represent our most significant provision against gross accounts receivable and related reduction to gross revenue. Chargebacks are credits given to our wholesale customers for the price difference on our product they sell (at a contractual price) to retail, chain stores, and managed care organizations at prices lower than we sell to our wholesale customer. We record an estimate at the end of the reporting period to the wholesaler of the amount to be charged back to us, over and above those already received by us. Such estimated amounts, in addition to certain other deductions, are deducted from our gross sales to determine our net revenues. We have recorded provisions for chargebacks based upon various factors, including current contract prices, historical trends, and our future expectations. The amount of actual chargebacks claimed could be either higher or lower than the amounts we accrued. Changes in our estimates, if any, would be recorded in the income statement in the period of the change. If we over or under estimate the amount that will ultimately be charged back to us by our wholesaler customers, there could be a material impact on our financial statements.

We consider the following factors in the determination of the estimates of chargebacks.

1. We consider the historical data of chargebacks as a percentage of sales, as well as the various chargeback reports that we receive from the customers.
2. Volume of product sold to wholesalers and the average chargeback rates, on a quarterly and annualized basis are applied to current period and annual product sales to make a realistic accrual.
3. The sales trends for future estimated prices, wholesale acquisition cost (WAC), the contract prices with the retailers, chain stores and managed care organizations (end-users). Our prices with the wholesalers and end users are contracted prices.

### *Shelf Stock Adjustments*

Shelf stock adjustments are credits issued to our customers to reflect decreases in the selling prices of our product. These credits are customary in the industry and are intended to reduce the customers' inventory cost to better reflect current market prices. The determination to grant a shelf stock adjustment to a customer following a price decrease is at our discretion.

Factors considered when recording a reserve for a shelf stock adjustments include estimated launch dates of competing products based on market intelligence, estimated decline in market price of our product based on historical experience and input from customers and levels of inventory held by customers at the date of the adjustments as provided by them.

### *Product returns and other allowances*

In the pharmaceutical industry, customers are normally granted the right to return product for credit if the product has not been used prior to its expiration date. Our return policy typically allows product returns for products within a 12-month window from six months prior to the expiration date and up to six months after the expiration date. We estimate the level of sale, which will ultimately be returned pursuant to our return policy, and record a related reserve at the time of sale. These amounts are deducted from our gross sales to determine our net revenues. Our estimates take into consideration historical returns of our products and our future expectations. We periodically review the reserves established for returns and adjust them based on actual experience, if necessary. The primary factors we consider in estimating our potential product returns include shelf life of expiration date of each product and historical levels of expired product returns. In case we become aware



of any returns due to product related issues, such information from the customers, is used to estimate an additional reserve. The amount of actual product return could be either higher or lower than the amounts we accrued. Changes in our estimates, if any, would be recorded in the income statement in the period of the change. If we over or under estimate the quantity of product which will ultimately be returned, there may be a material impact to our financial statements.

Discounts (trade and prompt payment discounts) are accrued at the end of every reporting period based on the gross sales made to the customers during the period and based on their terms of trade. We review the contracts between the customer and us as well as the historical data and percentages to estimate the discount accrual.

Customer rebates are estimated at every period end, based on direct or indirect purchases. If the purchases are direct, the rebates are recognized when products are purchased and a periodic credit is given. For indirect purchases, the rebates are recognized based on the terms with such customer. Medicaid Rebates are estimated based on the historical data we receive from the public sector benefit providers, which is based on the final dispensing of our product by a pharmacy to a benefit plan participant.

*Doubtful Accounts*

Doubtful accounts are estimated based on the data available from external sources, including information on financial condition of customers. Also, a regular review of past due receivables is done on a quarterly basis to identify and make provision for such receivables not expected to be recovered.

Our gross sales for Fiscal 2006 were \$200.4 million, as compared to \$141.9 million for Fiscal 2005. Chargebacks, returns, discounts and other customary customer deductions and other sales costs constituted approximately 59% for Fiscal 2006 compared to 54% for Fiscal 2005. Net sales for Fiscal 2006 were \$82.8 million, as compared to \$64.1 million for Fiscal 2005. The primary cause of increase in the sales diluters by almost 4% between the periods is the impact of price erosions for the products we sell and the corresponding impact of such price erosions on chargebacks

The following is a roll forward of the provisions for chargebacks, shelf stock adjustments, returns and allowances and estimated doubtful account allowances during Fiscal 2005 and Fiscal 2006.

(\$ in Millions)

|                                       | <u>Allowances charged to Gross Sales</u> |                       |                     |                                   | <u>Balance at the end of period</u> |
|---------------------------------------|--|-----------------------|---------------------|-----------------------------------|-------------------------------------|
|                                       | <u>Balances at beginning of period</u>   | <u>Current Period</u> | <u>Prior Period</u> | <u>Credits taken by customers</u> |                                     |
| <b>For Fiscal 2005</b>                |  |                       |                     |                                   |                                     |
| Chargebacks & shelf stock adjustments | 16,051                                   | 72,505                | -0-                 | 68,746                            | \$ 19,810                           |
| Returns and other allowances          | 878                                      | 4,258                 | -0-                 | 4,016                             | 1,120                               |
| Doubtful Accounts                     | 500                                      | -0-                   | -0-                 | 400                               | 100                                 |
| <b>For Fiscal 2006</b>                |  |                       |                     |                                   |                                     |
| Chargebacks & shelf stock adjustments | \$ 19,810                                | \$ 111,525            | -0-                 | \$ 119,868                        | \$ 11,467                           |
| Returns and other allowances          | 1,120                                    | 7,471                 | -0-                 | 7,091                             | 1,500                               |
| Doubtful Accounts                     | 100                                      | -0-                   | -0-                 | -0-                               | 100                                 |

### **Income Taxes**

As part of the process of preparing our financial statements we are required to estimate our income taxes in each of the jurisdictions in which we operate. We account for income taxes by the liability method. Under this method, deferred income taxes are recognized for tax consequences in future years of differences between the tax bases of assets and liabilities and their financial reporting amounts at each year-end, based on enacted laws and statutory tax rates applicable for the differences that are expected to affect taxable income. Valuation allowances are provided if based upon the weight of available evidence, it is more likely than not that some or all of the deferred tax assets will not be realized. We have not recorded any federal tax provision or benefit for the Fiscal 2006, the Transition Period or for the years ended December 31, 2004 and 2003. We have provided a valuation allowance for the full amount of our net deferred tax assets since realization of any future benefit from deductible temporary differences and net operating loss carry forwards cannot be sufficiently assured at March 31, 2006, March 31, 2005, December 31, 2004 and 2003. At March 31, 2006, we had federal net operating loss carryforwards of approximately \$58.8 million available to reduce future taxable income, which will expire between 2007 and 2017. Under the provisions of the Internal Revenue Code, certain substantial changes in our ownership may result in a limitation on the amount of net operating loss carry forwards which can be used in future years. We believe that ownership changes to date will not limit future utilization of net operating loss carryforwards.

### **Inventory**

We value inventories at the lower of cost or market. We determine the cost of raw materials, work in process and finished goods using the specific identification cost method. We analyze our inventory levels quarterly and write down inventory that has become obsolete and inventory that has a cost basis in excess of its expected net realizable value. Expired inventory is disposed of and the related costs are written off. Materials acquired for R&D on products yet to be launched are written off in the year of acquisition. The determination of whether or not inventory costs will be realizable requires estimates by management. A critical estimate in this determination is the estimate of the future expected inventory requirements, whereby we compare our internal sales forecasts to inventory on hand. Actual results may differ from those estimates and inventory write-offs may be required. We must also make estimates about the amount of manufacturing overhead to allocate to our finished goods and work in process inventories. Although the manufacturing process is generally similar for our products, we must make judgments as to the portion of costs to allocate to purchased product, work in process and finished goods, and such allocations can vary based upon the composition of these components and the fact that each product produced does not necessarily require the same amount of time or effort for the same production step. Accordingly, the assumptions we make can impact the value of reported inventories and cost of sales.

### **FDA Compliance**

The FDA commenced an inspection of the Company's facility on May 1, 2006. This is a routine inspection which will continue over the next few weeks. While there is no assurance that the FDA will not issue observations, we believe that we are cGMP compliant.

**Overview of Fiscal 2006**

We recorded net sales of \$82.8 million during Fiscal 2006 compared to \$64.1 million during Fiscal 2005. We have generated cash from operations of \$8.9 million during Fiscal 2006 as compared to \$20.6 million during Fiscal 2005. This cash was generated after funding our working capital requirements of \$17.5 million and \$4.9 million during the relevant periods. We incurred a net loss of \$10.4 million during Fiscal 2006 compared to net loss of \$2.3 million during Fiscal 2005. The higher loss was primarily due to higher non-cash research and development expense (R&D) of \$35.1 million during Fiscal 2006 as compared to \$26.8 million during Fiscal 2005. This non-cash R&D expense relates to nine products passing their bio-equivalency studies and related value of the preferred stock issued to Sun Global during Fiscal 2006 as compared to eight products during Fiscal 2005. At March 31, 2006, we had stockholders' equity of \$56.4 million as compared to stockholders' equity of \$31.7 million at March 31, 2005.

In January 2005, the Company changed its fiscal year end from December 31 to March 31. The following discussion of historical operating results compares Fiscal 2006 to Fiscal 2005. Results from Fiscal 2005 were derived from the Company's published quarterly results and are unaudited. Accordingly, this twelve month period is not disclosed in the accompanying financial statements. It is included in this discussion for comparative purposes only. For the previous calendar year ended December 31, 2004, the comparison is to the calendar year ended December 31, 2003. The discussion of historical operating results also includes and compares the three months ended March 31, 2006 to the Transition Period. Results from the three month period ended March 31, 2006 were derived from the Company's published quarterly results and are unaudited.

**Fiscal 2006 Compared to Fiscal 2005**

|   | Year ended March 31,                  |                     |
|---|---------------------------------------|---------------------|
|   | 2006<br>(Audited)                     | 2005<br>(Unaudited) |
| Statement of operations data                        | (in thousands, except per share data) |                     |
|   | \$                                    | \$                  |
| Net sales   | 82,789                                | 64,116              |
| Cost of goods sold                                  | 41,873                                | 26,930              |
| Gross profit  | 40,916                                | 37,186              |
| Selling, general and administrative expense         | 8,183                                 | 5,874               |
| Research and development costs - affiliate non cash | 35,055                                | 26,769              |
| Research and development costs - other              | 8,437                                 | 6,640               |
| Operating loss                                      | (10,759)                              | (2,097)             |
| Other income (expense)                              | 336                                   | (181)               |
| Net Loss  | (10,423)                              | (2,278)             |
| Net Loss per share                                  |                                       |                     |
| Basic   | (0.39)                                | (0.08)              |
| Diluted   | (0.39)                                | (0.08)              |
| Weighted Average Shares Outstanding:                |                                       |                     |
| Basic   | 26,392                                | 26,348              |
| Diluted   | 26,392                                | 26,348              |



**Net Sales.** Net sales for the relevant periods of 2006 and 2005 were \$82.8 and \$64.1 million, reflecting an increase of over 29%. The increase is primarily due to the higher production, new product launches (primarily the sales of our generic equivalent of Ultracet® and increased marketing of our products to new and existing customers. Currently, we manufacture and market all except one of the approved products. Sales of three products accounted for approximately 70% and 77% of net sales for the relevant periods of 2006 and 2005, respectively. See Note 1 to Financial Statements Revenue Recognition for explanation of the determination of net sales.

**Gross Profit.** We earned a gross profit of \$40.9 million as compared to a gross profit of \$37.2 million during the relevant periods, reflecting an increase of 10%. The increase in gross profit for the relevant periods is primarily due to higher sales, new product launches, an improved balance in the mix of customers or the class of trade and product selection being sold partially offset by price erosion during the year.

The gross profit margin declined to 49% as compared to 58% during the relevant periods. The decrease was primarily the result of increased competition, both domestic and foreign, resulting in erosion of prices and profit margins.

**Selling, General and Administrative Expense.** Selling, general and administrative expense during the relevant periods were \$8.2 million and \$5.9 million, representing an increase of 39%. The selling, general and administrative expense have increased to 9.9% of net sales as compared to 9.2% of net sales during the relevant periods.

The increase in SG&A for Fiscal 2006 over Fiscal 2005 was due to an increase in regulatory costs for compliance with SEC regulations, including Sarbanes-Oxley requirements (\$0.4 million), primarily additions to management and associated compensation (\$0.7 million), higher taxes on property (\$0.2 million) and higher SG&A expenses associated with higher sales volumes as well as a one time charge (\$0.3 million) associated with our decision to forego an acquisition of real property in favor of alternate expansion opportunities.

**Research and Development Expenses.** Total R&D expenses for the relevant periods were \$43.5 million for Fiscal 2006 and \$33.4 million for Fiscal 2005. Cash research and development expenses were \$8.4 million for Fiscal 2006 and \$6.6 million during Fiscal 2005. We incurred non-cash research and development expenses (technology transfer cost) of \$35.1 million for the 4,896,000 shares of preferred stock for nine product transfers as compared to \$26.8 million for the 4,352,000 shares of preferred stock for eight product transfers. The substantially higher R&D expenses, both cash and non-cash, represent increased R&D activities.

**Interest Expense.** We incurred approximately four thousand dollars interest expense during Fiscal 2006 on a short term borrowing from JPMorgan Chase Bank See Note 2 to Financial Statements. Interest expense on loans from the EDC, ICICI Bank, the Bank of Nova Scotia and Citibank was \$0.2 million during Fiscal 2005. The decrease in the amount of interest is primarily due to paying off the entire loans due to the EDC, ICICI Bank, the Bank of Nova Scotia and CitiBank during Fiscal 2005.

**Results of Operations.** We incurred a net loss of \$10.4 million and \$2.3 million during the relevant periods. The lower results of operation are primarily due to higher non-cash R&D expenses and higher Cash R&D expenses.

**Three months ended March 31, 2006 compared with the Transition Period**

|   | 2006<br>(Unaudited) | Transition<br>Period<br>(Audited) |
|---|---------------------|-----------------------------------|
| (in thousands, except per share data)               |                     |                                   |
| Statement of operations data                        |                     |                                   |
| Net sales   | \$ 24,701           | \$ 17,337                         |
| Cost of goods sold                                  | 12,011              | 7,879                             |
| Gross profit  | 12,690              | 9,457                             |
| Selling, general and administrative expenses        | 2,481               | 1,879                             |
| Research and development costs - affiliate non cash | 14,008              | 10,200                            |
| Research and development costs - other              | 2,925               | 1,720                             |
| Operating loss                                      | (6,724)             | (4,342)                           |
| Other income (expenses)                             | 185                 | 21                                |
| Net Loss  | (6,539)             | (4,322)                           |
| Net Loss per share                                  |                     |                                   |
| Basic   | (0.25)              | (0.16)                            |
| Diluted   | (0.25)              | (0.16)                            |
| Weighted Average Shares Outstanding:                |                     |                                   |
| Basic   | 26,392              | 26,348                            |
| Diluted   | 26,392              | 26,348                            |

**Net Sales.** Net sales for the relevant periods of 2006 and 2005 were \$24.7 million and \$17.3 million, reflecting an increase of almost 43%. The increase is primarily due to the higher production, new product launches and increased marketing of our products to new and existing customers. Currently, we manufacture and market all except one of the approved products. See Part I, Item 1. Business Current Status above. Sales of four and three products accounted for approximately 76% and 77% of net sales for the relevant periods, respectively. See Note 1 to Financial Statements Revenue Recognition.

**Gross Profit.** We earned a gross profit of \$12.7 million as compared to a gross profit of \$9.5 million during the relevant periods, reflecting an increase of 34%. The improvement was primarily due to higher sales volumes during the three months ended March 31, 2006 compared to the Transition Period.

The gross profit margin declined to 51% as compared to 55% during the relevant periods. The decrease was primarily the result of increased competition, both domestic and foreign, resulting in erosion of prices and profit margins.

**Selling, General and Administrative Expenses.** Selling, general and administrative expenses during the relevant periods were \$2.5 million and \$1.9 million, representing an increase of 32%. The selling, general and administrative expenses have reduced to 9.4% of net sales compared to 10.8% of net sales during the relevant periods.

The increase in SG&A during the relevant periods has been due to an increase in regulatory costs for compliance with SEC regulations, including Sarbanes-Oxley requirements (\$0.1 million), primarily additions to management and associated compensation (\$0.2 million), and higher SG&A expenses associated with higher sales volumes.

**Research and Development Expenses.** Total R&D expenses for the relevant periods were \$16.9 million and \$11.9 million. Cash research and development expenses were \$3.0 million and \$1.7 million during the relevant periods. We incurred non-cash research and development expenses (technology transfer cost) of \$14.0 million for the 1,632,000 shares of preferred stock for three product transfers as compared to \$10.2 million for the 1,632,000 shares of preferred stock for three product transfers. The substantially higher R&D expenses, both cash and non-cash, represent increased R&D activities.

**Interest Expense.** Interest expense on loans from the JP Morgan Chase Bank was approximately four thousand dollars during the relevant period of 2006. There was no corresponding expense during the Transition Period.

**Results of Operations.** We incurred a net loss of \$6.5 million and \$4.3 million during the relevant periods. The lower results of operation are primarily due to higher non-cash R&D expenses.

**Year Ended December 31, 2004 Compared with Year Ended December 31, 2003**

**Net Sales.** Net sales for 2004 and 2003 were \$60.3 million and \$45.5 million, respectively, reflecting an increase of almost 33%. The increase is due to the higher production and marketing of our products to new and existing customers. Currently, we manufacture and market all except one of the approved products. See Part I, Item 1. Business Current Status above. Sales of two products accounted for approximately 74% and 87% of net sales in 2004 and 2003, respectively.

**Gross Profit.** We earned a gross profit of \$35.9 million for 2004 as compared to a gross profit of \$26.0 million for 2003, reflecting an increase of 38% over 2003. The improvement was primarily due to higher sales volumes with improved margins due to product mix in the current period as compared to the corresponding period of 2003 and ability to absorb operational overheads due to higher sales.

In addition to increased sales, the gross profit margin has marginally improved to 59% in 2004 as compared to 57% for 2003. The increase was primarily the result of:

Change in the product mix of sales.

Reduction in manufacturing costs due to increased batch sizes.

Further improved efficiency in the overall manufacturing process associated with higher utilization of plant capacity.

Utilization of newly installed larger and faster equipment to achieve economies of scale.

**Selling, General and Administrative Expenses.** Selling, general and administrative expenses for 2004 and 2003 were \$5.3 million and \$7.4 million, respectively, representing a decrease of 28%. Selling, general and administrative expenses have decreased to 9% of net sales for 2004 as compared to 16% of net sales for 2003.

The decrease in SG&A of approximately \$2.1 million in 2004 was primarily due to one time recording of variable compensation expense during 2003 on the extension of the term of two former directors stock options and severance compensation to a former CEO.

**Research and Development Expenses.** Total R&D expense for 2004 of \$30.5 million was substantially higher as compared to \$6.2 million during 2003. Cash research and development expenses of \$6.1 million for 2004 were higher by 97% when compared with \$3.1 million incurred for 2003. We incurred non-cash research and development expenses (technology transfer cost) of \$24.4 million for the 3,808,000 shares of preferred stock for seven product transfers during 2004 as compared to \$3.1 million for the 544,000 shares of preferred stock for one product transfer during 2003. The substantially higher R&D expenses, both cash and non-cash, represent increased R&D activities.

**Interest Expense.** Interest expense on loans from the EDC, Sun Pharma and its affiliates, ICICI Bank, the Bank of Nova Scotia and Citibank, was \$0.4 million and \$1.2 million for 2004 and 2003, respectively. The decrease in the amount of interest is primarily due to paying off the entire loans due to the EDC, ICICI Bank, the Bank of Nova Scotia and CitiBank during 2004 as well as Sun Pharma loans during 2003.

**Results of Operations.** We incurred a net loss of \$0.2 million for 2004 as compared to earning a net income of \$11.2 million for 2003. The significantly lower results of operation for 2004 as compared to 2003 are primarily due to higher non-cash R&D expenses.

**Liquidity and Capital Resources**

**Fiscal 2006 and Fiscal 2005**

We generated cash of \$8.9 million from operations as compared to cash of \$20.6 million during the relevant periods. The lower cash generation during Fiscal 2006 was primarily due to augmenting working capital. Cash generated from operations was used to finance our capital expenditures of \$3.6 million. Cash from operations during Fiscal 2005 was used to





finance capital expenditure of \$3.3 million.

At March 31, 2006, we had working capital of \$41.4 million compared to a working capital of \$18.8 million at March 31, 2005. The working capital was significantly higher due to higher receivables and inventories at the end of March 2006 compared to that at March 31, 2005, partially offset by higher current liabilities.

**Three Months ended March 31, 2006 to the Transition Period**

We generated cash of \$4.3 million from operations as compared to cash of \$4.8 million during the relevant periods. In addition to augmenting working capital, the cash generated from operations was used to finance our capital expenditures of \$1.2 million and \$0.7 million during the relevant periods.

At March 31, 2006, we had working capital of \$41.4 million compared to a working capital of \$18.8 million at March 31, 2005. The working capital was significantly higher due to higher receivables and inventories at the end of March 2006 compared to that at March 31, 2005, partially offset by higher current liabilities.

**Years ended December 31, 2004 and 2003**

During 2004, we generated cash of \$22.0 million from operations as compared to cash of \$15.5 million during 2003. The higher cash generation during 2004 has been primarily due to higher sales volumes, better-cost absorption, an improved product mix, obtaining more competitive prices for raw materials and better utilization of new equipment to improve production and productivity.

In addition to paying down debt, the cash generated from operations for both 2004 and 2003 was used to finance our capital expenditures of \$4.0 million during 2004 and \$2.4 million during 2003.

During 2004, we repaid the entire balance of \$4.4 million due to ICICI Bank Limited and the \$6.4 million mortgage loan due to the Economic Development Corporation of the City of Detroit (the EDC), and repaid \$12.5 million due to the Bank of Nova Scotia. These payoffs were funded from internal cash flow and by utilizing a \$10.0 million credit line arranged with Citibank, FSB. We have also repaid the entire borrowing of \$10.0 million from Citibank during 2004. These repayments leave us debt-free (other than normal accounts payables and accruals) at December 31, 2004, and our entire property, plant, equipment and intellectual property free of any mortgages, liens or restrictions. In comparison, during 2003 we borrowed \$1.6 million from the Bank of Nova Scotia and repaid the entire Sun Pharma loans of \$9.7 million and the scheduled payments of \$1.2 million to the EDC and \$0.6 million to the ICICI Bank.

During 2004, we generated \$3.5 million from the exercise of stock options by Sun Pharma, our employees and one officer and director. During 2003, we generated \$0.9 million from the exercise of stock options by our employees and directors.

At December 31, 2004, we had working capital of \$13.2 million compared to a negative working capital of \$1.1 million at December 31, 2003. The negative working capital as on December 31, 2003 was primarily due to classification of loans as current of \$8.8 million due to ICICI Bank and the Bank of Nova Scotia and \$1.1 million due to the EDC.

The available increased cash flow during 2004 was partly utilized to increase inventories, up from \$9.6 million in 2003 to \$17.1 million. These increased inventories served us well to satisfy increased sales requirement from \$45.5 million in 2003 to \$60.3 million in 2004. To meet customer demands in timely manner, it is essential to keep sufficient inventories at all levels including Finished goods stock. Therefore, if necessary the trend of increasing inventories will continue in 2005 to support increased sales.

The following tables present a summary of each of the four quarters of Fiscal 2006. The unaudited interim financial statements include all adjustments, consisting only of normal recurring adjustments, necessary for a fair statement of such information when read in conjunction with our audited financial statements and related notes. Our quarterly operating results have varied in the past, may continue to do so and are not necessarily indicative of results for any future period.

Fiscal 2006 April 1, 2005 to March 31, 2006 (unaudited)

(In thousands, except per share data)

|                    | Quarter 1 | Quarter 2 | Quarter 3 | Quarter 4 |
|--------------------|-----------|-----------|-----------|-----------|
| Net Sales          | 17,613    | 19,796    | 20,679    | 24,701    |
| Net (Loss) Profit  | 1,616     | (4,820)   | (680)     | (6,539)   |
| Earnings Per Share |           |           |           |           |
| Basic              | 0.06      | (0.18)    | (0.03)    | (0.25)    |
| Diluted            | 0.05      | (0.18)    | (0.03)    | (0.25)    |

**Contractual Obligations and Off Balance Sheet Transactions**

## Contractual Obligations

|                         |           |
|-------------------------|-----------|
| Contractual Obligations | 1-3 years |
|-------------------------|-----------|

|  |                |
|--|----------------|
| Operating Leases   | \$ 0.5 million |
| There are no other contractual obligations requiring disclosure. |                |

## Off Balance Sheet Transactions

None

**Future Outlook**

Management is optimistic about our future outlook. We have been substantially compliant with cGMPs since 2001, and received approvals of 18 ANDAs and tentative approvals for 2 ANDAs. We expanded and upgraded our facilities and expanded our customer base during the last five years including Fiscal 2006. We have improved our market share on products that have been in our portfolio and we have gained the appropriate marketshare to date on new product launched in 2006. Our efforts in developing new products has increased and our momentum should permit us to grow at a reasonable level. We believe that we will continue to achieve 25% to 30% revenue growth during Fiscal 2007 over Fiscal 2006.

Pricing pressures, however, due to increased competition, have continued during 2004, the Transition Period and Fiscal 2006 and are expected to continue in Fiscal 2007, which may result in lower growth rates and gross margins. Management has and will continue to work diligently to counter the pricing pressures through increased sales volumes, better-cost absorption of operational overheads, and cost reductions where possible.

As disclosed, under the products agreement dated November 21, 2002 between Sun Global and the Company, Sun Global has agreed to transfer the technology for 25 products to the Company over a five year period in exchange for 544,000 preferred shares (which are convertible on a one-to-one basis into common shares) per product. Since the date of the products agreement, the Company has selected all 25 products for development and twenty of these products have passed their respective bio-equivalency studies (one in December 2003, seven in 2004, three during the Transition Period and nine during Fiscal 2006) and one since then. If some or all of the four remaining products pass their bio-equivalency studies in fiscal 2007, the fair value of the preferred shares earned by Sun Global in exchange for such products could cause our non-cash research and development expenses to increase to an amount which would significantly decrease profit or create a loss.

While the increased development of new products will increase both our cash and non-cash R&D expense and will impact EPS, we expect that cash will be available for among other things, to meet increased working capital requirements, fund potential Paragraph IV Certification litigation and finance further capital investments.

The Company will continue to aggressively move forward with the development of new products. We believe that receiving products from Sun provides us with a partner with a proven track record; one that already has provided us with quality products. Moreover, Sun Pharma's increased beneficial ownership in us to approximately 64%, should, we believe, provide it with the incentive to continue to help us succeed. Sun Pharma has previously provided us with capital, loans, guarantees of loans, personnel, raw materials and equipment, which have significantly helped us to date.

Management's plans for fiscal 2007 include:

Continued focus and improvement on FDA compliance.

Increased pace of research and development activities, with a view to maximize the number of ANDA filings.

Continue to invest in equipment and facilities to expand capacity to meet requirements of projected short term and long term growth.

Increased market share for certain existing products and recently introduced new products and enhanced customer reach and satisfaction.

Prompt introduction of new approved products to the market.

Achieving further operational efficiencies by attaining economies of scale and cost reduction per unit.

Increase the number of products, as well as anticipated volume increases for existing products, which, in turn, will improve manufacturing capacity utilization.

Consider alternative ways of increasing cash, such as marketing ANDAs owned by Sun Pharma.

Expand our relationships with financial institutions to fortify our credit position and borrowings as necessary.

Research alternate product development sources and product licenses such as in licensing authorized generics from brand innovator companies and acquisitions of ANDAs from competitor manufacturers both domestically and abroad.

#### **Item 7A. Quantitative and Qualitative Disclosures About Market Risk.**

The Company has no debt or other market risk securities or transactions in foreign exchange.

#### **Line of Credit**

On November 17, 2005, the Company entered into a one-year, \$10 million Credit Agreement with JP Morgan Chase Bank, N.A. Under the Credit Agreement, the lender may make loans and issue letters of credit to the Company for the Company's working capital needs and general corporate purposes. Letters of credit, if issued, expire one year from their date of issuance, but no later than November 17, 2007. As of March 31, 2006, we utilized \$1.5 million of the available line and have repaid the same. Borrowings are secured by the Company's receivables, inventory and all proceeds therefrom. Borrowings may be prepaid at any time by the Company. Interest is payable based on LIBOR or an alternate base rate (determined by reference to the prime rate or the federal funds effective rate), as selected by the Company. The rate of interest is LIBOR plus 75 basis points or Prime rate minus 100 basis points. The Credit Agreement requires that certain financial covenants be met on a quarterly basis. The Company is in compliance with these financial covenants at March 31, 2006.

#### **Item 8. Financial Statements and Supplementary Data**

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3. Financial Statements:

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**Item 9. Changes in and Disagreements With Accountants on Accounting and Financial Disclosure.**

None.

**Item 9A. Controls and Procedures.**

a. The term "disclosure controls and procedures" is defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934 (the Exchange Act). These rules refer to the controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files under the Exchange Act is recorded, processed, summarized and reported within required time periods. Our Chief Executive Officer and our Chief Financial Officer have evaluated the effectiveness of our disclosure controls and procedures as of the end of the period covered by this report (the Evaluation Date), and have concluded that, as of the Evaluation Date, our disclosure controls and procedures are effective in providing them with material information relating to the Company known to others within the Company which is required to be included in our periodic reports filed under the Exchange Act.

b. There has been no change in the Company's internal control over financial reporting that occurred during the Transition Period that materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

**Management's Report on Internal Control Over Financial Reporting**

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rule 13a-15(f). Under the supervision and with the participation of management, including our Chief Executive Officer and Chief Financial Officer, we conducted an evaluation of the effectiveness of our internal control over financial reporting based on the framework in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Based on our evaluation, management concluded that our internal control over financial reporting was effective as of March 31, 2006. Our management's assessment of the effectiveness of our internal control over financial reporting as of March 31, 2006 has been audited by Rehmann Robson, an independent registered public accounting firm, as stated in its Report of Independent Registered Public Accounting Firm on Internal Control Over Financial Report which appears on pages F-3 and F-4 below.

**Item 9B. Other Information.**

None.

**PART III**

**Item 10. Directors and Executive Officers of the Registrant.**

The information with respect to directors and executive officers of the Corporation, the Corporation's Code of Ethics, and compliance with Section 16(a) of the Exchange Act included under the sections Nominees For Directors Terms Expiring in 2008, Incumbent Directors Terms Expiring in 2006, Incumbent Directors Terms Expiring in 2007, Committees and Meetings of Directors, Nomination of Directors, Executive Officers, Code of Business Conduct and Ethics, and Section 16(a) Beneficial Ownership Reporting Compliance in our 2005 Proxy Statement to be filed with the Securities and Exchange Commission on or before July 31, 2006, is incorporated herein by reference.

**Item 11. Executive Compensation.**

The information regarding executive compensation included under the section Compensation of Executive Officers and Compensation of Directors in our 2005 Proxy Statement to be filed with the Securities and Exchange Commission on or before July 31, 2006, is incorporated herein by reference.

**Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters.**

The information with respect to the security ownership of certain beneficial owners and management and with respect to equity compensation plans included under the sections Security Ownership of Certain Beneficial Owners, Security Ownership of Management and Directors and Equity Compensation Plan Information in our 2005 Proxy Statement to be filed with the Securities and Exchange Commission on or before July 31, 2006, is incorporated herein by reference. In addition, the information contained under the Equity Compensation Plan Information subheading under Item 5 of this report is incorporated herein by reference.

**Item 13. Certain Relationships and Related Transactions.**

The information with respect to certain relationships and related transactions included under the section Transactions of Directors, Executive Officers and Certain Beneficial Owners of Caraco in our 2005 Proxy Statement to be filed with the Securities and Exchange Commission on or before July 31, 2006, is incorporated herein by reference.

**Item 14. Principal Accountant Fees and Services.**

The information under the caption Relationship with Independent Auditors Audit and Non-Audit Fees in our 2005 Proxy Statement to be filed with the Securities and Exchange Commission on or before July 31, 2006, is incorporated herein by reference.

**Part IV**

**Item 15. Exhibits Financial Statement Schedules.**

(a) 1 Financial Statements

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| 1. | Report of Independent Registered Public Accounting Firm on Internal Control Over Financial Reporting | F-1 & F-2 |
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3. Financial Statements:

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2. Financial Statement Schedules

None

3. Exhibits

The exhibits filed in response to Item 601 of Regulation S-K are listed in the Exhibit Index, which is incorporated herein by reference.

(b) Exhibits

The exhibits filed in response to Item 601 of Regulation S-K are listed in the Exhibit Index, which is incorporated herein by reference.

(c) Other Schedules

None

**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 on the 12th day of June, 2006.

CARACO PHARMACEUTICAL LABORATORIES, LTD.

/s/ Daniel H. Movens

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Daniel H. Movens  
Chief Executive Officer

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***CARACO PHARMACEUTICAL LABORATORIES, LTD.***

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(a subsidiary of Sun Pharmaceutical Industries Limited)  
***FINANCIAL STATEMENTS***

***AND***

***REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM***

***FOR THE YEAR ENDED MARCH 31, 2006,  
THE THREE MONTHS ENDED MARCH 31, 2005 AND  
THE YEARS ENDED DECEMBER 31, 2004 AND 2003***

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**CARACO PHARMACEUTICAL LABORATORIES, LTD.**  
(a subsidiary of Sun Pharmaceutical Industries Limited)

**INDEX TO FINANCIAL STATEMENTS**

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| <b><u>Report of Independent Registered Public Accounting Firm</u></b>  | F-3 - 4   |
| <b>Financial Statements as of March 31, 2006 and 2005, and for the Year Ended March 31, 2006, the Three Months Ended March 31, 2005 and the Years Ended December 31, 2004 and 2003</b> |           |
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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM  
ON INTERNAL CONTROL OVER FINANCIAL REPORTING**

Stockholders and Board of Directors  
Caraco Pharmaceutical Laboratories, Ltd.  
Detroit, Michigan

We have audited management's assessment, included in the accompanying Management's Annual Report on Internal Control Over Financial Reporting that **Caraco Pharmaceutical Laboratories, Ltd.** (a Michigan corporation) (a subsidiary of Sun Pharmaceutical Industries Limited) (the Corporation) maintained effective internal control over financial reporting as of March 31, 2006, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). The Corporation's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the Corporation's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the *Public Company Accounting Oversight Board (United States)*. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A corporation's internal control over financial reporting is a process designed by, or under the supervision of, the corporation's principal executive and principal financial officers, or persons performing similar functions, and effected by the corporation's board of directors, management, and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A corporation's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the corporation; (2) provide reasonable assurance that transactions are recorded as

necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assessment that the Corporation maintained effective internal control over financial reporting as of March 31, 2006, is fairly stated, in all material respects, based on the COSO criteria. Also in our opinion, the Corporation maintained, in all material respects, effective internal control over financial reporting as of March 31, 2006, based on the COSO criteria.

We have also audited, in accordance with the standards of the *Public Company Accounting Oversight Board (United States)*, the financial statements as of and for the year ended March 31, 2006 of the Corporation and our report dated May 7, 2006 expressed an unqualified opinion on those financial statements.

/s/ Rehmann Robson

Troy, Michigan  
May 7, 2006

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

Stockholders and Board of Directors  
Caraco Pharmaceutical Laboratories, Ltd.  
Detroit, Michigan

We have audited the accompanying balance sheets of *Caraco Pharmaceutical Laboratories, Ltd.* (a Michigan corporation) (a subsidiary of Sun Pharmaceutical Industries Limited) (the Corporation ) as of March 31, 2006 and 2005 and the related statements of operations, stockholders equity (deficit) and cash flows for the year ended March 31, 2006, the three months ended March 31, 2005 and for each of the two years in the period ended December 31, 2004. These financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the *Public Company Accounting Oversight Board (United States)*. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. 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 referred to above present fairly, in all material respects, the financial position of Caraco Pharmaceutical Laboratories, Ltd. as of March 31, 2006 and 2005, and the results of its operations and its cash flows for the year ended March 31, 2006, the three months ended March 31, 2005, and for each of the two years in the period ended December 31, 2004 in conformity with accounting principles generally accepted in the United States of America.

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We have also audited, in accordance with the standards of the *Public Company Accounting Oversight Board (United States)*, the effectiveness of the Corporation's internal control over financial reporting as of March 31, 2006, based on the criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated May 7, 2006 expressed an unqualified opinion on management's assessment of the effectiveness of the Corporation's internal control over financial reporting and an unqualified opinion on the effectiveness of the Corporation's internal control over financial reporting.

/s/ Rehmann Robson

Troy, Michigan

May 7, 2006

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**CARACO PHARMACEUTICAL LABORATORIES, LTD.**  
(a subsidiary of Sun Pharmaceutical Industries Limited)

**BALANCE SHEETS**

**ASSETS**

|  | March 31             |                      |
|--|----------------------|----------------------|
|  | 2006                 | 2005                 |
| <b>Current assets</b>                    |                      |                      |
| Cash and cash equivalents                | \$ 11,924,245        | \$ 6,627,425         |
| Accounts receivable, net                 | 20,859,099           | 6,736,778            |
| Inventories                              | 26,965,690           | 18,467,693           |
| Prepaid expenses and deposits            | 2,532,561            | 1,105,618            |
|  | <b>62,281,595</b>    | <b>32,937,514</b>    |
| <b>Property, plant and equipment</b>     |                      |                      |
| Land                                     | 197,305              | 197,305              |
| Buildings and improvements               | 10,790,703           | 9,605,888            |
| Equipment                                | 12,040,688           | 9,701,979            |
| Furniture and fixtures                   | 681,705              | 589,329              |
|  | 23,710,401           | 20,094,501           |
| Total                                    | 23,710,401           | 20,094,501           |
| Less accumulated depreciation            | 8,749,997            | 7,197,422            |
|  | <b>14,960,404</b>    | <b>12,897,079</b>    |
| <b>Net property, plant and equipment</b> | <b>14,960,404</b>    | <b>12,897,079</b>    |
| <b>Total assets</b>                      | <b>\$ 77,241,999</b> | <b>\$ 45,834,593</b> |

The accompanying notes are an integral part of these financial statements.



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**LIABILITIES AND STOCKHOLDERS EQUITY**

|  | March 31             |                      |
|--|----------------------|----------------------|
|  | 2006                 | 2005                 |
| <b>Current liabilities</b>   |                      |                      |
| Accounts payable, trade  | \$ 3,696,265         | \$ 2,577,668         |
| Accounts payable, Sun Pharma   | 14,678,085           | 9,639,890            |
| Accrued expenses   | 2,489,398            | 1,931,442            |
|  | <hr/>                | <hr/>                |
| <b>Total liabilities (all current)</b>   | <b>20,863,748</b>    | <b>14,149,000</b>    |
|  | <hr/>                | <hr/>                |
| <b>Commitments and contingencies</b><br>(Notes 9, 11 and 12)   |                      |                      |
| <b>Stockholders equity (Note 7)</b>  |                      |                      |
| Series B convertible preferred stock, no par value; issued and outstanding<br>10,880,000 shares (March 31, 2006) 5,984,000 shares (March 31, 2005)           | 72,755,770           | 37,700,410           |
| Common stock, no par value; authorized 30,000,000 shares, issued and<br>outstanding 26,421,994 shares (March 31, 2006) 26,360,294 shares<br>(March 31, 2005) | 44,988,597           | 44,927,987           |
| Additional paid-in capital   | 2,718,735            | 2,718,735            |
| Accumulated deficit  | (64,084,851)         | (53,661,539)         |
|  | <hr/>                | <hr/>                |
| <b>Total stockholders equity</b>   | <b>56,378,251</b>    | <b>31,685,593</b>    |
|  | <hr/>                | <hr/>                |
| <b>Total liabilities and stockholders equity</b>   | <b>\$ 77,241,999</b> | <b>\$ 45,834,593</b> |
|  | <hr/>                | <hr/>                |

**CARACO PHARMACEUTICAL LABORATORIES, LTD.**  
(a subsidiary of Sun Pharmaceutical Industries Limited)

**STATEMENTS OF OPERATIONS**

|   | Year Ended<br>March 31, 2006 | Three<br>Months Ended<br>March 31, 2005 | Year Ended December 31 |                      |
|---|------------------------------|---|------------------------|----------------------|
|   |                              |   | 2004                   | 2003                 |
| Net sales   | \$ 82,788,918                | \$ 17,336,500                           | \$ 60,340,309          | \$ 45,498,400        |
| Cost of goods sold (Notes 1 and 4)                  | 41,872,834                   | 7,879,425                               | 24,441,569             | 19,507,406           |
| <b>Gross profit</b>                                 | <b>40,916,084</b>            | <b>9,457,075</b>                        | <b>35,898,740</b>      | <b>25,990,994</b>    |
| Selling, general and administrative expenses        | 8,182,718                    | 1,879,480                               | 5,276,755              | 7,363,341            |
| Research and development costs - affiliate (Note 7) | 35,055,360                   | 10,200,000                              | 24,397,040             | 3,103,370            |
| Research and development costs - other              | 8,437,338                    | 1,719,865                               | 6,053,334              | 3,112,294            |
| <b>Operating (loss) income</b>                      | <b>(10,759,332)</b>          | <b>(4,342,270)</b>                      | <b>171,611</b>         | <b>12,411,989</b>    |
| <b>Other income (expense)</b>                       |                              |   |                        |                      |
| Interest income                                     | 233,385                      | 16,385                                  | 40,316                 | 9,102                |
| Interest expense                                    | (3,740)                      |   | (407,330)              | (1,233,531)          |
| (Loss) gain on sale of equipment                    |                              |   | (10,636)               | 25,531               |
| Other income  | 106,375                      | 4,172                                   | 6,671                  | 9,627                |
| <b>Other income (expense) - net</b>                 | <b>336,020</b>               | <b>20,557</b>                           | <b>(370,979)</b>       | <b>(1,189,271)</b>   |
| <b>Net (loss) income</b>                            | <b>\$ (10,423,312)</b>       | <b>\$ (4,321,713)</b>                   | <b>\$ (199,368)</b>    | <b>\$ 11,222,718</b> |
| <b>Net (loss) income per share</b>                  |                              |   |                        |                      |
| Basic   | \$ (0.39)                    | \$ (0.16)                               | \$ (0.01)              | \$ 0.46              |
| Diluted   | \$ (0.39)                    | \$ (0.16)                               | \$ (0.01)              | \$ 0.44              |

The accompanying notes are an integral part of these financial statements.

**CARACO PHARMACEUTICAL LABORATORIES, LTD.**  
(a subsidiary of Sun Pharmaceutical Industries Limited)

**STATEMENTS OF STOCKHOLDERS EQUITY (DEFICIT)**

|   | Preferred Stock |            | Common Stock |               | Additional<br>Paid-in<br>Capital | Preferred<br>Stock<br>Dividends | Accumulated<br>Deficit | Total           |
|---|-----------------|------------|--------------|---------------|----------------------------------|---------------------------------|------------------------|-----------------|
|   | Shares          | Amount     | Shares       | Amount        |                                  |                                 |                        |                 |
| <b>Balances at January 1, 2003</b>  |                 | \$         | 23,762,532   | \$ 40,457,028 | \$ 282,858                       | \$ (350,380)                    | \$ (60,012,796)        | \$ (19,623,290) |
| Payment of preferred stock dividends  |                 |            |              |               |                                  | 350,380                         | (350,380)              |                 |
| Issuance of common stock to directors in lieu of cash compensation                    |                 |            | 31,000       | 112,310       |                                  |                                 |                        | 112,310         |
| Common stock options exercised  |                 |            | 784,296      | 872,973       | 2,435,877                        |                                 |                        | 3,308,850       |
| Net income  |                 |            |              |               |                                  |                                 | 11,222,718             | 11,222,718      |
| <b>Balances at December 31, 2003</b>  |                 |            | 24,577,828   | 41,442,311    | 2,718,735                        |                                 | (49,140,458)           | (4,979,412)     |
| Issuance of preferred stock to affiliate in exchange for product technology transfers | 4,352,000       | 27,500,410 |              |               |                                  |                                 |                        | 27,500,410      |
| Common stock options exercised  |                 |            | 1,756,866    | 3,453,946     |                                  |                                 |                        | 3,453,946       |
| Net loss  |                 |            |              |               |                                  |                                 | (199,368)              | (199,368)       |
| <b>Balances at December 31, 2004</b>  | 4,352,000       | 27,500,410 | 26,334,694   | 44,896,257    | 2,718,735                        |                                 | (49,339,826)           | 25,775,576      |
| Issuance of preferred stock to affiliate in exchange for product technology transfers | 1,632,000       | 10,200,000 |              |               |                                  |                                 |                        | 10,200,000      |
| Common stock options exercised  |                 |            | 25,600       | 31,730        |                                  |                                 |                        | 31,730          |
| Net loss  |                 |            |              |               |                                  |                                 | (4,321,713)            | (4,321,713)     |
| <b>Balances at March 31, 2005</b>   | 5,984,000       | 37,700,410 | 26,360,294   | 44,927,987    | 2,718,735                        |                                 | (53,661,539)           | 31,685,593      |
| Issuance of preferred stock to affiliate in exchange for product technology transfers | 4,896,000       | 35,055,360 |              |               |                                  |                                 |                        | 35,055,360      |
| Common stock options exercised  |                 |            | 61,700       | 60,610        |                                  |                                 |                        | 60,610          |
| Net loss  |                 |            |              |               |                                  |                                 | (10,423,312)           | (10,423,312)    |

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Balances at March 31,  
2006

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|            |               |            |               |              |                 |               |
|------------|---------------|------------|---------------|--------------|-----------------|---------------|
| 10,880,000 | \$ 72,755,770 | 26,421,994 | \$ 44,988,597 | \$ 2,718,735 | \$ (64,084,851) | \$ 56,378,251 |
|------------|---------------|------------|---------------|--------------|-----------------|---------------|

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The accompanying notes are an integral part of these financial statements.

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**CARACO PHARMACEUTICAL LABORATORIES, LTD.**  
(a subsidiary of Sun Pharmaceutical Industries Limited)

**STATEMENTS OF CASH FLOWS**

|   | Year Ended<br>March 31, 2006 | Three<br>Months Ended<br>March 31, 2005 | Year Ended December 31 |                    |
|---|------------------------------|---|------------------------|--------------------|
|   |                              |   | 2004                   | 2003               |
| <b>Cash flows from operating activities</b>   |                              |   |                        |                    |
| Net (loss) income   | \$ (10,423,312)              | \$ (4,321,713)                          | \$ (199,368)           | \$ 11,222,718      |
| Adjustments to reconcile net (loss) income to net cash provided by operating activities |                              |   |                        |                    |
| Depreciation  | 1,552,578                    | 306,626                                 | 932,419                | 683,339            |
| Capital stock issued or to be issued to affiliate in exchange for product formula       | 35,055,360                   | 10,200,000                              | 24,397,040             | 3,103,370          |
| Common shares issued in lieu of compensation  |                              |   |                        | 112,310            |
| Loss (gain) on sale of property, plant and equipment                                    |                              |   | 10,636                 | (25,531)           |
| Variable compensation expense for stock options extended to director and officer        |                              |   |                        | 2,435,877          |
| Changes in operating assets and liabilities which provided (used) cash                  |                              |   |                        |                    |
| Accounts receivable   | (14,122,321)                 | (2,133,911)                             | (64,393)               | 945,662            |
| Inventories   | (8,497,997)                  | (1,333,882)                             | (7,523,001)            | (3,994,848)        |
| Prepaid expenses and deposits   | (1,426,943)                  | (441,807)                               | (140,430)              | (90,716)           |
| Accounts payable  | 6,156,792                    | 2,300,793                               | 4,690,789              | 1,243,139          |
| Accrued expenses  | 557,954                      | 220,793                                 | (64,548)               | (126,829)          |
| <b>Net cash provided by operating activities</b>  | <b>8,852,111</b>             | <b>4,796,899</b>                        | <b>22,039,144</b>      | <b>15,508,491</b>  |
| <b>Cash flows from investing activities</b>   |                              |   |                        |                    |
| Purchases of property, plant and equipment  | (3,615,901)                  | (657,673)                               | (3,982,413)            | (2,493,173)        |
| Proceeds from sale of property, plant and equipment                                     |                              |   |                        | 76,200             |
| <b>Net cash used in investing activities</b>  | <b>(3,615,901)</b>           | <b>(657,673)</b>                        | <b>(3,982,413)</b>     | <b>(2,416,973)</b> |
| <b>Cash flows from financing activities</b>   |                              |   |                        |                    |
| Proceeds from loans payable to financial institutions                                   | 1,500,000                    |   | 10,000,000             | 1,600,000          |
| Repayments of loans payable to financial institutions                                   | (1,500,000)                  |   | (26,875,000)           | (625,000)          |
| Payment of preferred stock dividends  |                              |   |                        | (350,380)          |
| Net repayments of subordinated stockholder notes  |                              |   |                        | (9,700,000)        |
| Repayments of EDC loan  |                              |   | (6,385,490)            | (1,217,057)        |
| Proceeds from issuance of common stock  | 60,610                       | 31,730                                  | 3,453,946              | 872,973            |
| <b>Net cash provided by (used in) financing activities</b>                              | <b>60,610</b>                | <b>31,730</b>                           | <b>(19,806,544)</b>    | <b>(9,419,464)</b> |
| <b>Net increase (decrease) in cash and cash equivalents</b>                             | <b>5,296,820</b>             | <b>4,170,956</b>                        | <b>(1,749,813)</b>     | <b>3,672,054</b>   |
| Cash and cash equivalents, beginning of year  | 6,627,425                    | 2,456,469                               | 4,206,282              | 534,228            |

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|  |    |                   |    |                  |    |                  |    |                  |
|--|----|-------------------|----|------------------|----|------------------|----|------------------|
| Cash and cash equivalents, end of year | \$ | <u>11,924,245</u> | \$ | <u>6,627,425</u> | \$ | <u>2,456,469</u> | \$ | <u>4,206,282</u> |
|--|----|-------------------|----|------------------|----|------------------|----|------------------|

The accompanying notes are an integral part of these financial statements.

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**CARACO PHARMACEUTICAL LABORATORIES, LTD.**  
(a subsidiary of Sun Pharmaceutical Industries Limited)

**NOTES TO FINANCIAL STATEMENTS**

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**1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

*Organization and Nature of Business*

Caraco Pharmaceutical Laboratories, Ltd. ( Caraco or the Corporation ), based in Detroit, Michigan, develops, manufactures and markets generic, prescription and over-the-counter pharmaceuticals in the United States. The process of developing a line of proprietary drugs requires approvals by the Food and Drug Administration (FDA) of Abbreviated New Drug Applications (ANDA). The Corporation's present product portfolio consists of a number of products in various strengths and package sizes. The Corporation's drugs relate to a variety of therapeutic segments including the central nervous system, cardiology, pain management and diabetes.

The Corporation's manufacturing facility and executive offices were constructed in 1991, pursuant to a \$9.1 million loan from the Economic Development Corporation of the City of Detroit (the EDC ). Since August 1997, capital infusions and loans have primarily come from Sun Pharmaceutical Industries Limited, a specialty pharmaceutical corporation organized under the laws of India ( Sun Pharma ). Among other things, Sun Pharma has acted as a guarantor on loans to Caraco, has supplied the Corporation with raw materials for certain products, assisted in obtaining machinery and equipment to enhance production capacities at competitive prices, and has transferred certain generic products. As of June 3, 2006, Sun Pharma beneficially owns approximately 64% (75% including its convertible Series B Preferred stock) of the outstanding common shares of Caraco.

*Sun Pharmaceutical Industries Limited*

Pursuant to a stock purchase agreement, a Mumbai, India based specialty pharmaceutical manufacturing company, Sun Pharmaceutical Industries Limited ( Sun Pharma ) made an initial investment of \$7.5 million for the purchase of 5.3 million common shares of Caraco in 1997.

Sun Pharma and its affiliates have loaned the Corporation approximately \$10 million since August 1997. As of December 31, 2003, all such loans had been repaid. Sun Pharma has also assisted the Corporation, by acting as guarantor, in obtaining line of credit loans from ICICI Bank Limited, The Bank of Nova Scotia and Citibank FSB in the amounts of \$5.0 million, \$12.5 million and \$10.0 million, respectively, all of which have been repaid and terminated as of December 31, 2004.

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In August 1997, Caraco entered into an agreement, whereby Sun Pharma was required to transfer the technology formula for 25 generic pharmaceutical products over a five-year period through August 2003 in exchange for 544,000 shares of Caraco common stock for each technology transfer of an ANDA product (when bio-equivalency studies were successfully completed) and 181,333 shares for each technology transfer of a DESI (Drug Efficacy Study Implementation) product. The products provided to the Corporation from Sun Pharma were selected by mutual agreement. Under such agreement, Caraco conducted, at its own expense, all tests including bio-equivalency studies. Pursuant to such agreement through 2002, Sun Pharma delivered the technology formula for 13 products. This agreement expired on November 21, 2002, and the Corporation entered into a new technology transfer agreement with Sun Global, Inc. ( Sun Global ), an affiliate of Sun Pharma.

Under the agreement, which was approved by the Corporation's independent directors, Sun Global agreed to provide the formulations for 25 new generic drugs over a five-year period. Caraco's rights to the products are limited to the United States and its territories or possessions, including Puerto Rico. Sun Global retains rights to the products in all other territories. The products are selected by mutual agreement. Under this agreement, Caraco conducts at its own expense all tests, including bio-equivalency studies. The Corporation also markets the products consistent with its customary practices and provides marketing personnel. In return for the technology transfer, Sun Global receives 544,000 shares of Series B Preferred Stock for each generic drug transferred when such drug has passed its bio-equivalency studies.

The products agreement was amended by the Independent Committee, comprised of the three independent directors, in the first quarter of 2004 to eliminate the provision requiring that the Independent Committee concur in the selection of each product, and provides instead that each product satisfy certain objective criteria developed by management and approved by the Independent Committee. Pursuant to such objective criteria, all 25 of the products under this agreement have been selected, 20 of which passed bio-equivalency studies through March 31, 2006.

Sun Pharma has established Research and Development Centers in Mumbai and Vadodara in India, where the development work for products is performed.

Sun Pharma and its subsidiaries supply the Corporation with certain raw materials (Note 4) and formulations, assist in acquiring machinery and equipment to enhance production capacities, and provide qualified technical professionals who work as Caraco employees.



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Also, four of the nine directors of Caraco are, or were, affiliated with Sun Pharma. Further, Sun Pharma and its affiliates may use Caraco as a contract manufacturer and/or distributor of their products. In December 2004, Caraco entered into an agreement for two such products.

During the three month period ended March 31, 2005 SPARC Bioresearch Private Limited ( SPARC ), an affiliate of Sun Pharma, performed certain analytical studies required as part of the bio-equivalency process for two products. The Corporation incurred approximately \$172,000 of costs during this period for the studies performed by SPARC. No similar studies were performed by SPARC during the years ended March 31, 2006, December 31, 2004 or 2003.

While management has a basis to reasonably believe that Sun Pharma's substantial investment in Caraco provides Sun Pharma with sufficient economic incentive to continue to assist Caraco in developing its business, and Sun Pharma has expressed its intent to continue to support Caraco's operations in the near term, as it has done in the past, there can be no assurance that such support will, in fact, continue.

During the first quarter of 2004, Sun Pharma acquired 3,452,291 additional shares of common stock and 1,679,066 stock options from two former directors and a significant shareholder. Sun Pharma exercised these stock options during the fourth quarter of 2004, thereby increasing its beneficial ownership to 64%.

In addition to its substantial relationship with and dependence on Sun Pharma as described above, the Corporation is subject to certain risks associated with companies in the generic pharmaceutical industry. Profitable operations are dependent on the Corporation's ability to market its products at reasonable profit margins. In addition to maintaining profitable operations, the ongoing success of the Corporation will depend, in part, on its continuing ability to attract and retain key employees, obtain timely approvals of its ANDAs, and develop new products (see *Operations*, below).

***Operations***

The Corporation recorded net sales of \$82.8 million during for the year ended March 31, 2006 (Fiscal 2006) and generated cash from operations of \$8.9 million during Fiscal 2006. This cash was generated after funding working capital requirements of \$17.5 million. The Corporation incurred a net loss of \$10.4 million during Fiscal 2006. The loss was primarily due to non-cash research and development expense (R&D) of \$35.1 million recorded during Fiscal 2006. This non-cash R&D expense relates to nine

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products passing their bio-equivalency studies and the related value of the preferred stock issued to Sun Global during this period. At March 31, 2006, the Corporation had stockholders' equity of \$56.4 million.

Management's plans for fiscal 2007 include:

Continued focus on FDA compliance.

Increased pace of research and development activities, with a view to maximize ANDA filings.

Continuing to invest in equipment and facilities to expand capacity to meet requirements of projected growth in the near term.

Increased market share for certain existing products and recently introduced new products and enhanced customer reach and satisfaction.

Prompt introduction of newly approved products to the market.

Achieving further operational efficiencies by attaining economies of scale and cost reduction per unit.

Increase the number of products, as well as anticipated volume increases for existing products that, in turn, will improve manufacturing capacity utilization.

Expanding relationships with financial institutions to fortify the Corporation's credit position and borrowings as necessary.

Considering alternative ways of increasing cash, such as through marketing ANDAs owned by Sun Pharma

Research alternative product development sources and product licenses such as in licensing authorized generics from brand innovator companies and acquisitions of ANDAs from competitor manufacturers both domestic and abroad.

***Use of Estimates***

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the dates of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates. Significant estimates include, but are not limited to, provisions for estimated

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customer returns, discounts, rebates and other price adjustments, including customer chargebacks (see Revenue Recognition , below), valuation allowances for deferred tax assets, and valuation of overhead components in inventory.

***Cash and Cash Equivalents***

Cash and cash equivalents consist of demand deposits in banks, cash on hand and all highly liquid investments purchased with an original maturity of three months or less. The Corporation invests its excess cash primarily in deposits with major banks and in other high quality short-term liquid money market investments. During the normal course of business, the Corporation may maintain cash on deposit in excess of federally insured limits with financial institutions. The Corporation maintains a policy of making investments only with institutions with at least an investment grade credit rating.

***Revenue Recognition***

Revenue from product sales, net of estimated provisions, is recognized when there is persuasive evidence that an arrangement exists, shipment of the goods has occurred, the selling price is fixed or determinable, and collectibility is reasonably probable. The Corporation's customers consist primarily of large pharmaceutical wholesalers who sell directly into the retail channel. Provisions for sales discounts, and estimates for chargebacks, rebates, and product returns are established as a reduction of product sales revenue at the time revenues are recognized, based on historical experience and current market trends adjusted to reflect known changes in the factors that impact these reserves. These revenue reductions are reflected as a direct reduction to accounts receivable through an allowance.

***Allowances for Sales Adjustments***

**Chargebacks**

Chargebacks represent the Corporation's most significant provision against gross accounts receivable and related reduction to gross revenue. Chargebacks are credits given to wholesale customers for the price difference on the products they sell (at a contractual price) to retail, chain stores, and managed care organizations at prices lower than the Corporation sells to the wholesale customer. The Corporation records an estimate at the end of the reporting period to the wholesaler of the amount to be charged back to them, over and above those already received by the Corporation. Such estimated amounts, in addition to certain other deductions, are deducted from the Corporation's gross sales to

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determine their net revenues. The Corporation records provisions for chargebacks based upon various factors, including current contract prices, historical trends, and their future expectations. The amount of actual chargebacks claimed could be either higher or lower than the amounts accrued. Changes in these estimates, if any, are recorded in the income statement in the period of the change. If the Corporation has over or under estimated the amount that will ultimately be charged back to them by their wholesale customers, there could be a material impact on the Corporation's financial statements.

The Corporation considers the following factors in the determination of the estimates of chargebacks:

1. Historical data of chargebacks as a percentage of sales, as well as the various chargeback reports that are received from the wholesale customers.
2. Volume of product sold to wholesalers and the average chargeback rates, on a quarterly and annualized basis are applied to current period and annual product sales.
3. The sales trends for future estimated prices, wholesale acquisition cost (WAC), the contract prices with the retailers, chain stores and managed care organizations (end-users). The Corporation's prices with the wholesalers and end users are contracted prices.

Approximately 88% and 94% of the total allowance for trade receivables at March 31, 2006 and 2005, respectively has been established to provide for estimated chargebacks (see Note 3).

Shelf Stock Adjustments

Shelf stock adjustments are credits issued to customers to reflect decreases in the selling prices of products. These credits are customary in the industry and are intended to reduce the customers' inventory cost to better reflect current market prices. The determination to grant a shelf stock adjustment to a customer following a price decrease is at the Corporation's discretion.

Factors considered when recording a reserve for shelf stock adjustments include estimated launch dates of competing products based on market intelligence, estimated decline in market price of products based on historical experience and input from customers, and levels of inventory held by customers at the date of the pricing adjustments.

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Product Returns and Other Allowances

In the pharmaceutical industry, customers are normally granted the right to return product for credit if the product has not been used prior to its expiration date. The Corporation's return policy typically allows product returns for products within a 12-month window from six months prior to the expiration date and up to six months after the expiration date. The Corporation estimates the level of sales, which will ultimately be returned pursuant to its return policy, and records a related reserve at the time of sale. These amounts are deducted from its gross sales to determine net revenues. These estimates take into consideration historical returns of our products and the Corporation's future expectations. The Corporation periodically reviews the reserves established for returns and adjusts them based on actual experience, as necessary. The primary factors considered in estimating its potential product returns include shelf life of expiration date of each product and historical levels of expired product returns. If the Corporation becomes aware of any returns due to product related issues, this information is used to estimate an additional reserve. The amount of actual product return could be either higher or lower than the amounts reserved. Changes in these estimates, if any, would be recorded in the income statement in the period of the change. If the Corporation over or under estimates the quantity of product that will ultimately be returned, there may be a material impact to its financial statements.

Discounts (trade and prompt payment discounts) are reserved for at the end of every reporting period based on the gross sales made to the customers during the period and based on their terms of trade. The Corporation reviews its contracts with its customers in addition to historical data and percentages to estimate the reserve for estimated discounts.

Customer rebates are estimated at the end of every reporting period, based on direct or indirect purchases. If the purchases are direct, the rebates are recognized when products are purchased and a periodic credit is given. For indirect purchases, the rebates are recognized based on the terms with such customer. Medicaid Rebates are estimated based on the historical data the Corporation receives from the public sector benefit providers, which is based on the final dispensing of our products by a pharmacy to a benefit plan participant.

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***Doubtful Accounts***

Doubtful accounts are estimated based on the data available from external sources, including information obtained related to the financial condition of customers. Delinquent accounts are reviewed by management on a quarterly basis, to identify and record allowances, as considered necessary, for accounts receivable not expected to be recoverable.

***Accounts Receivable***

The Corporation sells its products using customary trade terms; the resulting accounts receivable are unsecured. Accounts receivable are stated at the amount management expects to collect from outstanding balances. The Corporation provides for probable uncollectible amounts through a charge to earnings and a credit to a valuation allowance based on management's assessment of the current status of individual accounts. Balances that are still outstanding after the Corporation has attempted reasonable collection efforts are written off through a charge to the valuation allowance and a credit to trade accounts receivable.

***Inventories***

Inventories, which consist principally of raw materials, goods in transit and finished goods, as well as work-in-process, are stated at the lower of cost, determined using the specific identification method, or market. The Corporation analyzes its inventory levels quarterly and writes down any inventory that has become obsolete and inventory that has a cost basis in excess of its expected net realizable value. Expired inventory is disposed of and the related costs are written off. Materials acquired for research and development on products yet to be launched are written off in the year of acquisition. The determination of whether or not inventory costs will be realizable requires estimates by management. A critical estimate in this determination is the estimate of the future expected inventory requirements, whereby the Corporation compares its internal sales forecasts to inventory on hand. Actual results may differ from those estimates and inventory write-offs may be required. The Corporation must also make estimates about the amount of manufacturing overhead to allocate to its finished goods and work in process inventories. Although the manufacturing process is generally similar for its products, the Corporation must make judgments as to the portion of costs to allocate to purchased product, work in process and finished goods, and such allocations can vary based upon the composition of these components and the fact that each product produced does not necessarily require the same amount of time or effort for the same production

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step. Accordingly, the assumptions made can impact the value of reported inventories and cost of sales.

***Net (Loss) Income Per Share***

Net (loss) income per share is computed using the weighted average number of common shares outstanding during each period and considers a dual presentation and reconciliation of basic and diluted per share amounts. Diluted reflects the potential dilution of all common stock equivalents.

At March 31, 2006 and 2005 and at December 31, 2004 options to purchase 341,400, 357,000 and 381,600 shares respectively, 10,880,000, 5,984,000 and 4,352,000 shares of convertible preferred stock, respectively and 45,000 shares of common stock granted to the Corporation's Chief Executive Officer during 2006 (Note 7) were excluded from the computation of earnings per share because they would have an antidilutive effect on net loss per share.

The following table sets forth the computation of basic and diluted (loss) income per common share:

|  | Year Ended<br>March 31 | Three Months<br>Ended March 31 | Year Ended<br>December 31 |               |
|--|------------------------|--------------------------------|---------------------------|---------------|
|  | 2006                   | 2005                           | 2004                      | 2003          |
| <b>Numerator:</b>  |                        |                                |                           |               |
| Net (loss) income available for common stockholders                | \$ (10,423,312)        | \$ (4,321,713)                 | \$ (199,368)              | \$ 11,222,718 |
| <b>Denominator:</b>  |                        |                                |                           |               |
| Weighted average shares outstanding, basic                         | 26,392,054             | 26,348,347                     | 24,734,282                | 24,137,108    |
| Incremental shares from assumed conversion of common stock options |                        |                                |                           | 1,344,851     |
| Weighted average shares outstanding, diluted                       | 26,392,054             | 26,348,347                     | 24,734,282                | 25,481,959    |
| <b>Net (loss) income per common share</b>                          |                        |                                |                           |               |
| Basic  | \$ (0.39)              | \$ (0.16)                      | \$ (0.01)                 | \$ .46        |
| Diluted  | \$ (0.39)              | \$ (0.16)                      | \$ (0.01)                 | \$ .44        |

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***Property, Plant and Equipment and Depreciation***

Property, plant and equipment is carried at cost less accumulated depreciation. Land is carried at cost. Depreciation is computed using the straight-line method over the estimated useful lives of the related assets, which range from 3 to 40 years. Major improvements and renewals are capitalized while ordinary maintenance and repairs are expensed. Management annually reviews these assets for impairment and reasonably believes the carrying value of these assets will be recovered through cash flows from operations.

***Federal Income Taxes***

Deferred income tax assets and liabilities are determined based on the difference between the financial statement and federal income tax basis of assets and liabilities as measured by the estimated tax rates that will be in effect when these differences reverse. The principal difference between assets and liabilities for financial statement and federal income tax return purposes is attributable to accounts receivable allowances and the anticipated utilization of tax net operating losses.

***Research and Development Costs***

Series B convertible preferred stock (Note 7) is issued on an ongoing basis to Sun Pharma and its affiliates under the Products Agreement between the Corporation and Sun Global in exchange for the formulations of technology products delivered by Sun Global to the Corporation. The resulting amount of research and development expense is charged to operations and is determined based on the fair value of the preferred shares on the date the respective product formula passes its bio-equivalency studies. The fair value of such shares is based upon an independent valuation.

Research and development costs settled in cash are charged to expense as incurred.

***Common Stock Issued to Directors***

Common stock was issued from time to time in lieu of cash for directors fees, and was recorded as compensation expense at the fair values of such shares on the dates they were earned. Subsequent to December 31, 2003, directors' fees are paid in cash. Also, since December 31, 2003, independent directors are granted stock options upon completion of their anniversary of serving on the board of directors.



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***Fair Values of Financial Instruments***

The carrying values of cash equivalents, accounts receivable, and accounts payable approximate their fair values due to the short-term maturities of these financial instruments.

***Recent Accounting Pronouncements***

In July 2005, the *Financial Accounting Standards Board* ( FASB ) published an Exposure Draft of a proposed Interpretation, *Accounting for Uncertain Tax Positions*. The Exposure Draft seeks to reduce the significant diversity in practice associated with recognition and measurement in the accounting for income taxes. It would apply to all tax positions accounted for in accordance with *Statement of Financial Accounting Standards* ( SFAS ) 109, *Accounting for Income Taxes*. The Exposure Draft requires that a tax position meet a probable recognition threshold for the benefit of the uncertain tax position to be recognized in the financial statements. This threshold is to be met assuming that the tax authorities will examine the uncertain tax position. The Exposure Draft contains guidance with respect to the measurement of the benefit that is recognized for an uncertain tax position, when that benefit should be derecognized, and other matters. This proposed Interpretation would clarify the accounting for uncertain tax positions in accordance with SFAS 109. This Interpretation, once approved, is expected to be effective as of the end of the fiscal year ending after December 15, 2005. The Corporation does not expect that the exposure draft will have a significant impact on its operating results.

In May 2005, the FASB issued SFAS 154, *Accounting Changes and Error Corrections*, which replaces APB Opinion No. 20, *Accounting Changes*, and supersedes FASB Statement No. 3, *Reporting Accounting Changes in Interim Financial Statements* an amendment of APB Opinion No. 28. SFAS 154 requires retrospective application to prior periods financial statements of changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. When it is impracticable to determine the period-specific effects of an accounting change on one or more individual prior periods presented, SFAS 154 requires that the new accounting principle be applied to the balances of assets and liabilities as of the beginning of the earliest period for which retrospective application is practicable and that a corresponding adjustment be made to the opening balance of retained earnings for that period rather than being reported in an income statement. When it is impracticable to determine the cumulative effect of applying a change in accounting principle to all prior periods, SFAS 154 requires that the new accounting principle be applied as if it were

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adopted prospectively from the earliest date practicable. SFAS 154 shall be effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The Corporation does not expect that the provisions of the SFAS 154 will have a significant impact on its operating results.

The FASB has proposed amending SFAS 128, Earnings per Share, to make it consistent with International Accounting Standard 33, Earnings per Share, and make earning per share, or EPS, computations comparable on a global basis. Under the proposed amendment, the year-to-date EPS computation would be performed independently from the quarterly computations. Additionally, for all contracts that may be settled in either cash or shares of stock, companies must assume that settlement will occur by the issuance of shares for purposes of computing diluted EPS, even if they intend to settle by paying cash or have a history of cash-only settlements, regardless of who controls the means of settlement. Lastly, under the proposed amendment, shares that will be issued upon conversion of a mandatory convertible security must be included in the weighted-average number of shares outstanding used in computing basic EPS from the date that conversion becomes mandatory, using the if-converted method, regardless of whether the result is anti-dilutive. The proposed amended standard was expected to be issued during the first quarter of 2005. However, the FASB has not yet finalized the revised effective date of the proposed amendment or its transition provisions. Retrospective application in all periods presented would be required and could require the restatement of previously reported EPS. The Corporation does not expect that the provisions of the amended SFAS 128 will have a significant impact on its operating results.

In December 2004, the FASB issued SFAS 123R (revised 2004), Share-Based Payment, (SFAS 123R). SFAS 123R addresses the accounting for share-based payments to employees, including grants of employee stock options. Under the new standard, Caraco will no longer be able to account for share-based compensation transactions using the intrinsic method in accordance with APB Opinion No. 25, Accounting for Stock Issued to Employees. Instead, Caraco will be required to account for such transactions using a fair-value method and recognize the expense in the statement of operations. On April 14, 2005, the Securities and Exchange Commission announced the adoption of a new rule that amends the compliance dates for SFAS 123 (R). The new rule allows companies to implement SFAS 123 (R) at the beginning of their next fiscal year, instead of their next reporting period beginning after June 15, 2005. The Corporation plans to adopt the new statement beginning in the first quarter of fiscal 2007. The Corporation expects that the adoption of SFAS 123R will not have a significant impact on its results of operations, nor does it expect that the adoption of SFAS 123R will impact its overall financial position.

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However, the calculation of compensation cost for share-based payment transactions after the effective date of SFAS 123R may be different from the calculation of compensation cost under SFAS 123, but such differences have not yet been quantified.

In December 2004, the FASB issued SFAS 153 Exchanges of Nonmonetary Assets, and Amendment of APB Opinion No. 29. The guidance in APB Opinion No. 29, Accounting for Nonmonetary Transactions, is based on the principle that exchanges of nonmonetary assets should be measured based on the fair value of the assets exchanged. The guidance in APB Opinion No. 29, however, included certain exceptions to the principle. SFAS 153 amends APB Opinion No. 29 to eliminate the exception for nonmonetary exchanges of similar productive assets and replaces it with a general exception for exchanges of nonmonetary assets that do not have commercial substance. A nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. SFAS 153 is effective for nonmonetary asset exchanges in fiscal periods beginning after June 15, 2005. The Corporation does not believe that the adoption of SFAS 153 will have a material impact on its results of operations or financial position.

**2. SUPPLEMENTAL CASH FLOWS INFORMATION**

*Non-Cash Financing Activities*

As described in Notes 1 and 7, pursuant to the technology transfer agreement with an affiliate of the Corporation's parent, Caraco, on an ongoing basis, finances the acquisition of research and development costs in exchange for the issuance of preferred stock to its parent. Preferred stock earned or issued to affiliates had fair values of \$35,055,360 for the year ended March 31, 2006, \$10,200,000 for the three month period ended March 31, 2005, and \$24,397,040 and \$3,103,370 for the years ended December 31, 2004 and 2003, respectively.

*Other Cash Flows Information*

Cash paid for interest was approximately \$4,000, \$407,000 and \$1,783,000 for the years ended March 31, 2006, December 31, 2004 and 2003, respectively. No cash was paid for interest for the three month period ended March 31, 2005.

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**3. ACCOUNTS RECEIVABLE, NET OF ALLOWANCES FOR SALES ADJUSTMENTS AND DOUBTFUL ACCOUNTS (NOTE 1)**

Accounts receivable and related allowances are summarized as follows:

|  | March 31      |               |
|--|---------------|---------------|
|  | 2006          | 2005          |
| Accounts receivable - gross            | \$ 33,926,099 | \$ 27,766,778 |
| Allowances:                            |               |               |
| Chargebacks                            | 11,467,000    | 19,810,000    |
| Sales returns and allowances           | 1,500,000     | 1,120,000     |
| Doubtful accounts                      | 100,000       | 100,000       |
| Total allowances                       | 13,067,000    | 21,148,000    |
| Accounts receivable, net of allowances | \$ 20,859,099 | \$ 6,736,778  |

A summary of the activity in accounts receivable allowances is as follows:

|                                     | Total<br>Allowances |
|-------------------------------------|---------------------|
| <b>Balance at December 31, 2002</b> | <b>\$ 9,305,000</b> |
| Additions charged to net sales      | 56,515,000          |
| Deductions allowed to customers     | (49,777,000)        |
| <b>Balance at December 31, 2003</b> | <b>16,043,000</b>   |
| Additions charged to net sales      | 67,670,000          |
| Deductions allowed to customers     | (65,578,000)        |
| <b>Balance at December 31, 2004</b> | <b>18,135,000</b>   |
| Additions charged to net sales      | 21,712,000          |
| Deductions allowed to customers     | (18,817,000)        |
| <b>Balance at March 31, 2005</b>    | <b>21,130,000</b>   |
| Additions charged to net sales      | 118,996,000         |
| Deductions allowed to customers     | (126,959,000)       |

|                                  |                      |
|----------------------------------|----------------------|
| <b>Balance at March 31, 2006</b> | <b>\$ 13,067,000</b> |
|----------------------------------|----------------------|

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**4. INVENTORIES**

Inventories consist of the following amounts:

|                  | March 31      |               |
|------------------|---------------|---------------|
|                  | 2006          | 2005          |
| Raw materials    | \$ 9,735,502  | \$ 5,504,006  |
| Goods in transit | 5,974,600     | 3,700,651     |
| Work in process  | 3,283,911     | 2,607,903     |
| Finished goods   | 7,971,677     | 6,655,133     |
|                  | \$ 26,965,690 | \$ 18,467,693 |

The principal components used in the Corporation's business are active and inactive pharmaceutical ingredients and certain packaging materials. Some of these components are purchased from single sources, however, the majority of the components have an alternate source of supply. Because the FDA approval process requires manufacturers to specify their proposed supplier of components in their applications, FDA approval of a new supplier would be required if components were no longer available from the specified suppliers.

During the year ended March 31, 2006, the three months ended March 31, 2005, and during the years ended December 31, 2004 and 2003, the Corporation purchased inventory components of approximately \$28.1 million, \$5.3 million, \$16.7 million and \$10.3 million, respectively, from Sun Pharma.

**5. DEBT**

*EDC Loan*

During 2004, the Corporation repaid the entire amount due to the EDC under the Development and Loan Agreement dated August 10, 1990.

*Loans Payable to Financial Institutions*

During 2004, the Corporation obtained a \$10,000,000 line-of-credit with Citibank, N.A., that incurred interest at the London Interbank Offered Rate (LIBOR) plus 125 basis points. Borrowings on the line-of-credit were available to Caraco only when secured by an irrevocable standby letter-of-credit from Sun Pharma. Such a letter was provided by

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Sun Pharma during 2004. The letter had expired as of December 31, 2004, and was terminated on March 15, 2005.

On November 17, 2005, the Corporation entered into a one-year, \$10 million Credit Agreement with JP Morgan Chase Bank, N.A. Under the Credit Agreement, the lender may make loans and issue letters of credit to the Corporation for the Corporation's working capital needs and general corporate purposes. Letters of credit, if issued, expire one year from their date of issuance, but no later than November 17, 2007. Borrowings are secured by the Corporation's receivables and inventory. Interest is payable based on a LIBOR Rate or an alternate base rate (determined by reference to the prime rate or the federal funds effective rate), as selected by the Corporation. The rate of interest is LIBOR plus 75 basis points or the bank's prime rate minus 100 basis points (effective rates of 6.0% and 6.75%, respectively at March 31, 2006.) The Credit Agreement requires that certain financial covenants be met on a quarterly basis. The Corporation is in compliance with these financial covenants at March 31, 2006. There are no borrowings under this Credit Agreement at March 31, 2006.

**6. INCOME TAXES**

The Corporation's deferred income taxes result principally from its net operating loss carryforwards. At March 31, 2006 a net deferred income tax asset of approximately \$20.1 million (computed using a 34% tax rate) relating to these temporary differences exists. Based on the Corporation's prior operating results and operating characteristics, utilization of this deferred tax asset to offset future taxable income is not reasonably assured. Accordingly, Caraco has recorded a valuation allowance to fully offset the net deferred tax asset, resulting in no net deferred tax asset or liability in the accompanying balance sheets. The valuation allowance increased by approximately \$3.7 million for the year ended March 31, 2006, \$2.0 million for the three month period ended March 31, 2005, \$0.4 million in 2004, and decreased by approximately \$4.1 million in 2003.

At March 31, 2006, net operating loss carryforwards of approximately \$58.8 million, which expire between 2007 and 2017, are available to offset future federal taxable income, if any. Sun Pharma has, over time, increased its ownership of the Corporation's capital stock. Under rules established by the Internal Revenue Code, this change in ownership may adversely affect how the Corporation is able to utilize these net operating loss carryforwards in future years.

**CARACO PHARMACEUTICAL LABORATORIES, LTD.**  
(a subsidiary of Sun Pharmaceutical Industries Limited)

**NOTES TO FINANCIAL STATEMENTS**

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**7. STOCKHOLDERS EQUITY (DEFICIT)**

*Common Stock*

During 2003, the Corporation's shareholders approved the authorization of an additional 20,000,000 shares of common stock. The Corporation has not yet filed an amendment to its articles of incorporation to effect this change.

The Corporation granted 45,000 shares of common stock on May 2, 2005 to its Chief Executive Officer, which vest at a rate of 15,000 shares on each anniversary date until they are fully vested on May 2, 2008. The Corporation has recorded compensation expense of approximately \$109,000 related to the portion of the stock grant that vested during fiscal 2006.

*Preferred Stock*

Accrued dividends of \$0.4 million on Series A preferred shares were paid during 2003, and the holder, then a Corporation director, converted all Series A outstanding shares into an equivalent number of common shares. Accordingly, at March 31, 2006 and 2005, no Series A shares remain designated.

In November 2002, in connection with the new technology transfer agreement established with Sun Global (Note 1), the Corporation designated the Series B Convertible Preferred Stock. The Series B preferred shares are non-redeemable and have no par value. In addition, the Series B Convertible Preferred Stock has no voting or dividend rights or liquidation preference other than priority liquidation based on their values on the dates they were earned, and can be converted after three years from the issuance date (or immediately upon a change in control) into one share of common stock, subject to a conversion adjustment (Note 1). While such preferred shares are outstanding, Caraco cannot, without the consent of the holders of a majority of the outstanding shares of the preferred stock, amend or repeal its articles of incorporation or bylaws if such action would adversely affect the rights of the preferred stock. In addition, without such consent, capital stock having any preference or priority superior to the preferred stock may not be issued. As of March 31, 2006, the Corporation has issued 10,880,000 shares of the Series B Convertible Preferred stock to Sun Pharma in exchange for twenty product transfers. Such shares have been cumulatively valued at \$72,755,770 million as of March 31, 2006.



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**NOTES TO FINANCIAL STATEMENTS**

**8. COMMON STOCK OPTIONS**

*Common Stock Option Plans*

As of March 31, 2006, the Corporation maintains one stock option plan, the 1999 Equity Participation Plan (the 1999 Plan ) (all options under the 1993 plan were exercised during 2003, under which the Corporation may grant options to employees and non-employee-directors for the purchase of up to 3,000,000 shares of common stock.) The exercise price of options granted may not be less than the fair value of the common stock on the date of grant. Options granted under this plan generally vest in annual installments, from the date of grant, over a five-year period, and expire within six years from the date of the grant. Activity with respect to these options is summarized as follows:

|  | Year Ended<br>March 31, |  | Three Months Ended<br>March 31 |  | Year Ended December 31, |  |           |  |
|--|-------------------------|--|--------------------------------|--|-------------------------|--|-----------|--|
|  | 2006                    |  | 2005                           |  | 2004                    |  | 2003      |  |
|  | Shares                  | Weighted<br>Average<br>Exercise<br>Price | Shares                         | Weighted<br>Average<br>Exercise<br>Price | Shares                  | Weighted<br>Average<br>Exercise<br>Price | Shares    | Weighted<br>Average<br>Exercise<br>Price |
| Outstanding,<br>beginning of year      | 160,500                 | 1.68                                     | 181,600                        | 1.41                                     | 277,000                 | \$ 1.00                                  | 687,138   | \$ 1.04                                  |
| Granted                                | 46,000                  | 8.39                                     | 4,500                          | 9.60                                     | 9,000                   | 9.60                                     |           |  |
| Exercised                              | (61,700)                | 0.98                                     | (25,600)                       | 1.24                                     | (80,400)                | 1.08                                     | (410,138) | 0.97                                     |
| Terminated                             | (3,400)                 | 9.30                                     |                                |  | (24,000)                | 0.80                                     |           |  |
| Outstanding, end<br>of year            | 141,400                 | \$ 3.93                                  | 160,500                        | \$ 1.67                                  | 181,600                 | \$ 1.41                                  | 277,000   | \$ 1.00                                  |
| Options<br>exercisable, end<br>of year | 71,720                  | \$ 1.32                                  | 79,418                         | \$ 1.50                                  | 49,800                  | \$ 1.02                                  | 102,500   | \$ 1.07                                  |

Options at March 31, 2006:

| Range of Exercise Prices | Options Outstanding |                                    |                     | Options Exercisable |                     |
|--------------------------|---------------------|------------------------------------|---------------------|---------------------|---------------------|
|                          | Shares              | Remaining<br>Contractual<br>Life * | Exercise<br>Price * | Shares              | Exercise<br>Price * |
| \$0.68 to \$1.00         | 60,400              | 1.2                                | \$ 0.78             | 48,320              | \$ 0.78             |
| \$1.01 to \$2.00         | 25,000              | 1.7                                | 1.25                | 20,000              | 1.25                |
| \$7.01 to \$8.00         | 1,500               | 5.0                                | 7.90                | 300                 | 7.90                |
| \$8.01 to \$9.00         | 47,500              | 5.2                                | 8.41                | 300                 | 8.76                |
| \$9.01 to \$10.00        | 7,000               | 3.8                                | 9.55                | 2,800               | 9.55                |

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|       |                |            |                |               |                |
|-------|----------------|------------|----------------|---------------|----------------|
| Total | <u>141,400</u> | <u>2.8</u> | <u>\$ 3.93</u> | <u>71,720</u> | <u>\$ 1.32</u> |
|-------|----------------|------------|----------------|---------------|----------------|

\*Weighted average

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**CARACO PHARMACEUTICAL LABORATORIES, LTD.**  
(a subsidiary of Sun Pharmaceutical Industries Limited)

**NOTES TO FINANCIAL STATEMENTS**

***Other Common Stock Option Agreements***

The Corporation has issued other stock options outside of the 1999 Plan. These stock options have been issued with various vesting schedules and expire at various dates through October 2006. Activity with respect to these options is summarized as follows:

|  | Year Ended<br>March 31 |  | Three Months Ended<br>March 31 |  | Year Ended December 31 |  |           |  |
|--|------------------------|--|--------------------------------|--|------------------------|--|-----------|--|
|  | 2006                   |  | 2005                           |  | 2004                   |  | 2003      |  |
|  | Shares                 | Weighted<br>Average<br>Exercise<br>Price | Shares                         | Weighted<br>Average<br>Exercise<br>Price | Shares                 | Weighted<br>Average<br>Exercise<br>Price | Shares    | Weighted<br>Average<br>Exercise<br>Price |
| Outstanding,<br>beginning of period      | 200,000                | \$ 3.50                                  | 200,000                        | \$ 3.50                                  | 1,876,666              | \$ 2.01                                  | 2,250,824 | \$ 2.00                                  |
| Exercised                                |                        |  |                                |  | (1,676,666)            | 2.01                                     | (374,158) | 1.16                                     |
| Outstanding, end of<br>period            | 200,000                | \$ 3.50                                  | 200,000                        | \$ 3.50                                  | 200,000                | \$ 3.50                                  | 1,876,666 | \$ 2.01                                  |
| Options<br>exercisable, end of<br>period | 200,000                | \$ 3.50                                  | 200,000                        | \$ 3.50                                  | 200,000                | \$ 3.50                                  | 1,876,666 | \$ 2.01                                  |

Options at March 31, 2006:

| Range of Exercise Prices | Options Outstanding and Exercisable |                                  |                   |
|--------------------------|-------------------------------------|----------------------------------|-------------------|
|                          | Shares                              | Remaining<br>Contractual<br>Life | Exercise<br>Price |
| \$3.01 to \$4.00         | 200,000                             |                                  | \$ 3.50           |

The Corporation follows only the disclosure aspects of Statement of Financial Accounting Standards (SFAS) No. 123, Accounting for Stock-Based Compensation. Management believes that the fair value and pro-forma disclosures, required by SFAS No. 123, are not material to the financial statements. The Corporation continues to apply Accounting Principles Board (APB) Opinion No. 25 in accounting for its plan and, accordingly, no compensation cost has generally been recognized in the financial statements for its outstanding stock options. Options to purchase 46,000, 4,500 and 9,000 shares of common stock were granted for the year ended March 31, 2006, the three month period ended March 31, 2005 and the year ended December 31, 2004, respectively, to the independent directors of the Corporation. No options were granted during 2003.

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In December 2001, the Board of Directors extended the exercise date to December 31, 2005 with respect to options for 224,158 shares of Caraco common stock previously granted to a then independent director. Variable compensation expense of \$2.1 million

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**CARACO PHARMACEUTICAL LABORATORIES, LTD.**  
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**NOTES TO FINANCIAL STATEMENTS**

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and \$0.3 million triggered by the extension was recorded during 2003 and 2002 in recognition of this modification.

On October 2, 2003, the Corporation entered into a severance agreement with its former Chief Executive Officer. The agreement allowed vesting of options for the purchase of 40,000 common shares held by the former officer to be accelerated. The modification resulted in the options being treated as variable rather than fixed in accordance with Financial Accounting Standards Board Interpretation 44 (FIN 44). As a result variable compensation expense of \$0.3 million was charged to operations during 2003 for the difference between the fair value of the underlying common stock and the exercise price of the respective options.

The options modified for the independent director and for the former officer were exercised during 2003 resulting in an increase to additional paid in capital of \$2.4 million during 2003.

The Corporation granted options to purchase 40,000 shares of common stock on May 2, 2005 to its Chief Executive Officer, which vest at a rate of 15,000 shares on each anniversary date until they are fully vested on May 2, 2008.

***Strategic Alliance Stock Options Agreement***

Pursuant to an agreement between the Corporation and an unaffiliated large generic pharmaceutical Corporation, dated October 1, 1993, the Corporation was to receive the formulations, technology, manufacturing processes and know-how, and other relevant information, and to pay for the bio-equivalency studies required for the preparation of ANDAs for two products. Pursuant to the agreement, the Corporation was required to pay (i) a Sign-Up Option to purchase 100,000 shares of Common Stock at \$3.50 per share; and (ii) a Product Option to purchase shares to an exercise price of \$3.50 per share. These options may be exercised and payment for shares may be made only out of royalties and any interest earned on the royalties while held by the Corporation. No options have yet been exercised (Note 12).

**9. LEASES (INCLUDING RELATED PARTY)**

The Corporation entered into two non-cancelable operating leases during 2000 with Sun Pharma to lease production machinery. The leases each required quarterly rental payments of \$4,245 and expired during 2005.

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The Corporation entered into a non-cancelable operating lease with an unrelated party during 2002 to lease additional warehouse space. This lease was subsequently modified during 2003 in lieu of a new non-cancelable operating lease for additional space at this warehouse. The new lease requires monthly payments that increase from \$15,458 to \$16,892 over the term of the lease that expires in 2007 with an option to renew for an additional year.

Net rental expense on these operating leases was \$224,569 for the year ended March 31, 2006, \$64,896 for the three months ended March 31, 2005 and \$181,129 and \$176,065 for the years ended December 31, 2004 and 2003, respectively.

The Corporation entered into a non-cancelable operating lease with an unrelated party on March 13, 2006 to obtain additional space for its administrative staff. The lease commences in May 2006 and requires monthly payments that increase from \$8,481 to \$9,066 over the term of the lease that expires in 2009.

The following is a schedule of annual future minimum lease payments required under the operating leases with remaining non-cancelable lease terms in excess of one year as of March 31, 2006:

| Year              | Amount            |
|-------------------|-------------------|
| <u>          </u> | <u>          </u> |
| 2007              | 293,046           |
| 2008              | 104,992           |
| 2009              | 63,171            |

The Corporation also paid approximately \$0.2 million for the year ended March 31, 2006, \$0.1 million for the three month period ended March 31, 2005, respectively, and \$0.6 million and \$0.5 million to Sun Pharma during the years ended December 31, 2004 and 2003, respectively, for the purchase of various parts and machinery needed for operations.

**10. RETIREMENT PLAN**

The Corporation maintains a deferred compensation plan qualified under Section 401(k) of the Internal Revenue Code. Under this plan, eligible employees are permitted to contribute up to the maximum allowable amount determined by the Internal Revenue Code. The Corporation may make discretionary matching and profit sharing

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**NOTES TO FINANCIAL STATEMENTS**

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contributions under the provisions of the Plan. The Corporation made no discretionary contributions during the year ended March 31, 2006, the three months ended March 31, 2005, or for the years ended December 31, 2004 or 2003.

**11. CONCENTRATIONS AND COMMITMENTS**

***Major Customers***

Shipments to three wholesalers accounted for approximately 77% of gross revenue for the year ended March 31, 2006, 60% of gross revenue for the three months ended March 31, 2005 and 79% and 80% of gross revenue for the years ended December 31, 2004 and 2003, respectively. Balances due from these customers represented approximately 72% and 77% of gross accounts receivable at March 31, 2006 and 2005, respectively.

The loss of these customers could have a materially adverse effect on short-term operating results.

***Major Products***

Shipments of three products accounted for approximately 80% of gross revenue for the year ended March 31, 2006, 74% of gross revenue for the three months ended March 31, 2005 and 80% of gross revenue for the year ended December 31, 2004, respectively. Shipments of two products accounted for approximately 87% of gross revenue for the year ended December 31, 2003.

Approximately 84% of raw material purchases for the year ended March 31, 2006 and for the three months ended March 31, 2005 were made from Sun Pharma. Approximately 75% and 73% of Caraco's raw material purchases for the years ended December 31, 2004 and 2003, respectively, were made from Sun Pharma.

***Product Sales Commitment***

Certain of the Corporation's customers purchase its products through designated wholesalers, who act as an intermediary distribution channel for the Corporation's products. One such customer, the Veterans Administration, an agency of the United States Government, entered into a sales contract with the Corporation effective August 5, 2002 to purchase approximately \$13,000,000 of product per year over a one year base contract period that ended June 30, 2003. The contract has four one-year option periods,

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**NOTES TO FINANCIAL STATEMENTS**

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the first three of which were exercised. The agreement may be terminated by the purchaser without cause and in such case, Caraco would only be entitled to a percentage of the contract price, plus reasonable charges that have resulted from the termination. The agreement further provides for certain penalty provisions if the Corporation is unable to meet its sales commitment.

***Labor Contract***

The majority of the Corporation's hourly work force is covered by a collective bargaining agreement that expires in September 2008.

**12. OTHER MATTERS**

***Employment Contracts***

The Corporation has employment agreements with four of its executive officers that provide for fixed annual salaries and at least a six-month continuance including insurance benefits and immediate vesting of stock options upon termination without cause.

***Litigation***

As previously disclosed, on June 9, 2005, Novo Nordisk A/S and Novo Nordisk, Inc. ( Novo Nordisk ) filed a complaint in the United States District Court for the Eastern District of Michigan alleging that the Corporation's filing of an ANDA seeking approval to market its generic version of Novo Nordisk's Prandin® drug product infringed Novo Nordisk's patent, which expires June 12, 2018. Novo Nordisk seeks an order from the Court which, among other things, directs the FDA not to approve Caraco's ANDA any earlier than the claimed expiration date. The ANDA filed by Caraco contains a Paragraph IV certification challenging the Novo Nordisk patent. The corporation believes that the Novo Nordisk patent is invalid and/or will not be infringed by Caraco's manufacture, use or sale of the product, and the corporation intends to vigorously defend this action in order to capitalize on the potential 180 days of marketing exclusivity available for this product.

As previously disclosed, on September 22, 2004, Ortho-McNeil Pharmaceutical, Inc. ( Ortho-McNeil ) filed a complaint in the United States District Court for the Eastern District of Michigan alleging that the Corporation's filing of an ANDA seeking approval to market its generic version of Ortho-McNeil's Ultracet® drug product infringed Ortho-



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McNeil's patent, which expires on September 6, 2011. Ortho-McNeil seeks an order from the Court which, among other things, directs the FDA not to approve Caraco's ANDA any earlier than the claimed expiration date. The ANDA filed by Caraco contained a Paragraph IV Certification challenging the Ortho-McNeil patent. The corporation believes that the Ortho-McNeil patent is invalid and/or will not be infringed by Caraco's manufacture, use or sale of the product, and the corporation intends to vigorously defend this action. Since this action, Ortho-McNeil has entered into a license agreement with another manufacturer and has launched its product generically while another manufacturer has launched its approved generic at risk. On October 8, 2005, arguments were heard in the US District Court in the Eastern District of Michigan, on the Corporation's motion for summary judgment on the issue of non-infringement. On October 19, 2005 the motion for summary judgment was granted in the Corporation's favor. On December 19, 2005, the FDA approved the manufacture, use and sale of the product. Ortho-McNeil has filed an appeal of the finding of non-infringement by the Eastern District of Michigan. Additionally, the United States Patent and Trademark Office has allowed Ortho-McNeil's request for a reissue patent that, if issued, Ortho-McNeil could contend that its product will be infringed by Caraco's now-marketed product. The corporation believe that, like its original patent, Ortho-McNeil's reissue patent will be invalid and unenforceable.

As previously disclosed, on February 12, 2003, C. Arnold Curry filed a complaint in the Wayne County Circuit Court alleging breach of a written employment agreement. Dr. Curry sought 175,000 shares of the Corporation's common stock (35,000 shares for each of the first five ANDAs approved by the FDA). The corporation and the plaintiff each filed a motion for summary disposition. Both parties' motions were denied, and the parties submitted the matter to binding arbitration. In connection with the submission to arbitration, the parties agreed that Mr. Curry would receive a minimum of 15,000 shares of common stock. On April 20, 2006, the arbitrator entered a determination of no cause of action against Mr. Curry and in favor of the Corporation, thus capping the Corporation's liability to Mr. Curry at 15,000 shares. The Corporation has recorded an expense of approximately \$116,000 related to the 15,000 shares earned by Mr. Curry.

The Corporation is involved in certain legal proceedings from time to time incidental to normal business activities. While the outcome of any such proceedings cannot be accurately predicted, the Corporation does not believe the ultimate resolution of any existing matters would have a material adverse effect on its financial position or results of operations.

**CARACO PHARMACEUTICAL LABORATORIES, LTD.**  
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**NOTES TO FINANCIAL STATEMENTS**

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***Product Liability and Insurance***

The Corporation currently maintains general and product liability insurance, with coverage limits of \$10 million per incident and in the aggregate. The Corporation also maintains special product liability insurance coverage for one of its products with coverage limits of \$1 million per incident and in the aggregate. The Corporation's insurance policies provide coverage on a claim made basis and are subject to annual renewal. Such insurance may not be available in the future on acceptable terms or at all. There can be no assurance that the coverage limits of such policies will be adequate to cover the Corporation's liabilities, should they occur.

***Royalty Accrual***

Pursuant to the Strategic Alliance Stock Options Agreement (Note 8), Caraco received the formulation for one product, Metoprolol Tartrate, in March 1995. However, Caraco has determined that the formula provided to it with respect to Metoprolol Tartrate is different than the formula submitted in an ANDA to the FDA in 1995, approved by the FDA in 1996 and manufactured and introduced by Caraco since 1997. The Corporation has accrued royalties of approximately \$1 million, which is included with accrued expenses in the accompanying balance sheets at March 31, 2006 and 2005, and since April 2003, has discontinued to accrue royalties related to this agreement.

***Subsequent Transactions With and Relating to Sun Pharma***

On June 1, 2006 Sun Global earned 544,000 shares of Series B preferred stock pursuant to the products transfer agreement for one product transfer (Note 1).

**13. SEGMENT INFORMATION**

The Corporation does not manufacture, produce or sell branded products or controlled-release products. The Corporation is primarily in the business of manufacturing, developing, selling and distributing various therapeutic classes of solid oral dosage of generic pharmaceuticals. There are no separate management teams or individuals assigned to a product or products or therapeutic classes of products, no separate allocation of funds or resources to distinct products or products or therapeutic classes or products, and the performance of any individual product or products or therapeutic classes of products is not separately assessed. The Corporation revenues are solely based on the receipt of customers' orders.

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**NOTES TO FINANCIAL STATEMENTS**

SFAS No. 131, Disclosures About Segments of an Enterprise and Related Information establishes standards for reporting of financial information about operating segments in annual financial statements. The Corporation considers its business to be a single segment entity, as its revenues are solely attributable to its generic drug product line.

For informational purposes, the Corporation's sales, grouped by therapeutic categories, for the years ended March 31, 2006 and December 31, 2004 and the three months ended March 31, 2005 are as follows:

| Therapeutic Category                       | Year Ended<br>March 31<br>2006 | Three Months<br>Ended<br>March 31<br>2005 | Year Ended<br>December 31<br>2004 |
|--|--------------------------------|---|-----------------------------------|
| Antianxiety Drug                           | \$ 2,890,213                   | \$ 631,670                                | \$ 2,119,276                      |
| Antibiotic                                 | 652,055                        | 132,624                                   | 549,261                           |
| Anticonvulsant                             | 232,669                        | 45,578                                    | 204,003                           |
| Antidepressant                             | 8,010,744                      | 507,480                                   | 957,558                           |
| Antidiabetic                               | 32,110,625                     | 7,362,962                                 | 30,842,081                        |
| Antihypertensive Drug/Beta Blocker         | 16,788,820                     | 4,178,650                                 | 14,257,386                        |
| Antipsychotic                              | 2,167,911                      | 484,780                                   | 1,293,620                         |
| Cardiac                                    | 1,239,431                      | 514,139                                   | 1,344,603                         |
| Decongestants                              | 116,257                        | 316,524                                   | 358,059                           |
| Hormonal Replacement Therapy               |                                | 295,172                                   |                                   |
| Nonsteroidal Antiinflammatory Agent        | 2,101,804                      | 544,983                                   | 1,719,487                         |
| Opiate Agonist/Analgesic                   | 14,082,000                     | 1,887,640                                 | 5,121,809                         |
| Platelet Aggregation Inhibitor             | 147,856                        | 24,571                                    | 80,730                            |
| Skeletal Muscle Relaxant                   | 1,150,073                      | 201,673                                   | 1,492,437                         |
| Vascular and Migraine Headache Suppressant | 1,098,460                      | 208,054                                   |                                   |
| <b>Net Sales</b>                           | <b>\$ 82,788,918</b>           | <b>\$ 17,336,500</b>                      | <b>\$ 60,340,309</b>              |

Similar data for the year ended December 31, 2003 has not been presented as it is considered by the Corporation to be impracticable to do so.

\* \* \* \* \*

**EXHIBIT INDEX**

|              |  |
|--------------|--|
| 3.01         | Registrant s Amended and Restated Articles of Incorporation, as amended. (1)   |
| 3.02         | Certificate of Amendment to the Articles of Incorporation filed February 13, 1997. (2)   |
| 3.03         | Certificate of Amendment to the Articles of Incorporation filed February 10, 2000. (3)   |
| 3.04         | Certificate of Determination of Rights, Privileges and Preferences Series B Preferred Stock. (4)   |
| 3.05         | Registrant s Amended and Restated Bylaws. (5)  |
| 10.01        | Agreement, dated as of October 1, 1993, among Registrant and Non-Affiliate (6)   |
| 10.02        | Employment Agreement, dated October 22, 1993, of Robert Kurkiewicz. (6)  |
| 10.03        | Stock Purchase Agreement by and between Caraco Pharmaceutical Laboratories, Ltd. and Sun Pharmaceutical Industries, Ltd. dated as of April 23, 1997. (7) |
| 10.04        | Products Agreement by and between Caraco Pharmaceutical Laboratories, Ltd. and Sun Pharmaceutical Industries, Ltd. dated as of April 23, 1997. (7)       |
| 10.05        | Registration Rights Agreement dated as April 1997. (7)   |
| 10.06        | Amendment to Employment Agreement of Robert Kurkiewicz dated as of April 1, 1997. (8)  |
| 10.07        | 1999 Equity Participation Plan. (9)  |
| 10.08        | Renewal to Employment Agreement of Robert Kurkiewicz dated as of January 1, 1999. (3)  |
| 10.09        | Third Amendment to Employment Agreement of Robert Kurkiewicz dated August 30, 2002. (3)  |
| 10.10        | Employment Agreement of Jitendra N. Doshi. (3)   |
| 10.11        | Agreement between Caraco and Sun Pharma Global, Inc. dated November 21, 2002. (4)  |
| 10.12        | Sales contract with government vendor. (4)   |
| 10.13        | Employment Agreement of Mr. Singh (5)  |
| 10.14        | Employment Agreement of Mr. Movens (10)  |
| 10.15        | Confidentiality and Non-Competition Agreement of Dan Movens (10)   |
| 10.16        | Summary of Fiscal 2006 Executive Officer Salaries (11)   |
| 10.17        | Credit Agreement with JPMorgan Chase Bank, N.A. (12)   |
| 10.18        | Security Agreement with JPMorgan Chase Bank, N.A. (12)   |
| <u>10.19</u> | <u>Form of Grant of Employee Stock Option (+)</u>  |
| <u>21</u>    | <u>Subsidiaries of the Registrant (+)</u>  |
| <u>23.01</u> | <u>Consent of Registered Independent Public Accountants (+)</u>  |

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- 24.1 Power of Attorney (included on signature page) (+)
- 31.1 Certificate of Chief Executive Officer (+)
- 31.2 Certificate of Chief Financial Officer(+)
- 32.1 Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. (+)

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+ Filed herewith

- (1) Incorporated by reference from Exhibits to Registrant's Form 10-KSB filed on or about March 30, 1995 as Commission File no. 0-24676.
  - (2) Incorporated by reference from Exhibits to Registrant's Form 10-KSB filed on or about March 31, 1997, as Commission File No. 0-24676.
  - (3) Incorporated by reference from Exhibits to Pre-Effective Amendment No. 1 to Form SB-2 filed on September 4, 2002 as Commission File No. 333-91968.
  - (4) Incorporated by reference from Exhibits to Registrant's Form 10-KSB filed on or about March 31, 2003, Commission File No. 0-24676.
  - (5) Incorporated by reference from Exhibit to Registrant's Form 10-K filed on or about March 15, 2005, Commission File No. 0-24676.
  - (6) Incorporated by reference from Exhibits to Registrant's Registration Statement on Form SB-2, as amended, filed on November 5, 1993 as Commission File No. 33-71398C.
  - (7) Incorporated by reference from Exhibits to Registrant's Form 10-QSB filed on November 14, 1997 as Commission File No. 0-24676.
  - (8) Incorporated by reference from Exhibits to Registrant's Form 10-KSB filed on or about March 31, 1998, as Commission File No. 0-24676.
  - (9) Incorporated by reference from Appendix A to Registrant's Proxy Statement dated April 28, 1999 as Commission File No. 0-24676.
  - (10) Incorporated by reference from Exhibits to Registrant's Form 10-K/A filed on or about May 2, 2005, Commission File No. 0-24676.
  - (11) Incorporated by reference from Exhibits to Registrant's Form 8-K filed on or about August 25, 2005. Commission File No. 0-24676
  - (12) Incorporated by reference from Exhibits to Registrant's Form 10-Q filed on or about January 26, 2006. Commission File No. 0-24676
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