Advanced materials for catalyst technology

ANNUAL REPORT AND FINANCIAL STATEMENTS

31 December 2006

CSI Board of Directors (From Left):
Stephen J. Golden, Ph.D., Charles R. Engles, Ph.D., Alan Duncan MP, Charles F. Call,
Frank R. Greico, Alexander ("Hap") Ellis, III, and K. Leonard Judson

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A copy of this document is available on the Company's website at
www.catalyticsolutions.com

This document includes forward-looking statements. Forward-looking statements are identified by words such as "believe," "anticipate," "expect," "intend," "plan," "will," "may," "should," "could," "think," "estimate" and "predict," and other similar expressions. In addition, any statements that refer to expectations, projections or other characterizations of future events or circumstances are forward-looking statements. We based these forward-looking statements on our current expectations and projections about future events. Our actual results could differ materially from those discussed in, or implied by, these forward-looking statements. The Company assumes no responsibility to update any of the forward-looking statements contained herein.

Directors and Advisors

Directors:	Alexander (“Hap”) Ellis, III	*Non-Executive Chairman*
	Charles F. Call	*Chief Executive Officer*
	Frank R. Greico	*Chief Financial Officer*
	Stephen J. Golden, Ph.D.	*Chief Technology Officer*
	Charles R. Engles, Ph.D.	*Non-Executive Director*
	K. Leonard Judson	*Non-Executive Director*
	Alan Duncan MP	*Non-Executive Director*
Secretary:	Bruce W. McRoy	
Registered Office:	1640 Fiske Place, Oxnard, California 93033	
Corporate ID Number:	C1959299	
IRS Employer ID Number:	33-0700322	
Auditors:	KPMG LLP 21700 Oxnard Street, Suite 1200 Woodland Hills, CA 91367-3642 U.S.A.	
Solicitors:	Reed Smith Richards Butler LLP Minerva House, 5 Montague Close London SE1 9BB	
Registrar:	Computershare Investor Services (Channel Islands) Limited Ordnance House, 31 Pier Road, St. Helier Jersey JE4 8PW	
Nominated Advisor and Broker:	Canaccord Adams Limited 7th Floor, Cardinal Place, 80 Victoria Street London SW1E 5JL	
Financial Public Relations:	Buchanan Communications Limited 45 Moorfields London EC2Y 9AE	

Highlights

Catalytic Solutions, Inc. ("CSI" or "the Company") is an advanced material science company that creates and supplies catalyst systems for environmental applications that deliver high value to customers. Formed in 1996, CSI developed a technology that improves the performance and reduces the cost of catalytic converters. CSI has developed a catalytic coating and manufacturing process to apply its coating to a substrate that forms the functional element of a catalytic converter. CSI catalysts contain significantly less platinum group metals (PGMs) than competing catalysts. PGMs are the dominant cost component of most catalysts, and reducing their usage provides significant cost savings to the customer.

Financial Highlights:

- Successful flotation on the Alternative Investment Market ("AIM") of the London Stock Exchange in November 2006, with approximately $25.6 million raised after expenses
- Revenue increased 6.8% to $41.0 million, compared with $38.4 million in 2005
- Gross profit rose significantly to $8.0 million (gross margin - 19.5% of revenue) for 2006 up from $6.4 million or 16.7 % of revenue for 2005
- Adjusted net loss of $5.8 million – in line with expectations, before an expected non-cash charge of $26.4 million relating to the Company's capital structure prior to flotation
- Convertible notes and accumulated non-cash interest expense totalling $40.7 million converted to equity concurrent with the admission to trading on AIM
- Cash balance as of year-end was $31.4 million, compared with $10.2 million for 2005

Operational Highlights:

- Honda authorisation to supply catalysts for the four-cylinder petrol Accord beginning with the 2008 model year announced 14 May 2007, mass production scheduled for June 2007
- Acquired Applied Utility Systems ("AUS") in August 2006 for $6.25 million, an engineering technology business that focuses on emissions reduction and energy efficiency improvement in power generation and industrial boiler markets
- Final validation for Renault supply – for multiple 2008 model year platforms
- Diesel catalysts currently under testing by Honda, Renault/Nissan and Peugeot
- Commenced project with a large petrochemical company involving CSI's MPC® technology to improve the performance of an existing catalyst that if successful will result in licensing revenues

Chairman’s Statement

I am pleased to announce our first report to Shareholders as an AIM listed Company. We have a great deal of information to convey and hope that you find our style clear, concise, and easy to both read and understand. I also hope we are able to convey this information with the same level of enthusiasm and excitement that your dedicated management team has for the future.

2006 was a solid year of achievement and progress for your Company. Guided by our Chief Executive, Charlie Call, and our Chief Technology Officer, Dr. Steve Golden, with the strong support of the whole team, the Company made substantial headway in each of its core areas of focus. Importantly, the Board and the full team have delivered on the business plan presented and approved at the beginning of the fiscal year, despite the obvious distractions of the public offering process.

Creating Shareholder Value

CSI is an advanced materials technology company that creates and supplies advanced catalysts to the automotive and power sectors. CSI is also developing new solutions for our third key targeted sector: chemical manufacturing. Our core catalyst technology offers a very competitive platform with which to compete against much larger, established competitors. In the past three years, we have proven that we can be a top tier supplier to some of the most demanding customers in the global marketplace. Additionally, we are taking steps, thanks in part to the successful AIM listing, to expand operations in Europe and Asia broadening our capabilities and our reach, thus positioning ourselves for sustained growth by sector and by region.

We are particularly pleased with the loyal support and trust shown to our Company by Honda Motor Co., Ltd. We have a substantial volume of business with Honda, including a number of very exciting development projects that are already underway. We thank them for their support and look forward to continuing this relationship.

We also are very pleased with developments at Renault, who have worked very hard with Dr. Steve Golden and our R&D group to develop improved solutions for specific light duty (petrol) platforms. Like Honda, Renault is willing to look at the value of our overall approach to reducing the total cost of the catalyst, not just focus on who has the “cheapest” coating fee.

The growing relationship with Renault will pave the way for a new CSI factory in the Czech Republic. The new factory will bring the opportunity of introducing our innovative diesel solutions to the European market. The environmental regulations governing diesel emissions are driving an ever-tightening set of emissions limits, which in turn represents an enormous opportunity for CSI and its technology. While all eyes are on Europe at the moment, there are also plenty of exciting prospects in Asian markets.

In order to exploit the substantial opportunities for CSI in the automotive market, management has decided to stick to the strategy of working only with OEM’s, like Honda, who truly value a collaborative approach to creating advanced catalyst strategies and solutions, therefore avoiding those customers who are buying on price, and price alone. For precisely this reason, CSI is reluctant to compete for North American automakers’ platforms and will only do so if they adopt a more collaborative, total costing approach.

Four years ago, CSI was too young a Company to appreciate fully the difference in customer buying practices, but as we approach the second half of FY2007, we are confident that the way we choose to address the auto catalyst market will bring us substantial business with blue-chip customers at solid gross margins.

Although the Company has focused primarily on automotive emissions control in the past, there are compelling technological and business reasons for diversifying into other markets. Another major focus for near-term growth is the electrical power sector. There is enormous regulatory and legislative pressure on the power sector world-wide to remove sulphur dioxide (SO_2 – a precursor for Acid Rain), nitrogen oxides (NO_x – a precursor for smog), mercury (Hg) and particulate matter. Virtually all new generating plants and an increasing number of old plants will require emissions controls to capture these pollutants. In almost all cases to date, individual technologies are deployed for specific pollutant capture. CSI is focused on NOx reduction, where large catalysts are incorporated in what is commonly referred to as selective catalytic reduction (SCR) technologies, and CO oxidation. These can be very expensive catalysts with relatively short operating lives. CSI brings to the marketplace a robust solution that can improve efficiency, reduce the metals loadings required and extend the catalyst's operating life – a significant value proposition to power plant operators.

As with the auto sector, CSI has approached the power markets with a strategy for driving broader shareholder value. This led the Company to purchase an innovative engineering firm in August of 2006 that designs and sells emissions control solutions, AUS. Led by Dr. Mansour, AUS gives CSI the ability to gain significant margin for our advanced SCR catalyst solutions, as well as overall project margin. As an example, CSI's product for a typical natural gas-fired "peaking" turbine might be 20% more efficient, allowing for a substantially smaller catalyst, and the concurrent significant reductions in the catalyst housing and balance of plant.

The emissions controls market for natural gas-fired turbine-generator sets, typically used in "peaking" roles by utilities or by heavy industry, is in excess of $1 billion (USD). CSI expects to compete for the even larger SCR business in coal and other solid fuel applications.

The third and final sector where our technology can add significant value is process catalysis – or chemical/petrochemical refining. The Company believes the addressable market for specific processes where CSI's technology offers a compelling value proposition is $2.5 - $3.0 billion (USD). The process catalysis market is dominated by very large multinational companies, with long adoption cycles. We are working on specific applications with targeted partners in order to provide valuable products to our customers. CSI is focused on targeting R&D in this sector carefully to make sure we have a partner (or partners) with whom we can drive a serious business relationship. As the product offering becomes clearer, we will endeavour to maximize the value to be captured through selling that core product. This could mean a variety of product-specific strategies, from licensing in some cases to acquiring specific delivery capabilities.

Looking Ahead

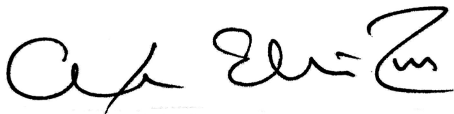
Looking more broadly at 2006 and the coming year, we believe the Company is well positioned to take advantage of the continuing growth in the environmental catalyst market. CSI made the successful transition from an established start-up technology company to a solid supplier of catalyst solutions to the world's most demanding companies. With the AIM listing and the capital raised, we will build our next factory in Europe and expect to build a strategic position in Asia. We will be selective about the customers we add in the petrol and diesel markets, establishing close partnerships rather than being simply a vendor. We will expand our power and process

offerings strategically while expanding the overall value proposition. We will strengthen the management team, enabling the Board to focus on growing the Company rapidly but prudently whilst we continue to build the systems and capabilities that will cement our reputation as a world-class supplier to global customers.

With regard to the Board of Directors, I would like to recognize and introduce Alan Duncan MP, a new Director as of November 2006. Alan is a Member of Parliament and a successful businessman, and he has already made his impact felt. We appreciate his dedication and service. I also want to recognize the other two Non-Executive Directors, K. Leonard Judson and Charles Engles, Ph.D. Known to many of our earliest shareholders, Leonard and Charles have been invaluable to management, participating fully and effectively helping the development of the Company.

I would also like to thank each and every employee. We appreciate the dedicated, hard-working, committed group of employees, and it is a privilege to be working along side them.

Finally, a word of thanks to our Shareholders for their support and enthusiasm. As your Chairman, I can speak for the entire Board of Directors when I say we are most grateful for your support and most excited about the future prospects of your Company.



Alexander ("Hap") Ellis, III
Non-Executive Director, Chairman

Chief Executive Officer's Statement

INTRODUCTION

Summary of results and operational performance

I am pleased to report the results for the financial year ended 31 December 2006 during which the Company made good progress. The Company reported revenue of $41.0 million for fiscal 2006, representing an increase of $2.6 million or 6.8% from the $38.4 million reported for 2005, primarily relating to sales in the energy markets served by the AUS business unit. We achieved significant gross margin improvement in our petroleum engine ("three-way") catalyst business through overall quality improvements that reduce scrap and enhance the consistency of our products. This in turn helped overall gross margins improve from 16.7% to 19.5%. The Company reported an adjusted net loss of $5.8 million for 2006, before an expected non-cash charge of $26.4 million due to interest expense and costs relating to convertible notes of $14.3 million that were converted to equity concurrent with the Company's admission to trading on AIM.

In August 2006, CSI completed the acquisition of AUS, a supplier of emissions control and energy efficiency improvement systems for gas turbines, boilers and process heaters. This combination enables CSI to offer complete cost effective burner control and catalyst technology solutions in the power generation market. The Company also introduced several next generation products in the pipeline for OEM's including formulations for potential new customers Renault and Nissan. CSI has developed diesel oxidation catalysts ("DOC"), selective catalytic reduction ("SCR") catalysts, and catalyzed soot filters ("CSF") for light duty diesel engines currently being tested by Honda, Renault/Nissan and Peugeot. This technology leadership we believe has the potential to bring significant new revenue streams to the Company. We have also progressed toward establishing new strategic alliances with materials suppliers that will continue to enhance our technology development.

STRATEGY

Core business strategy

CSI's strategy is to target customers within specific markets where its catalysts and catalyst systems create a significant economic value for its customers, and the Company is able to capture a meaningful share of the added value as profit. The Company intends to continue to supply the light duty vehicle market with a focus on sales growth in diesel applications while maintaining a strong base for the business in petrol engine catalytic converters. Diversity is a key element of our strategic plan. New markets and applications in power generation, heavy duty diesel, energy systems and chemical manufacturing provide the opportunity for higher margins through diversification beyond the three-way catalyst market. The Company intends to expand its capabilities in these areas through strategic acquisitions and partnerships that create more effective market and sales channels to sell more catalysts.

TECHNOLOGY

CSI has developed and owns intellectual property rights to a novel technology for creating and manufacturing catalysts known as mixed phase catalyst (MPC®). CSI's technology involves the self-assembly of a ceramic oxide matrix with catalytic metals precisely positioned within three-dimensional structures.

The MPC® design gives CSI catalyst products two critical attributes which differentiates them from competing offerings:

- Superior stability that allows heat–resistant, high performance with very low levels of precious metals; and
- Base metal activation allows base metals to be used instead of costly platinum group metals ("PGMs") without compromising catalytic performance.

CSI protects its intellectual property through the use of patents, trade secrets and registered and common law trademarks. The Company's intellectual property portfolio was strengthened in 2005 and continuing in 2006 with applications seeking patent protection in the areas of platinum group metal-free catalysts for use in diesel particulate filters, selective hydrogenation catalysts for use in light olefin streams and nitrogen oxide reduction in exhaust systems with hydrocarbons or alcohols. Global patent protection is being sought for CSI's expanding portfolio of low PGM and activated base metal products.

EXPANSION INTO EUROPE

The Company plans to add a second manufacturing facility in the Czech Republic to meet the expected demand of Renault and other potential European customers. CSI selected the Czech Republic for its high level of infrastructure development, well educated and well trained workforce, and good geographical location for key customers. The Company is nearing completion of equipment planning and engineering studies for an existing building on the site which is located near Prague. We believe that a local manufacturing capability is essential to compete effectively in the European market place.

BUSINESS REVIEW

Current business flow

CSI currently generates revenue through the sale of catalytic coated substrates (the active catalyst element) containing materials all purchased by the Company and a variation that includes all materials purchased by the Company except for PGM's which are consigned by customers. The AUS acquisition has added a third revenue stream through sales of complete burner and emissions control systems and related components. The Company recently announced that AUS has been awarded a significant emissions control systems contract for the Flying J refinery in Bakersfield, California.

Customer relationships

There is a focus on deepening our customer relationships with Honda, Renault, and Car Sound which provide the basis for sustained organic growth. Key to this is our commitment to our

partners to deliver quality products demonstrating best-in-class technology whilst providing superior economic value. CSI continues to improve its product offering through new product innovation, product quality improvements and superior service.

PRODUCT DEVELOPMENT/INITIATIVES/PARTNERSHIPS

Light duty petrol vehicles

CSI has a number of low PGM products currently in production for Honda, General Motors, Ford and aftermarket supplier Car Sound. There are also several next generation products in the pipeline for OEM's that have the essential characteristic of simultaneously converting nitrogen oxides, carbon monoxide and hydrocarbons into water, nitrogen and carbon dioxide (a process known as "three-way conversion" or "TWC") into a single catalyst.

Diesel vehicles light and heavy duty

The Company has developed diesel oxidation catalysts, NOx control catalysts and a catalyzed soot filter for light duty diesel engines and these are currently being tested by Honda, Renault/Nissan and Peugeot. In addition to the products required by light duty diesel vehicles, heavy duty diesel vehicles have certain unique requirements in that they are more demanding. CSI has developed DOC, SCR and CSF catalysts for heavy duty diesel engines. The DOC and SCR products are currently being tested by potential North American and European customers and a potential Japanese partner for the 2010/2011 model years.

Power generation and boilers

Power generation plants typically utilize two types of catalysts: 1) ammonia-based SCR catalysts for NOx control; and 2) oxidation catalysts for CO and HC control. CSI has developed catalysts that meet each of these needs. High temperature SCR catalysts are required for large and some small gas turbines, stationary diesel generators, medium temperature SCR, used for certain other gas turbines and gas, coal and oil-fired steam turbine plants and boilers. As a result of the AUS acquisition, CSI is now able to offer a fully customized solution approach to these markets that will provide higher value to our customers.

Chemical manufacturing

The Company is currently pursuing two types of applications in this market. The first is to apply MPC® technology to PGM based catalysts to improve their durability and stability. The second is to utilize the base metal activation feature of MPC® technology to increase the performance of conventional base metal catalysts. CSI is working with a major petrochemical catalyst supplier to extend its technology into refining and petrochemical applications.

SUMMARY AND OUTLOOK

The Company performed well in fiscal 2006, recording increases in revenues and strong increases in gross profit both in absolute terms and as a percentage of sales. These factors contributed to a significant reduction in the Company's operating loss versus the prior year when the non-recurring convertible note interest expense is excluded. 2007 revenues and gross profit are expected to benefit from the September 2006 acquisition of AUS which will accelerate the

diversification of the Company's revenue streams toward energy emissions control systems. The Company expects to begin volume shipments with Renault in the second half of 2007. Our management team has a proven track record of success and the Board of Directors feels that the Company is poised for significant growth.

Charles F. Call
Chief Executive Officer

Business and Financial Review

The Company reports its 2006 financial results under U.S. GAAP, consistent with prior periods and the placing and admission to AIM.

BUSINESS REVIEW

Catalytic Solutions, Inc. ("CSI" or "the Company") is an advanced material science Company that creates and supplies catalyst systems for environmental applications that deliver high value to customers. Formed in 1996, CSI developed a technology that improves the performance and reduces the cost of catalytic converters. CSI has developed a catalytic coating and manufacturing process to apply its coating to a substrate that forms the functional element of a catalytic converter. CSI catalysts contain significantly less platinum group metals (PGMs) than competing catalysts. PGMs are the dominant cost component of most catalysts, and reducing their usage provides significant cost savings to the customer.

FINANCIAL REVIEW

Key performance indicators

The Company considers its key performance indicators to be the sales and gross margin performance of its principal automotive (petrol) catalyst operations, revenue and margin growth in the power generation and industrial boiler markets facilitated by the acquisition of AUS, operating expenses and operating cash flow measured against a predetermined budget, and development progress toward commercialisation of its key growth opportunities in the light and heavy duty diesel markets.

	52 weeks ended 31 December 2006	52 weeks ended 31 December 2005	Percentage change
Sales	$ 41.0M	$ 38.4M	6.8%
Gross profit	$ 8.0M	$ 6.4M	25.0%
Gross margin percentage	19.5%	16.7%	2.8 points
Operating expenses	$ 14.7M	$ 14.1M	4.3%
Cash flow	$ 21.1M	$ 7.7M	174.0%

Company operating performance

Profit and loss accounts - The Company reported revenue of $41.0 million for fiscal 2006, representing an increase of $2.6 million or 6.8% from the $38.4 million reported for 2005, primarily relating to sales in the energy markets served by the AUS business unit. Gross profit rose to $8.0 million (gross margin - 19.5% of revenue) for 2006 up from $6.4 million or 16.7% of revenue for 2005. Operating expenses totalled $14.7 million for 2006 up by $0.6 million or 4.3% from $14.1 million reported for 2005. The increase was primarily due to higher employee related costs as the Company strengthened its management team and completed the AUS acquisition.

The Company reported a net loss, in line with expectations, of $32.2 million for 2006, up from a loss of $8.2 million reported for 2005. The increased net loss was primarily due to $26.4 million

of non-cash interest expense and costs related to the convertible notes of $14.3 million that were converted to equity concurrent with the Company's admission to trading on AIM. Excluding this non-recurring expense, the adjusted net loss for fiscal 2006 would have been $5.8 million, an improvement of $2.4 million or 29.3% versus 2005.

Balance sheet - As of 31 December 2006, the Company had cash and short term investments totalling $32.2 million compared to $11.7 million at the previous year end. At the balance sheet date, the costs and estimated earnings in excess of billings on uncompleted contracts was $1.3 million. This represents revenue and earnings from AUS contracts that were not billed at 31 December 2006. Goodwill of $2.6 million and intangible assets of $3.3 million at 31 December 2006 arose on the acquisition of AUS. The Directors have reviewed the carrying value of these assets and are satisfied they are fairly stated.

Financing - In January 2006, the Company completed issuance of $4.2 million of convertible notes. These notes and the $10.1 million issued in December 2005 were converted to equity concurrent with the admission to trading on AIM. As a component of consideration for the AUS acquisition, the Company entered into a $3.0 million note payable bearing interest at 5.36% due August 2009.

Cash flow - Net cash used in operating activities decreased to $2.7 million for the year ended 31 December 2006 from $6.3 million used for 2005 representing an improvement of $3.6 million. Investing activities used $1.8 million in net cash primarily due to $1.6 million of payments related to the acquisition of AUS and capital expenditures of $1 million. Net cash provided by financing activities totalled $25.6 million primarily related to net proceeds resulting from the Company's admission to trading on AIM.

Interest - For the year ended 31 December 2006 the Company recorded interest expense of $26.5 million primarily comprised of $26.2 million of non cash interest expense relating to $14.3 million of convertible notes that were converted to equity concurrent with admission to trading on the AIM market.

Acquisition - On 28 August 2006, CSI acquired the business and selected assets of AUS, located in Irvine, California. AUS is an engineering design firm with over 20 years experience in the industrial boiler market and power generation emissions control markets. This transaction is a key element of the Company's growth strategy providing the opportunity for significant business growth in these markets.

Frank R. Greico
Chief Financial Officer

Directors and Board Committees

EXECUTIVE DIRECTORS

Charles F. Call, Chief Executive Officer (Age 59)
Mr. Call joined the Company as Chief Executive Officer and Director in November 2004. He has over 30 years of broad management experience encompassing sales, marketing, plant management, general management and executive management roles in the automotive and electronics industries. His prior experience includes seven years (from 1997 to 2004) at Imperial Chemical Industries as General Manager of the electronic materials group and later General Manager of the specialty polymers and adhesives group. Mr. Call also served as President of JPE Trim from 1996 to 1997, a manufacturer of automotive exterior trim products supplying the major automotive companies. Before JPE, he served as President of Dexter Automotive Materials, a supplier of coatings, adhesives and acoustical materials to the major automotive companies. Mr. Call received a B.S. degree from Rochester Institute of Technology, New York.

Frank R. Greico, Chief Financial Officer (Age 49)
Mr. Greico joined the Company in September 2006 and became a Director in November 2006. He has more than 27 years of finance experience including experience as a Senior Operations and Finance Executive in publicly traded and privately held technology and manufacturing companies. His experience includes financing and capitalization, mergers and acquisitions, strategic planning, international expansion, product development, information systems, SEC reporting and investor relations. Prior to joining the Company, Mr. Greico held positions with Infotrieve, PhatNoise, PeopleLink, Quarterdeck, Knowledge Adventure and a division of W.R. Grace. He holds an M.B.A. from Pace University, New York in management information systems, a B.B.A. in accounting from Pace University, and is a certified public accountant.

Stephen J. Golden, Ph.D., Chief Technology Officer (Age 45)
Dr. Golden is the Chief Technical Officer of the Company and has been a Director since 1996. Dr. Golden is the developer of the Company's technology and one of the co-founders of the Company. From 1994 to late 1995, he was the Research Director for Dreisbach Electromotive Incorporated, a developer of advanced batteries based in Santa Barbara, California. Dr. Golden received his doctorate in Material Science at Imperial College of Science and Technology in London, England. He did extensive post-doctoral work at the University of California, Santa Barbara, and the University of Queensland, Australia in ceramic oxide and mixed metal oxide materials.

NON-EXECUTIVE DIRECTORS

Alexander ("Hap") Ellis, III, Non-Executive Chairman (Age 58)
Mr. Ellis has been a Director of the Company since June 2003, and was elected Chairman in December 2004. He is a General Partner in RockPort Capital Partners LLC, which manages two venture capital funds focused on energy technologies, advance materials and process innovations. Prior to starting Fund I in 2001, Mr. Ellis was a partner in RockPort Partners, LLC in 1998, a small merchant banking group based in Boston, Massachusetts. Prior to this, Mr. Ellis was a partner in several large electric power development companies, including most recently Casco Bay Energy Company, LLC, now a wholly-owned subsidiary of Duke Energy which developed a 520MW gas-fired electric generating station, and Acadia Bay Energy Company, LLC, now a wholly-owned subsidiary of Allegheny Energy which developed a 638MW gas-fired electric generating station. Prior to that, from 1991-1995, he was a member of the management

team at Kenetech Corporation, formerly America's largest wind turbine manufacturer. Prior to that, Mr. Ellis had been a member of the management team at Knoll International, a successful turnaround in 1988-1989. He also worked in the United States Senate for four years as a legislative aide and then Press Secretary to U.S. Senator Edward W. Brooke (R-MA). Mr. Ellis received a B.A. Degree from Colorado College and an M.B.A. from the Yale School of Management, Connecticut.

Charles R. Engles, Ph.D., Non-Executive Director (Age 59)
Dr. Engles has been a Director of the Company since 1999. He has a total of 15 years of experience serving as a Board member for U.S. public companies and has also been a Board member of seven private companies. Dr. Engles is currently President and Chief Executive Officer of Cutanix Corporation, a biopharmaceutical Company he co-founded in 1997 focused on dermatological drug discovery. From 1989 until 1994, Dr. Engles served as Senior Vice President of Johns-Manville Corporation responsible for corporate development and worldwide mining and minerals operations. In 1992, he organized the spin out from Johns-Manville Corporation and Chevron Corporation of Stillwater Mining Company ("Stillwater"), the only U.S. producer of platinum group metals. From 1994 to 1997, he served as Chairman and Chief Executive Officer of Stillwater and, under his direction, completed an initial public offering on NASDAQ in 1994, and since reached a market capitalization of $1.9 billion. Dr. Engles holds a Ph.D. from Stanford University in operations research, and attended Oxford University as a Rhodes Scholar.

K. Leonard Judson, Non-Executive Director (Age 46)
Mr. Judson joined the Board of Directors in 2005. From 2002 until 2005 he served as an observer to the Board. Mr. Judson is the President and Managing Director of Cycad Group, LLC, a venture capital fund. He also serves on the Board of Directors or is a Board observer of several of Cycad Group's portfolio companies. Prior to joining Cycad Group in 2000, he practiced law for 15 years in Phoenix, AZ. Mr. Judson was a shareholder in the law firm of Robbins and Green, P.A., practicing law with them from 1985 to 1996. In 1996 he co-founded the law firm of May, Potenza, Judson and Baran, P.C. and served as its President Chief Executive Officer until his departure to Cycad Group. Throughout his legal career, a substantial portion of his practice was devoted to corporate finance, mergers and acquisitions. From 1989 to 2002, he also served as a member of the NASD Board of Arbitrators. Mr. Judson holds a B.S. degree (Cum Laude) from Northern Arizona University, and a J.D. (with Honors) from the National Law Center, George Washington University, Washington, D.C.

Alan Duncan MP, Non-Executive Director (Age 50)
Mr. Duncan joined the Company as a Non-Executive Director immediately prior to its admission on the AIM exchange in 2006. He is a Member of Parliament for Rutland and Melton and is currently the Shadow Secretary of State for trade and industry. From 1979 to 1981, Mr. Duncan worked for Shell International Petroleum and from 1982 to 1988, for Marc Rich & Company, an independent commodity Company, as a trader of crude oil and refined products including two years based in Singapore. From 1988 to 1994 he ran his own oil advisory Company, Harcourt Consultants. Mr. Duncan was first elected as a Conservative MP in 1992 and was subsequently re-elected in 1997, 2001, and 2005. Since 1999, Mr. Duncan has held a number of front bench positions including being a Shadow Minister for trade and industry, health and foreign affairs. He has been Shadow Secretary of State for constitutional affairs, international development transport and now trade and industry. He was educated at St. John's College, Oxford, where he read philosophy, politics, and economics and was president of the Oxford Union. He later studied at Harvard as a Kennedy Scholar.

BOARD COMMITTEES

The principal standing committees appointed by the Board are as follows:

Audit Committee

The Audit Committee is responsible for monitoring the quality of internal control, ensuring that the financial performance of the Company is properly measured and reported on and for reviewing reports from the Company's auditors relating to the Company's accounting and internal controls. Appointments to the Audit Committee shall be for a period of up to three years, which may be extended for one further three year period, provided the Director remains independent. Only members of the Audit Committee have the right to attend Audit Committee meetings. However, other individuals such as the Chief Executive Officer, Chief Financial Officer, other Directors, the heads of risk, compliance and internal audit and representatives from the finance function may be invited to attend all or part of any meeting as and when appropriate. The external auditor will be invited to attend meetings of the Audit Committee on a regular basis. Meetings of the Audit Committee are presently held four times per year in conjunction with scheduled board meetings, to discuss general audit matters and the interim and full year reports and statements. The Audit Committee is authorized by the Board of Directors to investigate any activity within its terms of reference. It is authorized to seek any information it requires from any employee and all employees will be directed by the Board of Directors to co-operate with any request made by the Audit Committee. Currently, the Audit Committee consists of Charles R. Engles, Ph.D. as Chairman, Alan Duncan MP, and K. Leonard Judson.

Remuneration and Nomination Committee

The Remuneration and Nomination Committee is responsible for determining the terms and conditions of service, including the remuneration and grant of options to executive Directors under the Company's share option plans and also responsible for the identification of suitable candidates for the Board of Directors. Appointments to the Committee shall be for a period of up to three years, which may be extended for one further three year period, provided the Director remains independent. Only members of the Committee have the right to attend Committee meetings. However, other individuals such as other Non-Executive Directors and the Chief Executive Officer of the Company and its subsidiaries may be invited to attend for all or part of any meeting, as and when appropriate, and in any event, shall be consulted by the Committee on proposals relating to the remuneration of the other Executive Directors. Meetings of the Committee are presently held four times per year in conjunction with scheduled board meetings and at such other time as the Chairman of the Committee shall require. The Committee is authorized to take such external advice as it shall consider appropriate to determine the remuneration, terms of service and incentives of the Executive Directors and such other members of the Senior Executive Management of the Company as it is designated to consider. The Committee has no authority in relation to the remuneration of the Non-Executive Directors. The Remuneration and Nomination Committee consists of Alan Duncan MP as Chairman, Charles R. Engles, Ph.D., and Alexander ("Hap") Ellis, III.

Corporate Governance Statement

In June 2006, the Financial Reporting Council published the Principles of Good Governance and the Code of Best Practice ("the Combined Code").

Since admission to AIM, CSI has taken note of the Combined Code and has applied its principles of corporate governance commensurate with the Company's size, stage of development and resources and taking into account that CSI is incorporated in the U.S. rather than the U.K., not withstanding that the rules of the London Stock Exchange do not require companies that have securities traded on AIM to formally comply with the Combined Code. The Board is accountable to the Company's Shareholders for good governance and the statement set out below describes how the principles identified in the Combined Code are applied.

Board Composition

The Bylaws require the Company to have between five and nine Directors, and provide that each Director's term will continue until the next annual meeting of Shareholders. Vacancies in the Board may be filled by a majority of the remaining Directors, though less than a quorum, or by a sole remaining Director; provided, however, that a vacancy created by the removal of a Director by the vote or written consent of the Shareholders or by court order may be filled only by a vote of the Shareholders. The Board is currently comprised of a Non-Executive Chairman, three Executive Directors, and three Non-Executive Directors. The Board has identified that Alexander ("Hap") Ellis, III and K. Leonard Judson, due to their interests in the shareholdings of Rockport Capital Partners LLC and Cycad Group LLC respectively, are not considered to be fully independent for the purposes of the Combined Code. Notwithstanding their interests in Common shares and Dr. Engles' engagement as a paid consultant by CSI in relation to the preparation of the AIM admission document, the Board has identified that Dr. Engles and Alan Duncan MP should be considered fully independent for the purposes of the Combined Code. Biographies of the Board members begin on page 13 of this document.

Any Director may resign effective upon giving written notice to the Chairman of the Board, the President, the Secretary, or the Board, unless the notice specifies a later time for that resignation to become effective. If a Director's notice of resignation specifies a later effective date, the Board may elect a successor to take office when the resignation becomes effective.

Board Committees

The Board has established an Audit Committee and Remuneration and Nomination Committee, as described on page 15 of this document.

Workings of the Board

The Board meets on a pre-scheduled basis four times each year and more frequently when business needs require. The Board has a schedule of matters reserved to it for decision and is responsible for formulating, reviewing and approving the Company's strategy, budgets, major items of capital expenditure, acquisitions and disposals.

There is an agreed procedure for Directors to take independent professional advice if necessary at the Company's expense. This is in addition to the access which every Director has to the Company Secretary. The Secretary is charged by the Board with ensuring that Board procedures are followed.

To enable the Board to function effectively and allow Directors to discharge their responsibilities, full and timely access is given to all relevant information. In the case of Board meetings, this consists of a comprehensive set of papers, including regular business progress reports and discussion documents regarding specific matters.

The Company maintains Directors' and Officers' liability insurance.

Re-election of Directors

Under the General Corporation Law of California ("GCLC"), each Director is required to stand for re-election at each annual general meeting of the Company.

Remuneration of Directors

Executive Directors abstain from any discussion or voting at full Board meetings on Remuneration Committee recommendations where the recommendations have a direct bearing on their own remuneration package. A statement of the Company's remuneration policy is set out in the Remuneration Committee Statement on page 19 of this document.

Communication

The Company places a great deal of importance on communication with its Shareholders. The Company is chartered to publish an interim statement as well as its full year report and accounts. Both are available upon request to shareholders and other parties who have an interest in the Company's performance. Regular communication with Shareholders also takes place via the Company website **www.catalyticsolutions.com**.

There is regular dialogue with major shareholders as well as general presentations after the interim and preliminary results. The Company also holds an annual Shareholders' meeting each year where Shareholders may ask questions of the management team and hear a business update from the Chief Executive Officer.

Internal controls and risk management

The Board is responsible for the Company's system of internal control and for reviewing its effectiveness. Such a system is designated to eliminate the risk of failure to achieve business objectives and can only provide reasonable but not absolute assurance against material mis-statement or loss.

The Board has an ongoing process for identifying, evaluating and managing the Company's significant risks, which is regularly reviewed by the Board and has been in place for the period

ended 31 December 2006 and up to the date of approval of the annual report and financial statements.

The internal control procedures are delegated to executive Directors and senior management in the Company operating within a clearly defined departmental structure. The Board regularly reviews the internal control procedures in the light of the ongoing assessment of the Company's significant risks.

Auditor independence

The Audit Committee has sole responsibility for assessing the independence of the external auditors (KPMG LLP). The Committee has had due regard to the document published in May 2003 by the Institute of Chartered Accountants in England and Wales: *Reviewing Auditor Independence: Guidance for Audit Committees*. Each year the Committee:

- Seeks reassurance that the external auditors and their staff have no family, financial, employment, investment, or business relationship with the Company. To this end, the Committee requires the external auditors and their associates to confirm this in writing, and detail the procedures which the auditors have carried out in order to make this confirmation.

- Assesses the likely impact on the auditors' independence and objectivity before awarding them any contract for additional services. It is Company policy to require Audit Committee approval for all non-audit services provided by the independent auditors.

- Has as a standing agenda item at each Audit Committee meeting the consideration of auditor independence.

Remuneration Committee Statement

The Remuneration and Nomination Committee is chaired by Alan Duncan MP and includes Charles R. Engles, Ph.D. and Alexander (“Hap”) Ellis, III. All are Non-Executive Directors. The Committee is responsible for determining the contract terms and conditions of service, including remuneration and other benefits to Executive Directors and for monitoring the remuneration of first-line executive management. The Committee may also call on outside compensation experts as required. The Committee is also responsible for the identification of suitable candidates for the Board of Directors.

For 2007, the Committee has consulted with Mercer and Co. remuneration consultants for information on market practice and advice on policy. In addition, the committee has also had access to advice from the Human Resources Director, and the Executive Directors. None of these individuals participated in discussions relating to their own remuneration.

Remuneration policy

The objective of the Company’s remuneration policy is to attract and retain experienced and capable senior executives to conduct the Company’s business and to ensure that such executives are provided with appropriate incentives to encourage enhanced performance and are, in a fair and responsible manner, rewarded for their individual contributions to the success of the Company. Compensation levels are generally targeted between the 50th and 75th percentiles of compensation paid for comparable positions in a peer group of companies selected on the basis of their size, industry focus and operating structure. It is also an objective of the remuneration policy to ensure that there is a strong link between the level of Executive Director’s remuneration and the performance of the Company in achieving its goals. This is accomplished through an annual bonus plan tied to the achievement of specific financial performance targets established at the beginning of each year and through the award of share options which, beginning in 2007, are only exercisable if the stock appreciates above a threshold level.

Report of the Directors for the Year Ended 31 December 2006

The Directors present their report together with the audited financial statements for the year ended 31 December 2006.

Results

The results of the Company for the year are set out on page 28 of this document and show a loss for the year of $32.2 million (2005: loss of $8.2 million). The increased net loss includes $26.4 million of non-cash interest expense and costs related to convertible notes of $14.3 million that were converted to equity concurrent with the Company's admission to trading on AIM.

Principal activities, review of business and future developments

Details of the Company's principal activities and a review of business and future developments are included in the Chief Executive Officer's statement beginning on page 7 of this document.

Directors' shares

The Directors of the Company at the end of the year and their beneficial interests in the ordinary share capital of the Company and options to purchase ordinary shares of the Company were as follows.

	As of 31 December 2006		As of 31 December 2005	
	Shares	**Options**	Shares	Options
Executive:				
Charles F. Call (1)	**21,276**	**2,087,461**	nil	1,002,000
Frank R. Greico (2)	**1,420**	**695,820**	nil	nil
Stephen J. Golden, Ph.D. (3)	**1,290,324**	**405,000**	1,290,324	75,000
Non-Executive:				
Alexander ("Hap") Ellis, III	**nil**	**nil**	nil	nil
Charles Robert Engles, Ph.D. (4)	**283,798**	**48,000**	274,080	36,000
K. Leonard Judson	**nil**	**nil**	nil	nil
Alan Duncan MP (5)	**60,000**	**nil**	nil	nil

(1) As of 31 December 2006, Mr. Call was fully vested in 1,002,000 of his stock options.
(2) Mr. Greico's shares are held in The Greico Family Trust dated February 25, 1997.
(3) Dr. Golden's shares are held in the Golden Family Trust dated May 5, 2006. As of 31 December 2006, Dr. Golden was fully vested in 75,000 of his stock options.
(4) As of 31 December 2006, Dr. Engles was fully vested in 41,999 of his stock options.
(5) Mr. Duncan's shares were granted as restricted stock pursuant to the 2006 Stock Option Plan and are subject to annual vesting over four years from date of grant.

All of the Directors served throughout the year, with the exception of Mr. Greico, who joined the Company in September 2006 and was appointed to the Board in November 2006, and Mr. Duncan, who was also appointed in November 2006.

Directors' share options

The Directors received the following option grants during 2006:

	Number of options	Exercise price per share	Grant date (1)	First vest date	Expiration date
Executive:					
Charles F. Call (2)	1,085,461	$2.35	22 Nov 2006	22 Nov 2007	22 Nov 2016
Frank R. Greico (3)	395,820	$2.35	22 Nov 2006	05 Sep 2007	22 Nov 2016
	300,000	$2.74	05 Sep 2006	05 Sep 2007	05 Sep 2016
Stephen J. Golden, Ph.D. (4)	330,000	$2.35	22 Nov 2006	22 Nov 2007	22 Nov 2016
Non-Executive:					
Alexander ("Hap") Ellis, III	nil	nil		nil	nil
Charles Robert Engles, Ph.D. (5)	12,000	$1.67	23 Jun 2006	23 Jul 2006	23 Jun 2016
K. Leonard Judson	nil	nil		nil	nil
Alan Duncan MP	nil	nil		nil	nil

(1) Shares granted prior to 22 November 2006 were issued from the 1997 Stock Option Plan; shares granted there after were issued from the 2006 Stock Option Plan.
(2) Mr. Call's shares vest so as to one-third become vested and exercisable on the first anniversary of the date of grant and the balance quarterly over the following two years.
(3) Mr. Greico's grant on 22 November 2006 vest so as to one-third become vested and exercisable on the first anniversary of the date of grant and the balance quarterly over the following two years. Mr. Greico's 05 September 2006 grant vests annually over four years.
(4) Dr. Golden's shares vest so as to one-third become vested and exercisable on the first anniversary of the date of grant and the balance quarterly over the following two years.
(5) Dr. Engles' grant vests monthly over one year.

There have been no post year-end dealings as of the date of this document.

None of the Directors has any holding in any subsidiary Company, nor any material interest in the transactions of the Company.

Substantial Shareholders

As of 14 May 2007, the Company was aware of the following holdings representing an excess of 3% of the Company's ordinary shares:

Name	***Shares held***	***Percent of issued share capital***
Cinergy Ventures II, LLC	6,639,674	10.40
Pictet Asset Management S.A.	6,395,000	10.02
Rockport Capital Partners LP (1)	4,898,123	7.67
Cycad Group LLC (2)	4,360,829	6.83
Advent Energy II Limited Partnership (3)	3,582,790	5.61
BASF Venture Capital GMBH	3,121,772	4.89
NGEN Enabling Technologies Fund LP	2,752,849	4.31
Enertech Capital Partners II LP (4)	2,610,567	4.09
UBS	2,028,000	3.18
GE Capital Equity Investments (5)	1,951,538	3.06

(1) Includes 3,475,723 securities held by Rockport Capital Partners, L.P. and 1,422,400 securities held by RP Co-Investment Fund I. Alexander ("Hap") Ellis, III has interests in the shareholdings of Rockport Capital Partners LP and therefore is not considered to be a fully independent Director for the purposes of the Combined Code.
(2) K. Leonard Judson has interests in the shareholdings of Cycad Group LLC and therefore is not considered to be a fully independent Director for the purposes of the Combined Code.
(3) Includes 3,557,712 securities held by Advent Energy II Limited Partnership and 25,078 securities held by Advent Partners II Limited Partnership
(4) Includes 2,512,812 securities held by Enertech Capital Partners II L.P., and 97,755 securities held by ECP II Interfund, L.P.
(5) Includes 1,920,420 securities held by GE Capital Equity Investments, 20,894 securities held by Heller Financial Leasing, Inc. and 10,224 securities held by affiliates Alex and Lynne Georgopoulos

Research and development

The Company continues to invest in research and development activities with an emphasis on the commercialisation of existing technologies and formulation of products to meet specific customer needs.

Enhanced business review

For a discussion of the Company's 2006 performance against its key performance indicators, see the Business and Financial Review beginning on page 11 of this document.

Board meetings and attendance

The following table shows the attendance of Directors at meetings of the Board and Audit and Remuneration Committees held during the 2006 financial year since the Company's listing on AIM.

	Board	Audit Committee	Remuneration and Nomination Committee
Number of meetings held (1)	**1**	**1**	**1**
Executive:			
Charles F. Call	1		1
Frank R. Greico	1	1	
Stephen J. Golden, Ph.D.	1		
Non-Executive:			
Alexander ("Hap") Ellis, III	1	1	1
Charles Robert Engles, Ph.D.	1	1	1
K. Leonard Judson	1	1	1
Alan Duncan MP	1	1	1

(1) Reflects meetings held since the Company's listing on AIM. Prior to the AIM listing, the Board of Directors met at least quarterly during the 2006 financial year.

Auditors

All of the current Directors have taken all the steps that they ought to have taken to make themselves aware of any information needed by the Company's auditors for the purposes of their audit and to ensure that the auditors are aware of that information. The Directors are not aware of any relevant audit information of which the auditors are unaware.

Annual General Meeting

At the forthcoming Annual General Meeting of the Company, resolutions will be put forward to re-elect Charles F. Call, Alan Duncan MP, Alexander ("Hap") Ellis, III, Charles R. Engles, Ph.D., Stephen J. Golden, Ph.D., Frank R. Greico, and K. Leonard Judson as Directors of the Corporation.

By order of the Board

Bruce McRoy
Secretary
May 21, 2007

Statement of Directors' Responsibilities

The Directors are responsible for preparing the annual report and financial statements in accordance with applicable law and United States Generally Accepted Accounting Principles (U.S. GAAP).

Company law requires the Directors to prepare financial statements for each financial year which give a true and fair view of the state of affairs of the Company and of the profit or loss for that year. In preparing those financial statements, the Directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and estimates that are reasonable and prudent;
- state whether applicable accounting standards have been followed, subject to any material departures disclosed and explained in the financial statements; and
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the Company will continue in business.

The Directors are responsible for keeping proper accounting records which disclose with reasonable accuracy at any time the financial position of the Company and to enable them to ensure that the financial statements comply with U.S. GAAP. They are also responsible for safeguarding the assets of the Company and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

Financial statements are published on the Company’s website in accordance with legislation in the United Kingdom governing the preparation and dissemination of financial statements, which may vary from legislation in other jurisdictions. The maintenance and integrity of the Company’s website is the responsibility of the Directors. The Directors' responsibility also extends to the ongoing integrity of the financial statements contained therein.

KPMG LLP
Suite 2000
355 South Grand Avenue
Los Angeles, CA 90071-1568

Independent Auditors' Report

The Board of Directors
Catalytic Solutions, Inc.:

We have audited the accompanying consolidated balance sheets of Catalytic Solutions, Inc. and subsidiaries as of December 31, 2006 and 2005, and the related consolidated statements of operations, stockholders' equity (deficit) and comprehensive loss, and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, 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 consolidated financial statements referred to above present fairly, in all material respects, the financial position of Catalytic Solutions, Inc. and subsidiaries as of December 31, 2006 and 2005, and the results of their operations and their cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

KPMG LLP

May 21, 2007

KPMG LLP, a U.S. limited liability partnership, is the U.S.
member firm of KPMG International, a Swiss cooperative.

Consolidated Balance Sheets

December 31, 2006 and 2005
(In thousands, except for share information)

	2006	2005
Assets	$000	$000
Current assets:		
Cash and cash equivalents	31,377	10,242
Short-term investments	798	1,490
Trade accounts receivable, less allowance for doubtful accounts of $422,000 at December 31, 2006 and 2005	3,110	5,277
Inventories	3,454	4,315
Costs and estimated earnings in excess of billings on uncompleted contracts	1,254	-
Prepaid expenses and other current assets	1,202	508
Total current assets	41,195	21,832
Property and equipment, net	7,161	8,365
Intangible assets	3,355	36
Goodwill	2,600	-
Other assets	94	87
	54,405	30,320
Liabilities and Stockholders' Equity (Deficit)		
Current liabilities:		
Current portion of long-term debt	-	4
Accounts payable	3,949	3,412
Accrued salaries and benefits	1,088	849
Accrued expenses	676	1,946
Total current liabilities	5,713	6,211
Long-term debt, less current portion	-	1,469
Note payable	3,000	-
Convertible notes	-	10,300
Total liabilities	8,713	17,980
Commitments		
Series C redeemable convertible preferred stock – 8%, no par value. Authorized 2,151,303 shares; issued and outstanding 0 and 2,095,514 shares at December 31, 2006 and 2005, respectively	-	42,129
Series D redeemable convertible preferred stock – 8%, no par value. Authorized 3,411,285 shares, issued and outstanding, 0 and 3,150,677 shares at December 31, 2006 and 2005, respectively	-	49,459
Stockholders' equity (deficit):		
Series A convertible preferred stock, no par value. Authorized 100,000 shares; issued and outstanding 0 and 100,000 shares at December 31, 2006 and 2005, respectively.	-	1,500

Consolidated Balance Sheets - continued

December 31, 2006 and 2005
(In thousands, except for share information)

	2006	2005
Series B convertible preferred stock, no par value. Authorized 139,000 shares; issued and outstanding 0 and 139,000 shares at December 31, 2006 and 2005, respectively.	-	2,780
Common stock, no par value. Authorized 148,500,000 shares and 51,000,000 at December 31, 2006 and 2005; issued and outstanding 63,909,573 shares and 7,136,202 shares at December 31, 2006 and 2005, respectively	145,064	1
Treasury stock at cost (60,000 shares at December 31, 2006 and 2005, respectively)	(100)	(100)
Accumulated other comprehensive income (loss)	4	(2)
Accumulated deficit	(99,276)	(83,427)
Total stockholders' equity (deficit)	45,692	(79,248)
	54,405	30,320

See accompanying notes to consolidated financial statements.

Consolidated Statements of Operations

Years ended December 31, 2006 and 2005
(In thousands)

	2006	**2005**
	$000	$000
Revenues	40,975	38,425
Cost of revenues	32,938	32,042
	8,037	6,383
Operating expenses:		
Sales and marketing	1,986	1,556
Research and development	6,616	7,081
General and administrative	6,095	5,474
Total operating expenses	14,697	14,111
Loss from operations	(6,660)	(7,728)
Other income (expense):		
Interest income	682	172
Interest expense	(26,468)	(587)
Other	266	(57)
Total other expenses	(25,520)	(472)
Loss before provision for income taxes	(32,180)	(8,200)
Provision for income taxes	20	11
Net loss	(32,200)	(8,211)
Loss per share:		
Basic and diluted	$(0.25)	$(0.39)
Weighted average number of common shares outstanding (000s):		
Basic and diluted	63,850	40,002

See accompanying notes to consolidated financial statements.

Consolidated Statement of Stockholders' Equity (Deficit) and Comprehensive Loss

Years ended December 31, 2006 and 2005
(In thousands)

	Series A convertible preferred stock		Series B convertible preferred stock		Common stock		Treasury stock		Accumulated other comprehensive gain (loss)	Accumulated deficit	Net stockholders' equity (deficit)
	Shares	Amount	Shares	Amount	Shares	Amount	Shares	Amount			
Balance at December 31,2004	100,000	1,500	139,000	2,780	7,136,142	1	(30,000)	(50)	(11)	(67,756)	(63,536)
Net loss										(8,211)	(8,211)
Unrealized gain on foreign currency translation									7		7
Unrealized gain on investments									2		2
Other comprehensive loss											(8,202)
Common stock-option exercise					60	0					0
Treasury stock purchased							(30,000)	(50)			(50)
8% dividend and accretion on Series C redeemable converible preferred stock										(3,550)	(3,550)
8% dividend and accretion on Series D redeemable converible preferred stock										(3,910)	(3,910)
Balance at December 31, 2005	**100,000**	**1,500**	**139,000**	**2,780**	**7,136,202**	**1**	**(60,000)**	**(100)**	**(2)**	**(83,427)**	**(79,248)**
Net loss										(32,200)	**(32,200)**
Unrealized gain on foreign currency translation									3		3
Unrealized gain on investments									3		3
Other comprehensive loss											(32,194)
Stock based compensation						140					140
Issuance of restricted stock					60,000	4					4
Warrants earned						3					3
Warrants exercised					20,894						0
Termination of warrants						(833)					(833)
Convertible notes conversion					9,315,222	40,667					40,667
Issuance of common stock on IPO					12,870,000	25,566					25,566
Conversion of Series A preferred stock to common stock	(100,000)	(1,500)			600,000	1,500					0
Conversion of Series B preferred stock to common stock			(139,000)	(2,780)	834,000	2,780					0
Series C and D dividends (8%) and accretion						(6,923)					(6,923)
Conversion of Series C preferred stock to common					13,196,904	32,736					32,736
Conversion of Series D preferred stock to common					19,876,351	42,440					42,440
Cash paid for fractional shares						(1)					(1)
Series C preferred stock dividends forfeiture						12,581					12,581
Series D preferred stock dividend forfeiture						10,754					10,754
Reclass Series C & D dividends/accretion from accumulated deficit						(16,351)				16,351	0
Balance at December 31, 2006	**-**	**-**	**-**	**-**	**63,909,573**	**145,064**	**(60,000)**	**(100)**	**4**	**(99,276)**	**45,692**

Consolidated Statements of Cash Flows

Years ended December 31, 2006 and 2005
(In thousands)

	2006	**2005**
	$000	$000
Cash flows from operating activities:		
Net loss	(32,200)	(8,211)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	2,403	2,274
Provision for bad debt	-	422
Accretion of interest on convertible debt	18,677	167
Stock-based compensation	147	-
Beneficial conversion feature of notes payable	6,562	-
Amortization of investment premiums/(discounts)	(22)	125
Loss on disposal of equipment	190	17
Changes in operating assets and liabilities:		
Trade accounts receivable	2,167	(1,816)
Inventories	861	(540)
Prepaid expenses and other assets	(1,984)	548
Accounts payable	537	731
Accrued expenses	(31)	(50)
Net cash used in operating activities	(2,693)	(6,333)
Cash flows from investing activities:		
Purchase of available-for-sale securities	(3,797)	-
Sales and maturities of available-for-sale securities	4,515	5,667
Purchase of Applied Utility Systems	(1,563)	-
Capital expenditures	(964)	(1,235)
Proceeds from sale of equipment	-	79
Net cash provided by (used in) investing activities	(1,809)	4,511
Cash flows from financing activities:		
Proceeds from convertible notes	4,177	10,123
Purchase of treasury stock	-	(50)
Proceeds from short-term borrowings	-	1,469
Repayment of short-term borrowings	(3,219)	(1,823)
Repayment of long-term debt	(4)	(97)
Payments for debt issuance costs	(49)	(135)
Payment to extinguish warrants	(833)	-
Preferred Series C stock split (cash paid for fractional shares)	(1)	-
Net proceeds from issuance of common shares	25,566	-
Net cash provided by financing activities	25,637	9,487

Consolidated Statements of Cash Flows - continued

December 31, 2006 and 2005
(In thousands, except for share information)

	2006	2005
Net increase in cash and cash equivalents	21,135	7,665
Cash and cash equivalents, beginning of year	10,242	2,577
Cash and cash equivalents, end of year	31,377	10,242
Supplemental disclosures of cash flow information:		
Cash paid during the year for		
Interest	15	261
Income taxes	26	14
Non cash investing and financing activities:		
Accretion and dividends on preferred stock	6,923	7,460
Conversion of Series C and D redeemable convertible preferred stock to common stock	75,176	-
Forfeited dividends of Series C and D redeemable convertible preferred stock	23,335	-
Convertible notes (principal and accrued interest) of conversion to common stock	34,155	-
Conversion of Series B preferred stock to common stock	2,780	-
Conversion of Series A preferred stock to common stock	1,500	-
Reclass dividends/discounts of Series C and D redeemable convertible preferred stock from retained earnings to common stock	16,351	-
Note payable issued for the acquisition of Applied Utility Systems	3,000	-

See accompanying notes to consolidated financial statements.

Notes to Consolidated Financial Statements

(1) Basis of Preparation

(a) Description of Business

Catalytic Solutions, Inc. ("CSI" or "the Company") is an advanced material science Company that creates and supplies catalyst systems for environmental applications. Formed in 1996, CSI developed a technology that improves the performance and reduces the cost of catalytic converters. CSI has developed a catalytic coating and manufacturing process to apply its coating to a substrate that forms the functional element of a catalytic converter. Catalytic converters assist manufacturers of motor vehicles and operators of power plants and boilers to meet emissions standards around the world.

On August 28, 2006, the Company acquired certain tangible and intangible assets from Applied Utility Systems (AUS) and established Applied Utility Systems, Inc. (a wholly owned subsidiary of the Company) as the operating Company for the new business. AUS, Inc. is engaged in designing and installing systems related to the clean and efficient use of fossil fuels outside of their use in motor vehicles.

(b) Preparation based on U.S. Generally Accepted Accounting Principles (U.S. GAAP)

The consolidated financial statements and accompanying notes are presented in US$ and have been prepared in accordance with U.S. GAAP.

(2) Summary of Significant Accounting Policies

(a) Principles of Consolidation

The consolidated financial statements include the financial statements of Catalytic Solutions, Inc. and its majority-owned subsidiaries. All significant inter-company balances and transactions have been eliminated in consolidation.

(b) Fiscal Year/Period

The Company uses a fiscal year ending on the Saturday closest to December 31. For fiscal years 2006 and 2005 the year end dates were on December 30, 2006 and December 31, 2005, respectively. In these consolidated financial statements, the fiscal year is shown as December 31 for clarity of presentation.

(c) Concentration of Risk

During the years ended December 31, 2006 and 2005, certain customers accounted for 10% or more of the Company's revenues as follows:

	Years ended December 31,	
Customer	**2006**	**2005**
A	49%	42%
B	35%	44%

For purposes of the presentation provided above, Customer A represents the cumulative sales to the various suppliers of the end customer who designates which suppliers to sell to.

As of December 31, 2006 and 2005, certain customers accounted for 10% or more of the Company's accounts receivable balance as follows:

	Years ended December 31,	
Customer	**2006**	**2005**
A	34%	51%
B	23%	23%
C	18%	-
D	12%	19%

During the years ended December 31, 2006 and 2005, certain vendors accounted for 10% or more of the Company's raw material purchases as follows:

	Years ended December 31,	
Vendor	**2006**	**2005**
A	21%	21%
B	17%	16%
C	17%	22%
D	14%	11%

(d) Use of Estimates

The preparation of the financial statements in conformity with accounting principles generally accepted in the United States of America requires management of the Company to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Areas where significant judgments are made include, but are not limited to: stock-based compensation, allowance for doubtful accounts, accounting for construction-type contracts, inventory valuation, taxes, investments, valuation of long-lived assets, and accrued liabilities. Actual results could differ from those estimates.

(e) Cash and Cash Equivalents

Cash and cash equivalents of $31,377,000 and $10,242,000 at December 31, 2006 and 2005, respectively, consist of cash balances, money market mutual funds, and highly liquid corporate bonds with an initial term of less than three months. For purposes of the consolidated statements of cash flows, the Company considers the money market funds and all highly liquid debt instruments with original maturities of three months or less to be cash equivalents.

(f) Trade Accounts Receivable

Trade accounts receivable are recorded at the invoiced amount and do not bear interest. The allowance for doubtful accounts is the Company's best estimate of the amount of probable credit losses in the Company's existing accounts receivable.

The Company determines the allowance based on historical write-off experience and past-due balances over 60 days that are reviewed individually for collectibility. Account balances are charged off against the allowance after all means of collection have been exhausted and the potential for recovery is considered remote. The Company does not have any off-balance sheet credit exposure related to its customers.

(g) Investments

Investments at December 31, 2006 and 2005, consist of corporate and U.S. government bonds. The Company classifies these securities as available-for-sale.

Available-for-sale securities are recorded at fair value. Unrealized holding gains and losses, net of the related tax effect, on available-for-sale securities are excluded from earnings and are reported as a separate component of other comprehensive income or loss until realized. Realized gains and losses from the sale of available-for-sale securities are determined on a specific-identification basis.

Available-for-sale securities are subject to periodic impairment review. Losses are recognized when management determines that a decline in value is other than temporary, which requires judgment regarding the amount and timing of recovery. The impairment is charged to earnings and a new cost basis for the security is established. To determine whether an impairment is other than temporary, the Company considers whether it has the ability and intent to hold the investment until a market price recovery and considers whether evidence indicating the cost of the investment is recoverable outweighs evidence to the contrary. Evidence considered in this assessment includes the reasons for the impairment, the severity and duration of the impairment, changes in value subsequent to year-end and forecasted performance of the Company issuing the security

Premiums and discounts are amortized or accreted over the life of the related available-for-sale security as an adjustment to yield using the effective-interest method. Interest income is recognized when earned.

(h) Inventories

Inventories are stated at the lower of cost (specific-identification method) or market (net realizable value). Finished goods inventory includes materials, labor, and manufacturing overhead.

(i) Property and Equipment

Property and equipment are stated at cost. Property and equipment under capital leases are stated at the present value of the minimum lease payments. Depreciation and amortization have been provided using the straight-line method over the following estimated useful lives:

Machinery and equipment	2 – 10 years
Furniture and fixtures	2 – 5 years
Computer hardware and software	2 – 5 years
Vehicles	2 – 5 years

When an asset is sold or otherwise disposed of, the cost and related accumulated depreciation are removed from the accounts and any resulting gain or loss is recognized. Repairs and maintenance are charged to expense as incurred and major replacements or betterments are capitalized. Property and equipment held under capital leases and leasehold improvements are amortized straight-line over the shorter of the lease term or estimated useful life of the asset. Total depreciation for the years ended December 31, 2006 and 2005 was $2,110,000 and $2,269,000, respectively.

(j) Goodwill

Goodwill is recorded when the purchase price of an acquisition exceeds the estimated fair value of the net identified tangible and intangible assets acquired. Goodwill is tested for impairment on an annual basis and written down when impaired. In fiscal year 2006, there was no impairment test performed on the goodwill resulting from the August 2006 acquisition of assets from AUS. No impairment test was deemed necessary due to the reliance placed on an independent analysis performed by a valuation firm engaged to assist in the allocation of the purchase price.

(k) Purchased Intangible Assets

Purchased intangible assets are carried at cost, less accumulated amortization. Amortization is computed on a straight-line basis over the estimated useful lives of the respective assets, ranging from 1 to 15 years. Intangible assets consist of trade name, a non-competition agreement, patents and know-how, and work-in-progress on a construction contract.

(l) Income Taxes

Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax basis and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. A valuation allowance against deferred tax assets is required if, based on the weight of available evidence, it is more likely than not that some portion or all of the deferred tax assets will not be realized. The valuation allowance should be sufficient to reduce the deferred tax asset to the amount that is more likely than not to be realized.

(m) Revenue Recognition

The Company generally recognizes revenue when products are shipped and the customer takes ownership and assumes risk of loss, collection of the relevant receivable is probable, persuasive evidence of an arrangement exists, and the sales price is fixed or determinable. There are certain customers whose revenue recognition policy is FOB destination point. For these customers, revenue is recognized upon receipt at the customer's warehouse. This generally occurs within five days from shipment date.

AUS, Inc. accounts for revenue and earnings from construction contracts under the percentage-of-completion accounting in accordance with AICPA Statement of Position 81-1, "Accounting for Performance of Construction-Type and Certain Production-Type Contracts". Under this method, AUS, Inc. recognizes revenue measured by the percentage of cost incurred to date to estimated total cost for each contract. This method is used because management considers total cost to be the best available measure of progress on the contracts. Because of inherent uncertainties in estimating costs, it is at least reasonably possible that the estimates used may change materially.

Contract cost includes all direct labor and related fringe benefits, materials installed in the project, and subcontractor costs. Indirect labor and related fringe benefits and selling, general and administrative expenses are charged to operations as incurred. Provisions for estimated losses on uncompleted contracts are made in the period in which such losses are determined. Changes in estimated job profitability resulting from job performance, job conditions, claims, change orders, and settlements, are accounted for as changes in estimates in the current period. Amounts representing contract change orders, claims or other items are included in revenues only when they can be reliably estimated and realization is probable.

(n) Research and Development

Research and development costs are expensed as incurred.

(o) Long-Lived Assets

In accordance with SFAS 144, "Accounting for the Impairment or Disposal of Long-Lived Assets," assets such as property, plant, and equipment are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated future cash flows, an impairment charge is recognized for the amount by which the carrying amount of the asset exceeds the fair value of the asset. Assets to be disposed of would be separately presented in the balance sheet and reported at the lower of the carrying amount or fair value less costs to sell, and are no longer depreciated. The assets and liabilities of a disposed group classified as held for sale would be presented separately in the appropriate asset and liability sections of the balance sheet.

(p) Stock Compensation

On January 1, 2006, the Company began using the modified prospective transition method for accounting for stock options as prescribed by SFAS 123R, "Share-Based Payment," which revised SFAS 123, "Accounting for Stock-Based Compensation." For stock-based awards vesting in 2006, the Company recognizes compensation expense based on the estimated grant date fair value method using the Black-Scholes valuation model. For the year ended December 31, 2006 stock-based compensation expense was $140,000.

Prior to the adoption of SFAS 123R, the Company had applied the intrinsic-value-based method of accounting prescribed by Accounting Principles Board (APB) Opinion No. 25, "Accounting for Stock Issued to Employees," and related

interpretations including FASB Interpretation No. 44, “Accounting for Certain Transactions Involving Stock Compensation,” an Interpretation of APB Opinion No. 25, to account for its fixed plan stock options.

(q) Foreign Currency

The functional currency of the Company’s Japanese branch office is the Japanese Yen. Assets and liabilities of the Japanese branch office are translated into U.S. dollars at period-end exchange rates. The resulting adjustments are charged or credited directly to accumulated comprehensive income (loss) within Stockholders’ Equity. Revenue and expense accounts are translated at the average exchange rates for the period. All realized and unrealized transaction adjustments are included in other income (loss).

On November 22, 2006, the Company issued stock on the Alternative Investment Market on the London Stock Exchange and raised $30.1M. This financing event was primarily transacted in Great Britain sterling pounds. During the time that funds were held in sterling pounds by the Company’s agent, the U.S. dollar weakened against the sterling pound. As a result, there was a net realized transaction gain of $470,000 when the funds were translated into U.S. dollars.

(r) Stock Split

On September 29, 2006, our Board of Directors approved a six-for-one stock split of the Company’s common stock to be effected in the form of a stock dividend. Each Shareholder of record at the close of business on October 17, 2006 was issued five additional shares of common stock for every share of common stock owned as of that time. The additional shares were distributed on or about December 31, 2006. All share and per share amounts in the consolidated financial statements have been adjusted to reflect the 2006 stock split.

(s) New Accounting Pronouncements

In July 2006, FASB issued FASB Interpretation No. 48, “Accounting for Uncertainty in Income Taxes” – an Interpretation of FASB Statement No. 109, “Accounting for Income Taxes,” or FIN 48. FIN 48 clarifies the accounting and reporting for uncertainties in income taxes recognized in an enterprise’s financial statements. The interpretation prescribes a comprehensive model for the financial statement recognition, measurement, presentation and disclosure of uncertain tax positions taken or expected to be taken in income tax returns. FIN 48 will be adopted at the beginning of fiscal year 2007. Management does not expect the impact to be material to the Company’s consolidated financial statements.

(3) Trade Accounts Receivable

Trade accounts receivable at December 31, 2006, and 2005 consisted of the following:

	2006 $	2005 $
Non-contract trade accounts receivable, less allowance for doubtful accounts of $422,000 at December 31, 2006 and 2005	2,380,000	5,277,000
Completed contracts	91,000	-
Contracts in progress	639,000	-
	3,110,000	5,277,000

At December 31, 2006, there are no amounts included in receivables under retainage provisions in contracts.

In December 2005, the Company fully reserved an accounts receivable balance from Delphi in the amount of $422,000. The $422,000 represents the amount owed to CSI at the time of Delphi's filing for bankruptcy protection in October 2005. The entire balance was reserved when the Company determined it was unlikely that Delphi would improve the priority of the debt beyond those of general creditors and a probable loss would be incurred by the Company.

(4) Uncompleted Contracts

Costs and estimated earnings on uncompleted contracts at December 31, 2006 and 2005 consisted of the following:

	2006 $	2005 $
Costs incurred on uncompleted contracts	1,839,000	-
Estimated earnings	1,087,000	-
	2,926,000	-
Less: Billings to date	(1,672,000)	-
	1,254,000	-

The following table details the net balance of $1,254,000 and $0 is included in the accompanying balance sheet at December 31, 2006 and 2005, respectively:

	2006 $	2005 $
Costs and estimated earnings in excess of billings on uncompleted contracts	1,255,000	-
Billings in excess of costs and estimated earnings on uncompleted contracts	(1,000)	-
	1,254,000	-

(5) Inventories

Inventories at December 31, 2006, and 2005 consisted of the following:

	2006 $	2005 $
Finished goods	1,884,000	2,325,000
Work in progress	74,000	542,000
Raw materials	1,496,000	1,448,000
	3,454,000	4,315,000

(6) Short Term Investments

The amortized cost, gross unrealized holding gains, gross unrealized holding losses, and fair value of available-for-sale securities by major security type and class of security at December 31, 2006 and 2005 were as follows:

	Amortized cost $	Gross unrealized holding gains $	Gross unrealized holding loss $	Fair value $
Current investments at December 31, 2005:				
Available for sale				
Corporate debt securities	1,493,000	-	(3,000)	1,490,000
Current investments at December 31, 2006:				
Available for sale:				
Corporate debt securities	798,000	-	-	798,000

Proceeds from the sale and maturity of investment securities available-for-sale were $4,515,000 and $5,667,000 in the years ended December 31, 2006 and 2005, respectively. The cost of those securities is based on specific identification of the respective securities which were sold.

(7) Property and Equipment

Property and equipment at December 31, 2006 and 2005 consisted of the following:

	2006 $	2005 $
Furniture and fixtures	2,411,000	2,309,000
Computer hardware and software	1,914,000	1,863,000
Machinery and equipment	12,572,000	12,372,000
Vehicles	152,000	-
	17,049,000	16,544,000
Less accumulated depreciation	(9,888,000)	(8,179,000)
	7,161,000	8,365,000

(8) Stock Option Plan

The Company has two stock option plans (the 1997 Plan and the 2006 Plan) for the benefit of employees, officers, directors, and consultants of the Company. Under the 1997 Plan, a total of 4,020,000 shares and under the 2006 Plan, a total of 4,200,000 shares of the Company's common stock are reserved for issuance. Options granted under the plans are generally exercisable for a period of ten years from the date of grant at an exercise price that is not less than the fair market value of the common stock on the date of grant. Options granted under the 1997 Plan generally vest over a period of four years and those granted under the 2006 Plan generally vest over a period of 3 years.

The per share weighted average fair value of each option granted during the year ended December 31, 2006 was $1.02 on the date of grant using the Black-Scholes option pricing model with the following weighted average assumptions:

	2006 Plan	1997 Plan
Expected volatility	33.8%	33.8%
Risk-free interest rate	4.80%	4.80%
Dividend yield	0.0%	0.0%
Expected life in years	6.0	6.25
Cancellations	0.0%	8.9%

As of January 1, 2006, as required under SFAS 123R, the Company incorporated estimated volatility of 33.8% and cancellation factors of 8.9% for the 1997 Plan and 0.0% for the 2006 Plan, respectively, in its use of the Black Scholes pricing model. The 2006 Plan uses an expected cancellation of 0.0% because currently only 3 senior executives are participants in the plan.

The following summarizes the stock option transactions under the Company's stock option plans during the years presented:

	Shares	Weighted average exercise price $
Options outstanding at December 31, 2004	3,679,800	1.60
Grants	475,800	1.67
Exercised	(60)	1.67
Cancelled	(859,290)	1.61
Options outstanding at December 31, 2005	3,296,250	1.61
Grants	2,633,881	2.40
Cancelled	(327,900)	1.67
Options outstanding at December 31, 2006	5,602,231	1.98

At December 31, 2006, the range of exercise prices and weighted average remaining contractual life of outstanding options was $1.07 – $2.74 and 8 years, respectively.

At December 31, 2006, the number of options exercisable was 2,998,348 and the weighted average exercise price of those options was $1.61.

In December 2005, the Board of Directors approved an acceleration of the vesting of all outstanding stock options granted as of December 31, 2005, pursuant to the 1997 Stock Option Plan. Effective December 31, 2005, all outstanding stock options issued prior to December 31, 2005 became fully vested and exercisable and retained their original terms, including exercise price and expiration date. There were two primary reasons for taking this action:

1. Reward employees for their contributions towards successfully growing the business.

2. Benefit the Company's future operating results by eliminating compensation expense attributable to options vesting during these future years.

There were a total of 1,680,414 options accelerated pursuant to this action.

(9) Stockholders' Equity

(a) Initial Public Offering on Alternative Investment Market on London Stock Exchange

In November 2006, the Company issued 12,870,000 shares in an initial public offering on the Alternative Investment Market on the London Stock Exchange at a price of $2.35 per share raising net proceeds of $25.6 million. As a result of this financing event, all outstanding preferred stock and convertible notes payable, plus accrued interest at the time of the IPO were converted into common stock.

(b) Conversion of Preferred Stock to Common Stock

Convertible notes of $10.1 million were issued in December 2005 and $4.2 million in January 2006, funded entirely by existing common and preferred Shareholders. In accordance with the terms of the offering, preferred Shareholders not participating in the convertible notes offering had their preferred shares converted to common stock. The conversion was effective on January 31, 2006, the date of the second and final closing of the convertible note offering. The number of shares converted is shown below:

Series of Preferred Stock	Preferred Shares Outstanding before Conversion	Preferred Shares Converted to Common Stock	Preferred Shares Outstanding after Conversion
A	100,000	38,837	61,163
B	139,000	139,000	-
C	2,095,514	707,003	1,388,511
D	3,150,677	110,693	3,039,984
Total	5,485,191	995,533	4,489,658

(c) Series A and B Convertible Preferred Stock

In May 2000, the Company issued 100,000 shares of Series A convertible preferred stock for $15 per share or $1,500,000. In October 2000, the Company issued 139,000 shares of Series B convertible preferred stock for $20 per share or $2,780,000.

In accordance with the terms of the convertible note offering, 38,837 and 139,000 shares of Series A and Series B preferred stock, respectively, were converted into 233,022 shares and 834,000 shares of common stock, respectively, on January 31, 2006. Following the conversion, 61,163 shares of Series A and no Series B preferred stock remained outstanding.

Upon completion of the AIM IPO in November 2006, the remaining 61,163 shares of Series A were converted into 366,978 shares of common stock.

(d) Series C Redeemable Convertible Preferred Stock

In November and December 2001, the Company issued 1,522,066 and 301,127 shares, respectively, of 8% Series C redeemable convertible preferred stock (Series C preferred) in exchange for gross proceeds of $29,595,000.

In April 2001, the Company issued stock rights to purchase shares of Series C redeemable convertible preferred stock at a 25% discount from the actual price per share to be determined at the closing of the Series C redeemable preferred stock financing in November 2001. Such actual price per share at closing was $17.75. The stock rights participants were also granted warrants to purchase 70,143 additional Series C preferred shares at $17.75 per share and warrants to purchase 96,330 shares of common stock at $1.67 per share. The Series C preferred warrants expired in November 2003 and the common warrants expired in April 2003. The fair value attributable to the common warrants, as determined using

the Black-Scholes pricing model at the date of the grant, was $30,000 and was allocated to common stock. No warrants were exercised during years ended December 31, 2006 and 2005.

On December 28, 2005, the Company affected a 1.13625-for-1 stock split on the Series C preferred shares. The stock split was made to simplify the capitalization table and align the voting rights and shares owned by the Series C Shareholders. The split reduced the redemption value from $17.75 to $15.6215 per share. The number of shares outstanding as a result of the split was 2,095,514.

In accordance with the terms of the convertible note offering, 707,003 shares of Series C preferred stock, was converted into 4,242,018 shares of common stock on January 31, 2006. Following the conversion, 1,388,511 shares of Series C preferred stock were outstanding.

Upon completion of the AIM listing in November 2006, the remaining 1,388,511 shares of Series C were converted into 8,331,066 shares of common stock. In accordance with the terms of the Series C Shareholder agreement, the AIM IPO triggered an anti-dilution provision that resulted in an additional 623,820 shares of common stock being issued to the Series C Shareholders.

The dividends associated with the Series C preferred were cumulative, calculated at 8% per annum, accrued whether or not declared, and were payable in cash upon liquidation or redemption. The dividends were payable in preference and priority to any payment of any dividend on shares of Series A preferred, Series B preferred, common stock, or any other class or Series of stock ranking junior to the Series C Preferred. As a result of the AIM listing, all accrued dividends were forfeited.

The following is a summary of the Series C preferred activity and amounts for the years ended December 31, 2006 and 2005:

	Series C redeemable convertible preferred stock	
	Shares	**Amount**
		$
Balance at December 31, 2004	1,844,277	38,579,000
Dividend	-	2,619,000
Accretion	-	931,000
Stock split	251,237	-
Balance at December 31, 2005	2,095,514	42,129,000
Dividend	-	1,861,000
Dividends forfeited	-	(12,581,000)
Accretion	-	1,327,000
Conversion to common stock	(707,003)	(11,046,000)
Conversion to common stock upon IPO	(1,388,511)	(21,690,000)
Balance at December 31, 2006	-	-

(e) Series D Redeemable Convertible Preferred Stock

In May and June 2003, the Company issued 2,405,345 shares of 8% Series D redeemable convertible preferred stock (Series D preferred) in exchange for $32,400,000.

In October 2004, the Company issued 745,332 shares of 8% Series D redeemable convertible preferred stock in exchange for $10,040,000.

In accordance with the terms of the convertible note offering, 110,693 shares of Series D preferred stock, was converted into 664,158 shares of common stock on January 31, 2006. Following the conversion, 3,039,984 shares of Series D preferred stock were outstanding.

Upon completion of the AIM IPO in November 2006, the remaining 3,039,984 shares of Series D were converted into 18,239,904 shares of common stock. In accordance with the terms of the Series D Shareholder agreement, the AIM IPO triggered an anti-dilution provision that resulted in an additional 972,289 shares of common stock being issued to the Series D Shareholders.

The dividends associated with the Series D preferred were cumulative, calculated at 8% per annum, accrued whether or not declared, and were payable in cash upon liquidation or redemption. The dividends were payable in preference to any dividends to other preferred or common shareholders. As a result of the AIM listing, all accrued dividends were forfeited.

The following is a summary of the Series D preferred activity and amounts for the years ended December 31, 2006 and 2005:

	Series D redeemable convertible preferred stock	
	Shares	**Amount**
		$
Balance at December 31, 2004	3,150,677	45,549,000
Dividend	-	3,395,000
Accretion	-	515,000
Balance at December 31, 2005	3,150,677	49,459,000
Dividend	-	3,013,000
Dividends forfeited	-	(10,754,000)
Accretion	-	722,000
Conversion to common stock	(110,693)	(1,491,000)
Conversion to common stock upon IPO	(3,039,984)	(40,949,000)
Balance at December 31, 2006	-	-

(f) Warrants

In January 2002, the Company entered into a warrant agreement with Ford Motor Company (Ford), which provides warrants to Ford in exchange for its assistance with the development, use, and promotion of the Company's products. Under this agreement, the Company granted warrants to purchase 2,871,738 shares of

common stock. These warrants become exercisable based on Ford achieving certain performance objectives. As of December 31, 2006 and 2005, the total number of warrants exercisable by Ford under this agreement was 0 and 1,013,802, respectively. The Company recognized $3,417 as a sales discount to Ford revenue in 2006 for the issuance of 5,892 warrants to Ford. The warrants were valued using the Black-Scholes model.

On November 8, 2006 the Company and Ford agreed to terminate their warrant agreement. In exchange for terminating their rights under the agreement, the Company paid Ford $833,129.

On October 23, 2006 the Company and General Electric reached an agreement to perform a cashless conversion of 72,000 warrants resulting in the issuance of 20,894 shares of common stock.

In October 2005, the Company issued warrants to purchase 37,500 shares of common stock to Silicon Valley Bank as part of the line of credit agreement (See note 11). The warrants are valued at $11,794 and are expensed over the life of the credit agreement as interest expense.

The exercisable warrants and their associated exercise prices are shown below at December 31, 2006 and 2005:

	2006	2005
Warrants exercisable into common stock	37,500	1,123,302
Exercise price	$1.67	$1.56 - $1.67

(10) Long Term Debt

In October 2005, the Company obtained a revolving line of credit from Silicon Valley Bank (the “Facility”). The Facility allows the Company to borrow the lesser of $5 million or the sum of 80% of eligible accounts receivable.

The term of the agreement is 24 months and expires in October 2007. The interest rate on the loan is based on a liquidity calculation with rates ranging from prime +2.0%, prime + 2.75%, or prime +3.75% , with the higher rates used as the amount of liquid funds available to pay off the line decreases. There is a minimum interest charge of $50,000 for the 1st year of the agreement. At December 31, 2006, the Company had no outstanding borrowings under the Facility. As a result, $2,489,000 was available under the Facility at December 31, 2006.

The Company entered into a note payable of $3,000,000 as part of the AUS acquisition. The note is due August 28, 2009 and accrues interest at 5.36%. At December 31, 2006 the Company had accrued $55,000 of unpaid interest on the note.

Long-term debt at December 31, 2006 and 2005 is summarized as follows:

	2006 $	2005 $
Line of credit	-	1,469,000
Note payable	3,000,000	-
Notes payable, interest ranging from 6% to 12%, secured by equipment, repaid in December 2006	-	4,000
	3,000,000	1,473,000
Less current portion	-	4,000
	3,000,000	1,469,000

(11) Convertible Notes

In December 2005, the Company issued $10.1 million of subordinated secured promissory notes. A second closing of notes in the amount of $4.2 million was completed in January 2006. Only current stockholders of the Company were solicited to participate in the note offering. The notes were secured by a security interest in the assets of the Company subordinated to the first lien security interest given to Silicon Valley Bank. The notes bore interest at a rate of 8% per year, and were due and payable on the earlier of (1) a qualified financing event; (2) a liquidation event; (3) certain events of default; or (4) December 28, 2006, later amended to mature August 31, 2007. Upon the occurrence of a qualified financing event, the notes (principal and accrued interest) would automatically convert at a 30% discount into the identical securities issued as part of the qualified financing event. A qualified financing event was deemed to be an initial public offering with aggregate proceeds of not less than $30 million or a preferred equity financing of not less than $20 million excluding the conversion of the notes.

If the notes were not converted as part of a qualified financing event, then upon occurrence of an event that requires payment of the notes, the amount due and payable would equal all the accrued interest plus three-times the outstanding principal amount. The accretion of the note principal to three-times the original notes would be recognized ratably through maturity date and charged to interest expense.

On June 26, 2006, the Company amended the notes to change the maturity date from December 28, 2006 to August 31, 2007.

On November 22, 2006 upon the Company's listing on the AIM market, the convertible notes principal of $14,309,000 plus accrued coupon interest of $1,002,000 converted according to the terms of the notes into common stock resulting in the issuance of 9,315,222 shares of common stock of the Company. The terms of the notes provided for a 30% conversion discount which is deemed a beneficial conversion feature that resulted in a charge to interest expense of $6,562,000. Accreted interest totaled $18,627,000 and $167,000 for the years ended December 31, 2006 and 2005, respectively.

(12) Commitments and Contingencies

The Company leases certain equipment and facilities under operating leases that expire through February 2010. Minimum future payments at December 31, 2006 are as follows:

Years ending December 31:	$
2007	785,000
2008	432,000
2009	76,000
2010	9,000
	1,302,000

Rent expense during 2006 and 2005 totaled $691,000 and $719,000, respectively.

(13) Income Taxes

Income tax expense attributable to loss from continuing operations is summarized as follows:

	Current	Deferred	Total
Year ended December 31, 2005:	$	$	$
U.S Federal	-	-	-
State and local	800	-	800
Foreign	10,200	-	10,200
Total	11,000	-	11,000
Year ended December 31, 2006:			
U.S Federal	-	-	-
State and local	5,600	-	5,600
Foreign	14,400	-	14,400
Total	20,000	-	20,000

Income taxes differ from the amounts computed by applying the federal statutory rate of 34% to loss before provision for income taxes as shown below:

	2006	2005
	$	$
Expected tax benefit	(10,941,000)	(2,788,000)
Net tax effects of:		
State taxes, net of federal benefit	(473,000)	(637,000)
Research credits	(104,000)	(257,000)
Convertible debt interest	8,919,000	56,000
Other	(7,000)	26,000
Warrant repurchase	301,000	-
Change in deferred tax asset valuation allowance due to carry forward of net operating losses	2,325,000	3,611,000
	20,000	11,000

Deferred tax assets consist of the following:

	2006	2005
	$	$
Research and development credits	4,670,000	4,245,000
Other credits	234,000	234,000
Operating loss carry forwards	22,551,000	24,048,000
Warrant expense	-	353,000
Other	241,000	171,000
Inventories	376,000	445,000
Allowance for doubtful accounts	168,000	167,000
Depreciation	(727,000)	(676,000)
Capitalized R&D expenses	3,756,000	-
Non-cash compensation	63,000	-
Gross deferred tax assets	31,332,000	28,987,000
Valuation allowance	(31,332,000)	(28,987,000)
Net deferred tax assets	-	-

The Company had approximately $59,000,000 of federal income tax net operating loss carryforwards at December 31, 2006. The Company had approximately $43,300,000 of state income tax net operating loss carryforwards at December 31, 2006. The federal and state income tax net operating loss carryforwards expire starting in 2013 and 2007, respectively. In accordance with Internal Revenue Code Section 382, the annual utilization of net operating loss carry forwards and tax credits is limited if a change in control occurs, including a change in control resulting from an initial public offering. The Company has not completed the analysis to determine the impact of the annual utilization limitation, if any.

In assessing the potential realization of deferred tax assets, consideration is given to whether it is more likely than not that some portion or all of the deferred tax assets will be realized. The ultimate realization of deferred tax assets is dependent upon the Company attaining future taxable income during the periods in which those temporary differences become deductible. In addition, the utilization of net operating loss carryforwards may be limited due to restrictions imposed under applicable federal and state tax laws due to a change in ownership. Based upon the level of historical operating losses and future projections, management believes it is more likely than not that the Company will not realize the deferred tax assets.

During the year ended December 31, 2006 the Company included $20,000 in deferred tax assets related to stock options which if recognized through a reduction of the valuation allowance will be recorded as additional paid in capital.

(14) Net Earnings per Share ("EPS")

The Company's EPS is calculated using net loss, adjusted for Series C and D preferred stock dividends and accretion of $6,923,000 and $7,460,000, and the impact of forfeited dividends upon the conversion of Series A, B, C and D preferred stock to common of $23,335,000 and $0 for the years ended December 31, 2006 and 2005, respectively. Basic net loss per share is computed using the weighted-average number of common shares outstanding during the period. Diluted net loss per share is computed using the weighted-average number of common shares and excludes certain dilutive potential

common shares outstanding, as their effect is antidilutive on loss from continuing operations. Dilutive potential common shares consist of employee stock options and other warrants that are convertible into the Company's common stock.

Because the Company incurred losses in the years ended December 31, 2006 and 2005, the effect of dilutive securities totalling 5,640,000 and 5,232,000 equivalent shares, respectively, has been excluded in net loss per share, as their impact would be antidilutive. The basic and diluted EPS is shown in the table below:

	2006	**2005**
Numerator: ($)		
Net loss	(32,200,000)	(8,211,000)
Less Series C and D dividends and accretion	(6,923,000)	(7,460,000)
Impact of conversion of Series A-D preferred to common stock	23,335,000	-
Net loss	(15,788,000)	(15,671,000)
Denominator		
Weighted average shares	63,850,000	40,002,000
Net loss per share		
Basic and diluted	$(0.25)	$(0.39)

(15) Applied Utility Systems Acquisition

On August 28, 2006, the Company acquired certain tangible and intangible assets from AUS. Based in Irvine, CA, AUS designs and sells products and services relating to the clean and efficient use of fossil fuels outside of their use in motor vehicles. As part of the acquisition, AUS, Inc. (a wholly owned subsidiary of the Company) was established as the operating Company for the new business. The transaction is a key element of the Company's growth strategy and provides the Company the opportunity to grow its business in the power generation and industrial markets.

The tangible assets consist of office furniture and equipment, computer equipment and related software, and vehicles. The intangible assets consist of the Company name, a non-compete agreement executed with the former owner, the right to complete a project in process, patents and know-how. In addition, the Company was provided the right to assume the existing facility lease, the right to hire the former employees of AUS who were terminated immediately before the transaction was completed, and the right to the former owner's services secured through a consulting agreement. The consulting agreement provides for the uninterrupted services of the former owner in assisting with the management and operation of the new business. A valuation study was completed by an independent valuation firm that was the source of the values and useful lives used to amortize the tangible and intangible assets acquired.

The purchase price consists of cash and notes payable totalling $6,250,000 and contingent consideration based on a percentage of revenue and profits of the new business. The cash payment consisted of $1,500,000 paid at closing. The notes payable consisted of $1,500,000 payable within thirty days after a "qualified financing event" (initial public offering or private equity transaction at specified minimum amounts),

$250,000 payable at December 31, 2006, and $3,000,000 payable on August 28, 2009. The notes payable accrue interest at a rate of 5.36%. As a result of the Company's successful listing on the AIM market on November 22, 2006, the Company paid principal of $1,750,000 and accrued interest of $26,000 on December 6, 2006. In addition, there are contingent payments under an "earn out" provision made annually for ten years starting with the 2010 fiscal year calculated as the sum of 2% of revenue and 10% of profits of the acquired business. The first payment under the "earn out" provision is due 180 days after the reporting period or June 30, 2011. Total consideration paid cannot exceed $28,000,000.

The following table summarizes the estimated fair value of the assets acquired on August 28, 2006:

	Useful life	**$**
Fair value of fixed assets	2 years	132,000
Patents and know-how	5.3 years	1,600,000
Tradename	15 years	1,517,000
Work-in-progress on acquired contract	1.4 years	353,000
Non-competition agreement	3 years	111,000
Goodwill	n/a	2,600,000
		6,313,000

The following table details the financing of the AUS acquisition on August 28, 2006:

	$
Cash payments	1,500,000
Notes payable	4,750,000
Direct acquisition costs	63,000
	6,313,000

(16) Related-party Transactions

One of the Company's investors is Honda Motor Company. Honda (and subsidiaries) is also one of the Company's largest original equipment manufacturers (OEM) customers accounting for in excess of $14 million of sales in December 2006 and in excess of $16 million of sales in 2005. The Company pays a royalty to Honda based on a percentage of catalyst sales to non-Honda OEM automotive customers. Total royalties earned by Honda during fiscal year 2006 and 2005 were $452,000 and $385,000, respectively. The Honda balance in accounts receivable was $0.9 million and $1.3 million at December 31, 2006 and 2005, respectively. As of December 31, 2006 and 2005 the Honda balance in accounts payable was $102,000 and $222,000, respectively.

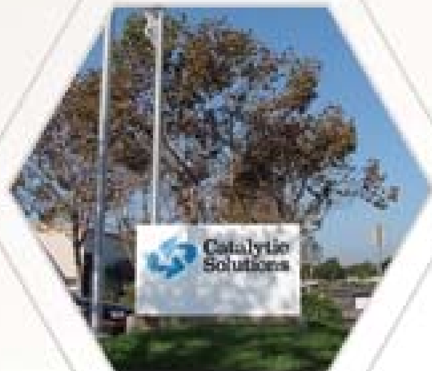
(17) Goodwill and Intangible Assets

During 2006, the Company recorded goodwill of $2,600,000 in connection with the acquisition of AUS. Prior to the acquisition, the Company did not have any goodwill.

Intangible assets as of December 31, 2006 and 2005 are summarized as follows:

	2006	2005
	$	$
Patents and know-how	1,819,000	187,000
Tradename	1,517,000	-
Work-in-progress on acquired contract	353,000	-
Non-competition agreement	111,000	-
	3,800,000	187,000
Less accumulated amortization	(445,000)	(151,000)
	3,355,000	36,000

Aggregate amortization for amortizable intangible assets, using the straight-line amortization method, for the years ended December 31, 2006 and 2005 was $293,000 and $5,000, respectively. Estimated amortization expense for existing intangible assets for the next five years is: $721,000 in 2007, $483,000 in 2008, $470,000 in 2009, $444,000 in 2010 and $215,000 in 2011.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CORPORATE HEADQUARTERS
1640 Fiske Place
Oxnard, CA 93033 USA
+1-805-486-4649
www.catalyticsolutions.com