NICHOLAS APPLEGATE CONVERTIBLE & INCOME FUND
Form N-2
April 01, 2003

As filed with the Securities and Exchange Commission on April 1, 2003

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1933 Act File No. 333-
1940 Act File No. 811-21284

U.S. SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
Form N-2

[X] REGISTRATION STATEMENT UNDER THE SECURITIES ACT OF 1933

[_] Pre-Effective Amendment No.

[_] Post-Effective Amendment No.
and

[X] REGISTRATION STATEMENT UNDER THE INVESTMENT COMPANY ACT OF 1940

[X] Amendment No. 4

Nicholas-Applegate Convertible & Income Fund
(Exact Name of Registrant as Specified in Declaration of Trust)

c/o PIMCO Advisors Fund Management LLC
1345 Avenue of the Americas
New York, New York 10105
(Address of Principal Executive Offices)
(Number, Street, City, State, Zip Code)

(212) 739-3369
(Registrant's Telephone Number, including Area Code)

Newton B. Schott, Jr.
c/o PIMCO Advisors Distributors LLC
2187 Atlantic Street
Stamford, Connecticut 06902
(Name and Address (Number, Street, City, State, Zip Code) of Agent for Service)

Copies of Communications to:

Joseph B. Kittredge, Jr., Esq.	Thomas A. Hale, Esq.
Ropes & Gray	Skadden, Arps, Slate, Meagher & Flom LLP
One International Place	333 West Wacker Drive, Suite 2100
Boston, Massachusetts 02110	Chicago, Illinois 60606

Approximate Date of Proposed Public Offering:

As soon as practicable after the effective date of this Registration Statement

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If any of the securities being registered on this form will be offered on a delayed or continuous basis in reliance on Rule 415 under the Securities Act of 1933, other than securities offered in connection with a dividend reinvestment plan, check the following box. [_]

It is proposed that this filing will become effective (check appropriate box)

[X] when declared effective pursuant to section 8(c)

CALCULATION OF REGISTRATION FEE UNDER THE SECURITIES ACT OF 1933

Title of Securities Being Registered	Amount Being Registered	Proposed Maximum Offering Price Per Unit	Proposed Maxim Aggregate Offering Pric
Preferred Shares, par value $0.00001	10 Shares	$ 25,000.00	$ 250,000.

/1/ Estimated solely for the purpose of calculating the registration fee.

The Registrant hereby amends this Registration Statement on such date or dates as may be necessary to delay its effective date until the Registrant shall file a further amendment which specifically states this Registration Statement shall thereafter become effective in accordance with Section 8(a) of the Securities Act of 1933 or until the Registration Statement shall become effective on such dates as the Commission, acting pursuant to said Section 8(a), may determine.

The information in this Prospectus is not complete and may be changed. We may not sell these securities until the registration statement filed with the Securities and Exchange Commission is effective. This Prospectus is not an offer to sell these securities, and it is not soliciting an offer to buy these securities in any state where the offer or sale is not permitted.

SUBJECT TO COMPLETION

PRELIMINARY PROSPECTUS 2003

[LOGO] PIMCO ADVISORS

Shares, Series A
Shares, Series B
Shares, Series C
Shares, Series D
Shares, Series E

Nicholas-Applegate Convertible & Income Fund

Auction Preferred Shares
Liquidation Preferred $25,000 Per Share

Investment Objective. The Fund is a recently organized, diversified, closed-end management investment company. The Fund's investment objective is to provide total return through a combination of capital appreciation and high current income.

Portfolio Contents. Under normal circumstances, the Fund will invest at least 80% of its total assets in a diversified portfolio of convertible securities and non-convertible income-producing securities. The Fund may invest up to 20% of its total assets in other types of securities. The portion of the Fund's assets invested in convertible securities, on the one hand, and non-convertible income-producing securities, on the other, will vary from time to time consistent with the Fund's investment objective, although the Fund will normally invest at least 50% of its total assets in convertible securities. In making allocation decisions, the Fund's portfolio manager will consider factors such as changes in equity prices, changes in interest rates and other economic and market factors. The Fund may invest without limit in securities that are below investment grade quality and expects that ordinarily the portfolio manager's strategies will result in the Fund investing primarily in these securities. Securities of below investment grade quality are regarded as having predominantly speculative characteristics with respect to capacity to pay interest and repay principal, and are commonly referred to as "high yield" securities or "junk bonds." They involve greater risk of loss, are subject to greater price volatility and are less liquid, especially during periods of economic uncertainty or change, than higher rated securities. Due to the risks involved in investing in high yield securities, an investment in the Fund should be considered speculative. There can be no assurance that the Fund will achieve its investment objective.

Certain capitalized terms used in this Prospectus are defined in the Glossary that appears at the end of this Prospectus.

Before buying any preferred shares you should read the discussion of the material risks of investing in the Fund in "Risks" beginning on page 29. Certain of these risks are summarized in "Prospectus summary--Special Risk Considerations" beginning on page 5.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or determined if this Prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

	Price to Public	Sales Load	Proceeds to Fund(1)
Per share	$25,000	$	$
Total	$	$	$

(1) Plus accumulated dividends if any, from the date the Auction Preferred Shares are issued, but before offering expenses payable by the Fund estimated to be $.

Auction Preferred Shares, Series A, Auction Preferred Shares, Series B, Auction Preferred Shares, Series C, Auction Preferred Shares, Series D, and Auction Preferred Shares, Series E (together, "APS") are being offered by the underwriters subject to certain conditions. The underwriters reserve the right to withdraw, cancel or modify the offering in whole or in part. It is expected that the APS will be delivered to the nominee of The Depository Trust Company on or about , 2003.

(continued from previous page)

Investors in APS will be entitled to receive cash dividends at an annual rate that may vary for the successive dividend periods for such shares. The dividend rate on the Series A APS for the initial period from and including the date of issue to, but excluding, , 2003 will be % per year. The dividend rate on the Series B APS for the initial period from and including the date of issue to, but excluding, , 2003 will be % per year. The dividend rate on the Series C APS for the initial period from and including the date of issue to, but excluding, , 2003 will be % per year. The dividend rate on the Series D APS for the initial period from and including the date of issue to, but excluding, , 2003 will be % per year. The dividend rate on the Series E APS for the initial period from and including the date of issue to, but excluding, , 2003 will be % per year. For each subsequent period, the Auction Agent will determine the dividend rate for a particular period by an auction conducted in accordance with the procedures described in this Prospectus and, in further detail, in Appendix A to the Statement of Additional Information (each, an "Auction").

The APS, which have no history of public trading, will not be listed on an exchange or automated quotation system. Broker-Dealers may maintain a secondary trading market in the APS outside of Auctions; however, they have no obligation to do so, and there can be no assurance that a secondary market for the APS will develop or, if it does develop, that it will provide holders with a liquid trading market (i.e., trading will depend on the presence of willing buyers and sellers and the trading price will be subject to variables to be determined at the time of the trade by such Broker-Dealers). A general increase in the level of interest rates may have an adverse effect on the secondary market price of the APS, and a selling shareholder that sells APS between Auctions may receive a price per share of less than $25,000. The Fund may redeem APS as described under "Description of APS--Redemption."

The APS will be senior in liquidation and distribution rights to the Fund's outstanding common shares. The Fund's common shares are traded on the New York Stock Exchange under the symbol "NCV." This offering is conditioned upon the APS receiving a rating of "Aaa" from Moody's Investors Service, Inc. ("Moody's").

You should read this Prospectus, which contains important information about the Fund, before deciding whether to invest, and retain it for future reference. A Statement of Additional Information, dated , 2003, containing additional information about the Fund, has been filed with the Securities and Exchange Commission and is incorporated by reference in its entirety into this Prospectus, which means that it is part of the Prospectus for legal purposes. You can review the table of contents of the Statement of Additional Information on page of this Prospectus. You may request a free copy of the Statement of Additional Information by calling (877) 819-2224 or by writing to the Fund, or obtain a copy (and other information regarding the Fund) from the Securities and Exchange Commission's web site (http://www.sec.gov).

The APS do not represent a deposit or obligation of, and are not guaranteed or endorsed by, any bank or other insured depository institution, and are not federally insured by the Federal Deposit Insurance Corporation, the Federal Reserve Board or any other government agency.

You should rely only on the information contained or incorporated by reference in this Prospectus. The Fund has not, and the underwriters have not, authorized anyone to provide you with different information. If anyone provides you with different or inconsistent information, you should not rely on it. The Fund is not, and the underwriters are not, making an offer of the APS in any state where the offer is not permitted. You should not assume that the information contained in this Prospectus is accurate as of any date other than the date on the front of this Prospectus. The Fund's business, financial condition, results of operations and prospects may have changed since that date.

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Prospectus summary

This is only a summary. This summary may not contain all of the information that you should consider before investing in the APS. You should review the more detailed information contained in this Prospectus and in the Statement of

Additional Information. Certain capitalized terms used in this Prospectus are defined in the Glossary that appears at the end of this Prospectus.

THE FUND

Nicholas-Applegate Convertible & Income Fund (the "Fund") is a recently organized, diversified, closed-end management investment company registered under the Investment Company Act of 1940, as amended (the "1940 Act"). See "The Fund." The Fund's common shares ("Common Shares") are traded on the New York Stock Exchange under the symbol "NCV." As of , 2003, the Fund had Common Shares outstanding and net assets of $.

THE OFFERING

The Fund is offering an aggregate of Series A APS, Series B APS, Series C APS, Series D APS and Series E APS, each at a purchase price of $25,000 per share plus accumulated dividends, if any, from the date of original issue. The APS are being offered through a group of underwriters led by (collectively, the "Underwriters"). See "Underwriting."

The APS will entitle their holders to receive cash dividends at an annual rate that may vary for successive Dividend Periods. In general, except as described under "Description of APS--Dividends," each Dividend Period will be seven days. The Auction Agent will determine the Applicable Rate for a particular period by an Auction conducted on the Business Day immediately prior to the start of that Dividend Period.

The APS are not listed on an exchange. Instead, investors may buy or sell APS at an Auction that normally is held weekly, by submitting orders to Broker-Dealers that have entered into an agreement with the Auction Agent and the Fund or to certain other Broker-Dealers. Deutsche Bank Trust Company Americas, the Auction Agent, reviews orders from Broker-Dealers on behalf of Existing Holders that wish to sell, or hold at the auction rate, or hold only at a specified Applicable Rate, and on behalf of Potential Holders that wish to buy, APS. The Auction Agent then determines the lowest Applicable Rate that will result in all of the outstanding APS continuing to be held. The first Auction Date for Series A APS will be , 2003, for Series B APS will be , 2003, for Series C APS will be , 2003, for Series D APS will be , 2003 and for Series E APS will be , 2003, each being the Business Day before the Initial Dividend Payment Date for the Initial Dividend Period for the relevant series of APS (, 2003, for Series A, , 2003 for Series B, , 2003 for Series C, 2003 for Series D and , 2003 for Series E). The Auction day for Series A APS generally will be Monday, for Series B APS generally will be Tuesday, for Series C APS generally will be Wednesday, for Series D APS generally will be Thursday and for Series E APS generally will be Friday, unless the then-current Dividend Period is a Special Dividend Period, or the day that normally would be the Auction Date or the first day of the subsequent Dividend Period is not a Business Day.

INVESTMENT OBJECTIVE AND STRATEGIES

Investment Objective

The Fund's investment objective is to provide total return through a combination of capital appreciation and high current income. The Fund attempts to achieve this objective by investing in a diversified portfolio of convertible securities and non-convertible income-producing securities described under

"Portfolio Contents" below. As described below, in seeking to achieve its investment objective, the Fund expects ordinarily to invest primarily in "high yield" securities or "junk bonds." The Fund cannot assure you that it will achieve its investment objective.

Portfolio Management Strategies
In selecting investments for the Fund, Nicholas-Applegate Capital Management LLC ("NACM"), the Fund's portfolio manager, attempts to identify issuers that successfully adapt to change. NACM uses traditional credit analysis combined with a disciplined, fundamental bottom-up research process that facilitates the early identification of issuers demonstrating an ability to improve their fundamental characteristics. See "Independent Credit Analysis" below. NACM attempts to identify potential investments that it expects will exceed minimum credit statistics and exhibit the highest visibility of future expected operating performance. NACM's sell discipline is clearly defined and designed to drive the Fund's portfolio continually toward strength, taking into account factors such as a change in credit fundamentals, a decline in attractiveness relative to other securities and a decline in industry fundamentals.

In selecting convertible securities for investment by the Fund, NACM evaluates each convertible security's investment characteristics as an income-producing security, using the techniques described above, as well as its potential for capital appreciation, using techniques that focus on the security's equity characteristics. NACM seeks to capture approximately 70-80% of any increase in the market price of the underlying equities (upside potential) and 50% or less of any decrease in the market price of the underlying equities (downside exposure). In analyzing specific companies for possible investment, NACM ordinarily looks for several of the following characteristics: above-average per share earnings growth; high return on invested capital; a healthy balance sheet; sound financial and accounting policies and overall financial strength; strong competitive advantages; effective research and product development and marketing; development of new technologies; efficient service; pricing flexibility; strong management; and general operating characteristics that will enable the companies to compete successfully in their respective markets. NACM will consider selling a particular convertible security when any of those factors materially changes.

Independent Credit Analysis
NACM relies heavily on its own analysis of the credit quality and risks associated with individual securities considered for the Fund, rather than relying exclusively on Rating Agencies or third-party research. The team managing the Fund utilizes this information in an attempt to minimize credit risk and identify issuers, industries or sectors that are undervalued or that offer attractive capital appreciation potential or high current income relative to NACM's assessment of their credit characteristics.

Portfolio Contents
Under normal circumstances, the Fund will invest at least 80% of its total assets in a diversified portfolio of convertible securities and non-convertible income-producing securities. The portion of the Fund's assets invested in convertible securities, on the one hand, and non-convertible income-producing securities, on the other, will vary from time to time consistent with the Fund's investment objective, although the Fund will normally invest at least 50% of its total assets in convertible securities. In making allocation decisions, NACM will consider factors such as changes in equity prices, changes in interest rates and other economic and market factors. The Fund may invest without limit in convertible securities and non-convertible income-producing securities that are below investment grade quality, and expects that ordinarily NACM's portfolio strategies will result in the Fund investing primarily in these securities. The Fund invests in securities with a broad range of

maturities. The weighted average maturity of the Fund will typically range from five to ten years, although the weighted average maturity of obligations held by the Fund may be shorter or longer at any time or from time to time depending on market

conditions. The Fund may invest up to 20% of its total assets in other types of securities. The Fund may invest in securities of companies with smaller market capitalizations. The principal types of securities in which the Fund will invest are described below. For more detailed descriptions, see "The Fund's investment objective and strategies--Portfolio Contents and Other Information."

Convertible Securities

The Fund may invest without limit in convertible securities, and these securities will ordinarily constitute a principal component of the Fund's investment program. Under normal circumstances, the Fund will invest at least 50% of its total assets in convertible securities. Convertible securities are bonds, debentures, notes, preferred stocks or other securities that may be converted or exchanged (by the holder or by the issuer) into shares of the underlying common stock (or cash or securities of equivalent value) at a stated exchange ratio or predetermined price (the "conversion price"). A convertible security is designed to provide current income and also the potential for capital appreciation through the conversion feature, which enables the holder to benefit from increases in the market price of the underlying common stock. A convertible security may be called for redemption or conversion by the issuer after a particular date and under certain circumstances (including a specified price) established upon issue. Depending upon the relationship of the conversion price to the market value of the underlying security, a convertible security may trade more like an equity security than a debt instrument. See "The Fund's investment objective and strategies--Portfolio Contents and Other Information--Convertible Securities."

Synthetic Convertible Securities

The Fund also may invest without limit in "synthetic" convertible securities, which combine separate securities that possess the two principal characteristics of a traditional convertible security, i.e., an income-producing security ("income-producing component") and the right to acquire an equity security ("convertible component"). The income-producing component is achieved by investing in non-convertible, income-producing securities such as bonds, preferred stocks and money market instruments. The convertible component is achieved by investing in warrants or options to buy common stock at a certain exercise price, or options on a stock index. A simple example of a synthetic convertible security is the combination of a traditional corporate bond with a warrant to purchase equity securities of the issuer of the bond. The Fund may also purchase synthetic securities created by other parties, typically investment banks, including convertible structured notes. The income-producing and convertible components of a synthetic convertible security may be issued separately by different issuers and at different times. The Fund's holdings of synthetic convertible securities are considered convertible securities for purposes of the Fund's policy to invest at least 50% of its total assets in convertible securities and 80% of its total assets in a diversified portfolio of convertible securities and non-convertible income-producing securities. See "The Fund's investment objective and strategies--Portfolio Contents and Other Information--Synthetic Convertible Securities."

Non-Convertible Income-Producing Securities

The Fund will also invest in non-convertible income-producing securities, including, but not limited to, corporate bonds, debentures, notes and other similar types of corporate debt instruments, as well as non-convertible preferred stocks, bank loans and loan participations, commercial paper, real estate investment trusts ("REITs") and commercial and other mortgage-related and asset-backed securities, payment-in-kind securities, credit-linked trust certificates and other securities issued by special purpose or structured vehicles, zero-coupon bonds, bank certificates of deposit, fixed time deposits, bankers' acceptances and U.S. Government securities. The Fund's investments in non-convertible income-producing securities may have fixed or variable principal payments and all types of interest rate and dividend payment and reset terms, including fixed rate, adjustable rate, zero-coupon, contingent, deferred, payment-in-kind and auction-rate features. See "The Fund's investment objective and strategies--Portfolio Contents and Other Information--Non-Convertible Income-Producing Securities."

High Yield Securities

The Fund may invest without limit in convertible securities and non-convertible income-producing securities that are below investment grade quality, and expects that ordinarily NACM's portfolio strategies will result in the Fund investing primarily in these securities. Below investment grade securities are securities rated, at the time of investment, below the four highest grades (i.e., rated Ba or lower by Moody's or BB or lower by Standard & Poor's ("S&P")) or securities that are unrated but judged to be of comparable quality by NACM. Below investment grade securities are sometimes referred to as "high yield" securities or "junk bonds." The Fund may invest in high yield securities of any rating, including securities given the lowest non-default rating (C by Moody's or S&P, as described in Appendix A) or unrated securities judged to be of comparable quality by NACM. Securities of below investment grade quality are regarded as having predominantly speculative characteristics with respect to capacity to pay interest and repay principal. Securities in the lowest investment grade category (i.e., Baa by Moody's or BBB by S&P) also may be considered to possess some speculative characteristics. The Fund may purchase distressed securities that are in default or the issuers of which are in bankruptcy. See "The Fund's investment objective and strategies--Portfolio Contents and Other Information--High Yield Securities."

Foreign (Non-U.S.) Investments

The Fund may invest up to 20% of its total assets in U.S. dollar-denominated securities of foreign issuers based in developed countries. For this purpose, foreign securities include, but are not limited to, foreign convertible securities and non-convertible income-producing securities, foreign equity securities (including preferred securities of foreign issuers), foreign bank obligations, and obligations of foreign governments or their subdivisions, agencies and instrumentalities, international agencies and supranational entities. For this purpose, foreign securities do not include American Depository Receipts ("ADRs") or securities guaranteed by a United States person, but may include foreign securities in the form of Global Depository Receipts ("GDRs") or other securities representing underlying shares of foreign issuers See "The Fund's investment objective and strategies--Portfolio Contents and Other Information--Foreign (Non-U.S.) Investments and Currencies."

Rule 144A Securities

The Fund may invest without limit in securities that have not been registered for public sale, but that are eligible for purchase and sale pursuant to Rule 144A under the Securities Act of 1933, as amended. Rule 144A permits certain qualified institutional buyers, such as the Fund, to trade in privately placed securities that have not been registered for sale under that Act. Rule 144A Securities may be deemed illiquid and thus subject to the Fund's limit on investments in illiquid securities, although the Fund may determine that certain Rule 144A Securities are liquid in accordance with procedures adopted by the Board of Trustees.

LEVERAGE

The Fund expects to utilize financial leverage on an ongoing basis for investment purposes. After completion of the offering of the APS, the Fund anticipates its total leverage from the issuance of APS will be approximately 35%. This amount may change, but total leverage will not exceed 50% of the Fund's total assets. Although the Fund may in the future offer other Preferred Shares, the Fund does not currently intend to offer Preferred Shares other than Series A APS, Series B APS, Series C APS, Series D APS and Series E APS. The Fund may also leverage the portfolio by borrowing money, issuing debt securities, and utilizing reverse repurchase agreements and other derivative instruments, although these forms of leverage will generally be used as a substitute for, rather than in addition to, the leverage obtained through the issuance of the APS.

The Fund generally will not utilize leverage if it anticipates that it would result in a lower return to Common Shareholders over time. Use of financial leverage creates an opportunity for increased income

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for Common Shareholders but, at the same time, creates the possibility for greater loss (including the likelihood of greater volatility of net asset value and market price of the shares and of dividends), and there can be no assurance that a leveraging strategy will be successful during any period in which it is employed. Because the fees paid to the Manager and NACM will be calculated on the basis of the Fund's managed assets, the fees will be higher when leverage (including the APS) is utilized, giving the Manager and NACM an incentive to utilize leverage. See "Risks--Leverage Risk."

INVESTMENT MANAGER

PIMCO Advisors Fund Management LLC (the "Manager") serves as the investment manager of the Fund. Subject to the supervision of the Board of Trustees, the Manager is responsible for managing, either directly or through others selected by it, the investment activities of the Fund and the Fund's business affairs and other administrative matters. The Manager will receive an annual fee, payable monthly, in an amount equal to 0.70% of the Fund's average daily total managed assets. "Total managed assets" means the total assets of the Fund (including any assets attributable to the APS or other forms of leverage that may be outstanding) minus accrued liabilities (other than liabilities representing leverage). The Manager is located at 1345 Avenue of the Americas, New York, New York 10105. Organized in 2000 as a subsidiary successor in the restructuring of a business originally organized in 1987, the Manager provides investment management and advisory services to several closed-end and open-end investment company clients. As of December 31, 2002, the Manager had approximately $16.6 billion in assets under management. Allianz Dresdner Asset Management of America L.P. is the direct parent company of PIMCO Advisors Retail Holdings LLC, of which the Manager is a wholly-owned subsidiary. As of December 31, 2002, Allianz Dresdner Asset Management of America L.P. and its subsidiary partnerships, including NACM, had approximately $357 billion in assets under management.

The Manager has retained its affiliate, NACM, as a sub-adviser to manage the Fund's portfolio investments. See "--Portfolio Manager" below.

PORTFOLIO MANAGER

NACM serves as the Fund's sub-adviser responsible for managing the Fund's portfolio investments, and is sometimes referred to herein as the "portfolio manager." Subject to the supervision of the Manager, NACM has full investment discretion and makes all determinations with respect to the investment of the Fund's assets.

NACM is located at 600 West Broadway, 30th Floor, San Diego, California 92101. Founded in 1984, NACM currently manages discretionary assets for numerous clients, including investment companies, employee benefit plans, corporations, public retirement systems and unions, university endowments, foundations, and other institutional investors and individuals. As of December 31, 2002, NACM had approximately $16.6 billion in assets under management.

The Manager (and not the Fund) will pay a portion of the fees it receives to NACM in return for NACM's services.

SPECIAL RISK CONSIDERATIONS

Risks of investing in APS include:

Auction Risk
You may not be able to sell your APS at an Auction if the Auction fails, that is, if there are more APS offered for sale than there are buyers for those shares. As a result, your investment in APS may be

illiquid. Neither the Broker-Dealers nor the Fund are obligated to purchase APS in an Auction or otherwise, nor is the Fund required to redeem APS in the event of a failed Auction.

Ratings and Asset Coverage Risk
A Rating Agency could downgrade the APS, which could affect their liquidity and value. In addition, the Fund may be forced to redeem your APS to meet regulatory or Rating Agency requirements. The Fund may also voluntarily redeem APS under certain circumstances.

Secondary Market Risk
You could receive less than the price you paid for your APS if you sell them outside of an Auction, especially when market interest rates are rising. Although the Broker-Dealers may maintain a secondary trading market in the APS outside of Auctions, they are not obligated to do so, and no secondary market may develop or exist at any time for the APS.

General risks of investing in the Fund include:

Limited Operating History
The Fund is a recently organized, diversified, closed-end management investment company which has been operational for less than   months.

Market Discount Risk
Shares of closed-end management investment companies like the Fund frequently trade at a discount from their net asset value.

Convertible Securities Risk
The Fund may invest without limit in convertible securities, and these securities will ordinarily constitute a principal component of the Fund's investment program. Under normal circumstances, the Fund will invest at least 50% of its total assets in convertible securities. Convertible securities

generally offer lower interest or dividend yields than non-convertible securities of similar quality. The market values of convertible securities tend to decline as interest rates increase and, conversely, to increase as interest rates decline. However, a convertible security's market value tends to reflect the market price of the common stock of the issuing company when that stock price is greater than the convertible security's "conversion price." The conversion price is defined as the predetermined price at which the convertible security could be exchanged for the associated stock. As the market price of the underlying common stock declines, the price of the convertible security tends to be influenced more by the yield of the convertible security. Thus, it may not decline in price to the same extent as the underlying common stock. In the event of a liquidation of the issuing company, holders of convertible securities would be paid before the company's common stockholders but after holders of any senior debt obligations of the company. Consequently, the issuer's convertible securities generally entail less risk than its common stock but more risk than its debt obligations. See "Risks--Convertible Securities Risk."

Synthetic Convertible Securities Risk
The Fund may invest without limit in synthetic convertible securities. The value of a synthetic convertible security will respond differently to market fluctuations than a traditional convertible security because a synthetic convertible is composed of two or more separate securities or instruments, each with its own market value. Because the convertible component is typically achieved by investing in warrants or options to buy common stock at a certain exercise price, or options on a stock index, synthetic convertible securities are subject to the risks associated with derivatives. See "Risks--Convertible Securities Risk" and "Risks--Derivatives Risk." In addition, if the value of the underlying common stock or the level of the index involved in the convertible component falls below the exercise price of the

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warrant or option, the warrant or option may lose all value. See "Risks--Synthetic Convertible Securities Risk."

Credit Risk/High Yield Risk
Credit risk is the risk that one or more securities in the Fund's portfolio will decline in price, or fail to pay interest or principal when due, because the issuer of the obligation or the issuer of a reference security experiences a decline in its financial status. Any default by an issuer of an debt obligation could have a negative impact on the Fund's ability to pay dividends on the APS and could result in the redemption of some or all of the APS. The Fund may invest without limit in securities that are below investment grade quality, and expects that ordinarily NACM's portfolio strategies will result in the Fund investing primarily in these securities. Securities of below investment grade quality (commonly referred to as "high yield" securities or "junk bonds") are predominantly speculative with respect to the issuer's capacity to pay interest and repay principal when due, and therefore involve a greater risk of default. The prices of these lower grade obligations are more sensitive to negative developments, such as a decline in the issuer's revenues or a general economic downturn, than are the prices of higher grade securities. The Fund may purchase distressed securities that are in default or the issuers of which are in bankruptcy. Securities in the lowest investment grade category also may be considered to possess some speculative characteristics by certain Rating Agencies. See "The Fund's investment objective and strategies--Portfolio Contents and Other Information--High Yield Securities," "Risks--Credit Risk" and "Risks--High Yield Risk" for additional information. Due to the risks involved in investing in high yield securities, an investment in the Fund should be considered speculative.

Interest Rate Risk

Generally, when market interest rates fall, the prices of convertible and non-convertible income-producing obligations rise, and vice versa. Interest rate risk is the risk that the securities in the Fund's portfolio will decline in value because of increases in market interest rates. Because market interest rates are currently near their lowest levels in many years, there is a greater risk that the Fund's portfolio will decline in value. The prices of longer-term obligations generally fluctuate more than prices of shorter-term obligations as interest rates change. Because the weighted average maturity of the Fund's securities typically will range from five to ten years, the Fund's net asset value will tend to fluctuate more in response to changes in market interest rates than if the Fund invested mainly in short-term obligations. If interest rates rise, the value of the Fund's investment portfolio may decline reducing asset coverage on the APS. See "Risks--Interest Rate Risk" for additional information.

Issuer Risk

The value of securities in the Fund's portfolio may decline for a number of reasons which directly relate to the issuer, such as management performance, financial leverage and reduced demand for the issuer's goods and services.

Equity Securities Risk

The Fund will often have substantial exposure to equity securities by virtue of the equity component of the convertible securities in which the Fund invests. The Fund may also hold equity securities in its portfolio upon conversion of a convertible security or through direct investments in preferred stocks. The market price of equity securities may go up or down, sometimes rapidly or unpredictably. Equity securities may decline in value due to factors affecting equity securities markets generally, particular industries represented in those markets or the issuer itself, including the historical and prospective earnings of the issuer and the value of its assets. Equity securities generally have greater price volatility than debt and other income-producing securities.

Leverage Risk

The Fund utilizes financial leverage for investment purposes. Leverage risk includes the risk associated with the issuance of the APS to leverage the Fund's Common Shares. The Fund may also leverage the portfolio by borrowing money, issuing debt securities, and utilizing reverse repurchase agreements and other derivative instruments, although these forms of leverage will generally be used as a substitute for, rather than in addition to, the leverage obtained through the issuance of the APS. If the dividend rate on the APS and interest rates (if applicable) on other forms of leverage, as reset periodically, exceeds the net rate of return on the Fund's portfolio, the leverage will result in a lower net asset value than if the Fund were not leveraged, and the Fund's ability to pay dividends and to meet its asset coverage requirements on the APS would be reduced.

Because the fees received by the Manager and NACM are based on the total managed assets of the Fund, the fees will be higher when leverage (including the APS) is utilized, giving the Manager and NACM an incentive to utilize leverage.

Liquidity Risk

The Fund may invest up to 5% of its total assets in securities which are illiquid at the time of investment (determined using the Securities and Exchange Commission's standard applicable to open-end investment companies, i.e., securities that cannot be disposed of within seven days in the ordinary course of business at approximately the value at which the Fund has valued the securities). Illiquid securities may trade at a discount from comparable, more liquid investments, and may be subject to wide fluctuations in market value. Also, the Fund may not be able to dispose of illiquid securities when that would be beneficial at a favorable time or price.

Foreign (Non-U.S.) Investment Risk

The Fund's investments in U.S. dollar-denominated securities of foreign issuers involve special risks. For example, the value of these investments may decline in response to unfavorable political and legal developments, unreliable or untimely information, or economic and financial instability. Foreign settlement procedures also may involve additional risks.

Smaller Company Risk

The general risks associated with corporate income-producing and equity securities are particularly pronounced for securities issued by companies with smaller market capitalizations. These companies may have limited product lines, markets or financial resources, or they may depend on a few key employees. As a result, they may be subject to greater levels of credit, market and issuer risk. Securities of smaller companies may trade less frequently and in lesser volume than more widely held securities and their values may fluctuate more sharply than other securities. Companies with medium-sized market capitalizations may have risks similar to those of smaller companies.

Derivatives Risk

The Fund may utilize derivative instruments for investment purposes, as well as to leverage its portfolio, generally as a substitute for, rather than in addition to, the issuance of the APS. These may include derivatives used as a component of a synthetic convertible security or to gain exposure to high yield securities and other securities in which the Fund may invest (pending investment of the proceeds of this offering). Such derivative instruments include, but are not limited to, warrants, options on common stock or stock indexes and futures contracts. The Fund may also have exposure to derivatives, such as credit default swaps and interest rate swaps, through investments in credit-linked trust certificates or other securities issued by special purpose or structured vehicles. Derivatives are subject to a number of risks described elsewhere in this Prospectus, such as liquidity risk, equity securities risk, issuer risk, credit risk, interest rate risk, leveraging risk, management risk and, if applicable, smaller company risk. They also

involve the risk of mispricing or improper valuation, the risk of ambiguous documentation, and the risk that changes in the value of the derivative may not correlate perfectly with an underlying asset, interest rate or index. Suitable derivative transactions may not be available in all circumstances and there can be no assurance that the Fund will engage in these transactions when that would be beneficial.

Counterparty Risk

The Fund will be subject to credit risk with respect to the counterparties to derivative contracts entered into directly by the fund or held by special purpose or structured vehicles in which the Fund invests. If a counterparty becomes bankrupt or otherwise fails to perform its obligations under a derivative contract due to financial difficulties, the Fund may experience significant delays in obtaining any recovery under the derivative contract in a bankruptcy or other reorganization proceeding. The Fund may obtain only a limited recovery or may obtain no recovery in such circumstances.

REITs and Mortgage-Related Risk

Investing in REITs involves certain unique risks in addition to investing in the real estate industry in general. REITs are subject to interest rate risks (especially mortgage REITs) and the risk of default by lessees or borrowers. An equity REIT may be affected by changes in the value of the underlying properties owned by the REIT. A mortgage REIT may be affected by the ability of the issuers of its portfolio mortgages to repay their obligations. REITs whose underlying assets are concentrated in properties used by a particular industry are also subject to risks associated with such industry. REITs may have limited financial resources, may trade less frequently and in a limited volume and may be subject to more abrupt or erratic price movements than larger company securities.

In addition to REITs, the Fund may invest in a variety of other mortgage-related securities, including commercial mortgage securities and other mortgage-backed instruments. Rising interest rates tend to extend the duration of mortgage-related securities, making them more sensitive to changes in interest rates, and may reduce the market value of the securities. In addition, mortgage-related securities are subject to prepayment risk--the risk that borrowers may pay off their mortgages sooner than expected, particularly when interest rates decline. This can reduce the Fund's returns because the Fund may have to reinvest that money at lower prevailing interest rates. The Fund's investments in other asset-backed securities are subject to risks similar to those associated with mortgage-backed securities, as well as additional risks associated with the nature of the assets and the servicing of those assets.

Reinvestment Risk

Income from the Fund's portfolio will decline if and when the Fund invests the proceeds from matured, traded or called obligations at market interest rates that are below the portfolio's current earnings rate. This could impact the Fund's net asset value and reduce asset coverage on the APS.

Inflation Risk

Inflation risk is the risk that the value of assets or income from the Fund's investments will be worth less in the future as inflation decreases the value of payments at future dates. As inflation increases, the real value of the APS and distributions, as well as the value of the Fund's portfolio, could decline.

Management Risk

The Fund is subject to management risk because it is an actively managed portfolio. NACM and the portfolio management team will apply investment techniques and risk analyses in making investment decisions for the Fund, but there can be no guarantee that these will produce the desired results.

Anti-Takeover Provisions

The Fund's Amended and Restated Agreement and Declaration of Trust (the "Declaration") and Amended Bylaws include provisions that could limit the ability of other entities or persons to acquire control of the Fund, convert the Fund to open-end status or to change the composition of the Board of Trustees. Preferred Shareholders will have voting rights in addition to and separate from the voting rights of the Common Shareholders in certain situations. See "Anti-takeover and other provisions in the Declaration of Trust." Preferred Shareholders, on the one hand, and Common Shareholders, on the other, may have interests that conflict in these situations.

Certain Affiliations

Because certain broker-dealers may be considered affiliated persons of the Fund, the Manager and/or NACM, the Fund's ability to utilize such broker-dealers is subject to restrictions and, in some cases, is prohibited.

This could limit the Fund's ability to engage in securities transactions and take advantage of market opportunities.

Market Disruption and Geopolitical Risk
The recent outbreak of war with Iraq is likely to have a substantial impact on the U.S. and world economies and securities markets. The nature, scope and duration of the war and such impact cannot be predicted with any certainty. Terrorist attacks on the World Trade Center and the Pentagon on September 11, 2001 closed some of the U.S. securities markets for a four-day period and similar events cannot be ruled out. The war, terrorism and related geopolitical risks have led, and may in the future lead, to increased short-term market volatility and may have adverse long-term effects on U.S. and world economies and markets generally. Those events could also have an acute effect on individual issuers or related groups of issuers. These risks could adversely affect interest rates, Auctions, secondary trading, ratings, credit risk, inflation and other factors relating to the Common Shares.

For additional information about the risks of investing in the APS and in the Fund, see "Risks."

DIVIDENDS ON APS

The APS will entitle their holders to receive cash dividends at a rate per annum that may vary for the successive Dividend Periods for such shares. In general, except as described below, each Dividend Period for each series of APS subsequent to the Initial Dividend Period will be seven days in length. The Applicable Rate for a particular Dividend Period will be determined by an Auction conducted on the Business Day next preceding the start of such Dividend Period.

Through their Broker-Dealers, Beneficial Owners and Potential Beneficial Owners of APS may participate in Auctions, although, except in the case of Special Dividend Periods of longer than 91 days, Beneficial Owners desiring to continue to hold all of their APS regardless of the Applicable Rate resulting from Auctions need not participate. For an explanation of Auctions and the method of determining the Applicable Rate, see "Description of APS--The Auction."

Except as described herein, investors in APS will not receive certificates representing ownership of their shares. Ownership of APS will be maintained in book-entry form by the Securities Depository or its nominee for the account of the investor's Agent Member. The investor's Agent Member, in turn, will maintain records of such investor's beneficial ownership of APS. Accordingly, references herein to an investor's investment in or purchase, sale or ownership of APS are to purchases, sales or ownership of those shares by Beneficial Owners.

After the Initial Dividend Period, each Subsequent Dividend Period for each series of APS will generally consist of seven days (a "7-Day Dividend Period"); provided, however, that prior to any Auction, the Fund may elect, subject to certain limitations described herein, upon giving notice to holders thereof, a

Special Dividend Period for any or all series. A "Special Dividend Period" is a Dividend Period consisting of a specified number of days, evenly divisible by seven and not fewer than 14 nor more than 364 (a "Short Term Dividend Period") or a Dividend Period consisting of a specified period of one whole year or more but not greater than five years (a "Long Term Dividend Period"). Dividends on the APS offered hereby are cumulative from the Date of Original Issue and are payable when, as and if declared by the Board of Trustees of the Fund, out of funds legally available therefor, commencing on the Initial Dividend Payment Date. In the case of Dividend Periods that are not Special Dividend Periods, dividends will be payable generally on each succeeding Tuesday for Series A APS, on each succeeding Wednesday for Series B APS, on each succeeding Thursday for Series C APS, on each succeeding Friday for Series D APS and on each succeeding Monday for Series E APS, subject to certain exceptions.

Dividends for the APS will be paid through the Securities Depository on each Dividend Payment Date. The Securities Depository's normal procedures provide for it to distribute dividends in same-day funds to Agent Members, who are in turn expected to distribute such dividends to the person for whom they are acting as agent in accordance with the instructions of such person. See "Description of APS--Dividends."

For each Subsequent Dividend Period, the cash dividend rate on each series of APS will be the Applicable Rate that the Auction Agent advises the Fund has resulted from an Auction. See "Description of APS--Dividends." The first Auction for each series of the APS is scheduled to be held on the ending date for the Initial Dividend Period as set forth above.

The Amended Bylaws provide that until the Fund gives a Request for Special Dividend Period and the related Notice of Special Dividend Period, only 7-Day Dividend Periods will be applicable to each series of APS. While the Fund does not currently intend to give a Request for Special Dividend Period with respect to any series of APS, it may so elect in the future subject to, and on, the conditions discussed under "Description of the APS--Dividends--Notification of Dividend Period."

A Special Dividend Period will not be effective for a series of APS unless Sufficient Clearing Bids exist at the Auction in respect of such Special Dividend Period. If Sufficient Clearing Bids do not exist at such Auction, the Dividend Period commencing on the Business Day succeeding such Auction will be a 7-Day Dividend Period, and the holders of the APS outstanding immediately prior to such Auction will be required to continue to hold some or all of such shares for such Dividend Period. In addition, the Fund may not give a Notice of Special Dividend Period with respect to the APS, or if the Fund has given a Notice of Special Dividend Period for the APS, the Fund will be required to give a Notice of Revocation in respect thereof, if (i) either the 1940 Act APS Asset Coverage is not satisfied or the Fund fails to maintain Moody's Eligible Assets with, an aggregate Discounted Value at least equal to the APS Basic Maintenance Amount, in each case on each of the two Valuation Dates immediately preceding the Business Day prior to-the related Auction Date for the APS, or (ii) sufficient funds for the payment of dividends payable on the immediately succeeding Dividend Payment Date have not been irrevocably deposited with the Auction Agent by the close of business on the third Business Day preceding the related Auction Date. In such event, the next succeeding Dividend Period will be a 7-Day Dividend Period.

DETERMINATION OF MAXIMUM APPLICABLE RATES

Except during a Non-Payment Period, the Applicable Rate for any Dividend Period for APS will not be more than the Maximum Applicable Rate applicable to such shares. The Maximum Applicable Rate for each series of APS will depend on the credit rating assigned to such series and on the duration of the Dividend Period. The Maximum Applicable Rate will be the Applicable Percentage of the Reference Rate. The Reference Rate is the applicable "AA" Financial Composite Commercial Paper Rate (for a dividend period of fewer than 184 days) or the applicable Treasury Index Rate (for a dividend period of 184 days or more). The Applicable Percentage is subject to upward but not downward adjustment in the discretion of the Board of Trustees after consultation with the Broker-Dealers. The Applicable Percentage is determined as follows:

Moody's Credit Rating	Applicable Percentage
Aa3 or higher	150%
A3 to A1	200%
Baa3 to Baa1	225%
Below Baa3	275%

There is no minimum Applicable Rate in respect of any Dividend Period. The Applicable Rate for any Dividend Period commencing during any Non-Payment Period, and the rate used to calculate the late charge described under "Description of APS--Dividends--Non-Payment Period; Late Charge," initially will be % of the Reference Rate.

AUCTION PROCEDURES

Separate Auctions will be conducted for each series of APS. Unless otherwise permitted by the Fund, Beneficial Owners and Potential Beneficial Owners of APS may only participate in Auctions through their Broker-Dealers. Broker-Dealers will submit the Orders of their respective customers who are Beneficial Owners and Potential Beneficial Owners to the Auction Agent, designating themselves as Existing Holders in respect of shares subject to Orders submitted or deemed submitted to them by Beneficial Owners and as Potential Holders in respect of shares subject to Orders submitted to them by Potential Beneficial Owners. On or prior to each Auction Date for the APS (the Business Day next preceding the first day of each Dividend Period), each Beneficial Owner may submit Orders to its Broker Dealer as follows:

- Hold Order--indicating its desire to hold the APS without regard to the Applicable Rate for the next Dividend Period for such shares.

- Bid--indicating its desire to hold the APS, provided that the Applicable Rate for the next Dividend Period for such shares is not less than the rate per annum specified in such Bid.

- Sell Order--indicating its desire to sell the APS without regard to the Applicable Rate for the next Dividend Period for such shares.

A Beneficial Owner may submit different types of Orders to its Broker-Dealer with respect to the APS then held by such Beneficial Owner, provided that the total number of APS covered by such Orders does not exceed the number of APS held by such Beneficial Owner. If, however, a Beneficial Owner offers through its Broker-Dealer to purchase additional APS in such Auction, such Beneficial Owner, for purposes of such offer to purchase additional shares, will be treated as a Potential Beneficial Owner as described below. Bids by Beneficial Owners through their Broker-Dealers with rates per annum higher than the Maximum Applicable Rate will be treated as Sell Orders. A Hold Order (in the case of an Auction relating to a Dividend Period of 91 days or less) or a Sell Order (in the case of an Auction relating to a Special Dividend Period of longer than 91 days) shall be deemed to have been submitted on behalf of a Beneficial Owner if an Order with respect to the APS then held by such Beneficial Owner is not submitted on behalf of such Beneficial Owner for any reason, including the failure of a Broker-Dealer to submit such Beneficial Owner's Order to the Auction Agent.

Potential Beneficial Owners of APS may submit Bids through their Broker-Dealers in which they offer to purchase APS, provided that the Applicable Rate for the next Dividend Period for such shares is not less than the rate per annum specified in such Bid. A Bid by a Potential Beneficial Owner with a rate per annum higher than the Maximum Applicable Rate will not be considered.

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Neither the Fund nor the Auction Agent will be responsible for a Broker-Dealer's failure to act in accordance with the instructions of Beneficial Owners or Potential Beneficial Owners or failure to comply with any of the foregoing.

A Broker-Dealer also may hold APS for its own account as a Beneficial Owner. A Broker-Dealer thus may submit Orders to the Auction Agent as a Beneficial Owner or a Potential Beneficial Owner and therefore participate in an Auction as an Existing Holder or Potential Holder on behalf of both itself and its customers. Any Order placed with the Auction Agent by a Broker-Dealer as or on behalf of a Beneficial Owner or a Potential Beneficial Owner will be treated in the same manner as an Order placed with a Broker-Dealer by a Beneficial Owner or a Potential Beneficial Owner. Similarly, any failure by a Broker-Dealer to submit to the Auction Agent an Order in respect of any APS held by it or its customers who are Beneficial Owners will be treated in the same manner as a Beneficial Owner's failure to submit to its Broker-Dealer an Order in respect of APS held by it, as described above. Inasmuch as a Broker-Dealer participates in an Auction as an Existing Holder or a Potential Holder only to represent the interests of a Beneficial Owner or Potential Beneficial Owner, whether it be a customer or itself, all discussion herein relating to the consequences of an Auction for Existing Holders and Potential Holders also applies to the underlying beneficial ownership interests represented thereby.

If Sufficient Clearing Bids exist in an Auction for a series of APS (that is, in general, the number of APS subject to Bids by Potential Holders with rates equal to or lower than the Maximum Applicable Rate is at least equal to the number of APS subject to Sell Orders by Existing Holders), the Applicable Rate will be the lowest rate per annum specified in the Submitted Bids which, taking into account such rate per annum and all lower rates per annum bid by Existing Holders and Potential Holders, would result in Existing Holders and Potential Holders owning all of the APS available for purchase in the Auction. If Sufficient Clearing Bids do not exist, the Dividend Period next following the Auction automatically will be a 7-Day Dividend Period and the Applicable Rate will be the Maximum Applicable Rate, and in such event, Existing Holders that have submitted Sell Orders will not be able to sell in the Auction all, and may not be able to sell any, APS subject to such Sell Orders. Thus, in certain circumstances, Existing Holders and, thus, the Beneficial Owners they represent may not have liquidity of investment. If all Existing Holders submit (or are deemed to have submitted) Hold Orders in an Auction, the Dividend Period next following the Auction automatically shall be the same length as the immediately preceding Dividend Period, and the Applicable Rate will be 40% of the Reference Rate (as defined under "Determination of Maximum Applicable Rates" above) in effect on the date of the Auction. The Auction Procedures include a pro rata allocation of shares for purchase and sale, which may result in an Existing Holder selling or holding, or a Potential Holder purchasing, a number of APS that is less than the number of APS specified in its Order. To the extent the allocation has this result, a Broker-Dealer will be required to make appropriate pro rata allocations among its customers and itself.

A Sell Order by an Existing Holder will constitute an irrevocable offer to sell the APS subject thereto, and a Bid placed by an Existing Holder also will constitute an irrevocable offer to sell the APS subject thereto if the rate per annum specified in the Bid is higher than the Applicable Rate determined in the Auction, in each case at a price per share equal to $25,000. A Bid placed by a Potential Holder will constitute an irrevocable offer to purchase the APS subject thereto at a price per share equal to $25,000 if the rate per annum specified in such Bid is less than or equal to the Applicable Rate determined in the Auction. Settlement of purchases and sales will be made on the next Business Day (also a Dividend Payment Date) after the Auction Date through the Securities Depository. Purchasers will make payment through their Agent Members in same-day funds to the Securities Depository against delivery by book-entry to their Agent Members. The Securities Depository will make payment to the sellers' Agent Members in accordance with the Securities Depository's normal procedures, which now provide for payment in same-day funds. See "Description of APS--The Auction."

ASSET MAINTENANCE

Under the Amended Bylaws, the Fund must maintain (i) Moody's Eligible Assets having, in the aggregate, a Discounted Value at least equal to the APS Basic Maintenance Amount and (ii) 1940 Act APS Asset Coverage of at least 200%. See "Description of APS--Asset Maintenance."

In the event that the Fund does not maintain (or cure a failure to maintain) these coverage tests, some or all of the APS will be subject to mandatory redemption. See "Description of APS--Redemption--Mandatory Redemption."

The Fund estimates that, based on the composition of its portfolio at , 2003, 1940 Act APS Asset Coverage with respect to APS would be approximately % immediately after the issuance of the APS offered hereby in an amount representing approximately % of the Fund's capital (including the capital attributable to the APS). This asset coverage will change from time to time.

The Discount Factors and guidelines for calculating the Discounted Value of the Fund's portfolio for purposes of determining whether the APS Basic Maintenance Amount has been satisfied have been established by Moody's in connection with the Fund's expected receipt of a rating of "Aaa" on the APS on their Date of Original Issue. See "Rating agency guidelines."

MANDATORY REDEMPTION

If the APS Basic Maintenance Amount or the 1940 Act APS Asset Coverage is not maintained or restored as specified herein, the APS will be subject to mandatory redemption, out of funds legally available therefor, at the Mandatory Redemption Price of $25,000 per share plus an amount equal to, dividends thereon (whether or not earned or declared) accumulated but unpaid to the date fixed for redemption. Any such redemption will be limited to the minimum number of APS necessary to restore the APS Basic Maintenance Amount or the 1940 Act APS Asset Coverage, as the case may be. The Fund's ability to make such a mandatory redemption may be restricted by the provisions of the 1940 Act. See "Description of APS--Redemption--Mandatory Redemption."

OPTIONAL REDEMPTION

The APS are redeemable at the option of the Fund, as a whole or in part, on any Dividend Payment Date (except during the Initial Dividend Period or a Non-Call Period) at the Optional Redemption Price of $25,000 per share, plus an amount equal to dividends thereon (whether or not earned or declared) accumulated but unpaid to the date fixed for redemption plus the premium, if any, resulting from the designation of a Premium Call Period. See "Description of APS--Redemption--Optional Redemption."

LIQUIDATION PREFERENCE

The liquidation preference of the APS will be $25,000 per share, plus an amount equal to accumulated but unpaid dividends (whether or not earned or declared). See "Description of APS--Liquidation Rights."

RATING

It is a condition to their issuance that the APS be issued with a credit quality rating of "Aaa" from Moody's. The Fund may at some future time seek to have the APS rated by an additional or Substitute Rating Agency. See "Rating agency guidelines."

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VOTING RIGHTS

The 1940 Act requires that the holders of APS and any other Preferred Shares, voting as a separate class, have the right to elect at least two Trustees at all times and to elect a majority of the Trustees at any time when two years' dividends on the APS or any other Preferred Shares are unpaid. The holders of APS and any other Preferred Shares will vote as a separate class on certain other matters as required under the Declaration and Amended Bylaws and under the 1940 Act. See "Description of APS--Voting Rights," "Description of capital structure" and "Anti-takeover and other provisions in the Declaration of Trust."

TAX CONSIDERATIONS

The distributions with respect to any series of APS (other than distributions in redemption of APS subject to Section 302(b) of the Internal Revenue Code of 1986, as amended (the "Code")) will constitute dividends to the extent of the Fund's current or accumulated earnings and profits, as calculated for federal income tax purposes. Such dividends generally will be taxable as ordinary income to holders. Distributions of net capital gains (i.e., the excess of net long-term capital gains over net short-term capital losses) that are designated by the Fund as capital gain dividends will be treated as long-term capital gains in the hands of holders receiving such distributions. The Internal Revenue Service (the "IRS") currently requires that a regulated investment company that has two or more classes of stock allocate to each such class proportionate amounts of each type of its income (such as ordinary income and capital gains) based upon the percentage of total dividends distributed to each class for the tax year. Accordingly, the Fund intends each year to allocate capital gain dividends as between and among its Common Shares and each series of the APS in proportion to the total dividends paid to each class during or with respect to such year. Ordinary income dividends and dividends qualifying for the dividends received deduction will similarly be allocated between and among classes. See "Tax matters."

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Financial highlights (unaudited)

The financial highlights table set forth below is intended to help you understand the Fund's recent financial performance. Information contained in the table below under the headings "Per Share Operating Performance" and "Ratios/Supplemental Data" shows the unaudited operating performance of the Fund from the commencement of the Fund's investment operations on March 31, 2003 through , 2003. Because the Fund is recently organized and commenced investment operations on March 31, 2003, the table covers weeks of operations, during which a substantial portion of the Fund's portfolio was held in temporary investments pending investment in securities that meet the Fund's investment objective and policies. Accordingly, the information presented may not provide a meaningful picture of the Fund's operating performance.

	For the Period From March 31, 2003* through , 2003 (Unaudited)	
Per Share Operating Performance		
Net Asset Value, Beginning of Period	$	**
Income from Investment Operations:		
Net Investment Income		
Net Realized and Unrealized Gain on Investments and Foreign Currency Transactions		
Net Increase in Net Assets from Investment Operations		
Common Stock Offering Expenses Charged to Paid-in-Capital in Excess of Par		
Net Asset Value, End of Period	$	
Market Price, End of Period	$	
Total Investment Return		%(1)
Ratios/Supplemental Data:		
Net Assets, End of Period (in thousands)	$	
Ratio of Expenses to Average Net Assets		%(2)
Ratio of Net Investment Income to Average Net Assets		%(2)
Portfolio Turnover		%

* Date of commencement of operations

** Initial public offering price of $ per share less underwriting discount of $ per share.

(1) Total Investment Return is calculated assuming a purchase of common stock at the current market price on the first day and a sale at the current market price on the last day of the period reported. Total Investment Return does not reflect brokerage commissions. Total Investment Return for a period less than one year is not annualized.

(2) Annualized

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The Fund

The Fund is a recently organized, diversified, closed-end management investment company registered under the 1940 Act. The Fund was organized as a Massachusetts business trust on January 17, 2003, pursuant to the Declaration, which is governed by the laws of The Commonwealth of Massachusetts. The Fund's principal office is located at 1345 Avenue of the Americas, New York, New York 10105, and its telephone number is (800) 331-1710.

The Fund commenced operations on March 31, 2003, upon the closing of an initial public offering of 60,000,000 of its Common Shares. The net proceeds of such offering were approximately $858,350,000 after the payment of organizational and offering expenses. In connection with the initial public offering of the Fund's Common Shares, the underwriters were granted an option to purchase up to an additional Common Shares to cover over-allotments. On , 2003, and , 2003, the underwriters purchased, at a price of $ per Common Share, an additional Common Shares of the Fund pursuant to the over-allotment option.

Use of proceeds

The net proceeds of the offering of APS will be approximately $ after payment of the estimated offering costs. The Fund will invest the net proceeds of the offering in accordance with the Fund's investment objective and policies as stated below. It is presently anticipated that the Fund will be able to invest substantially all of the net proceeds in convertible securities and non-convertible income-producing securities within three months after the completion of this offering. Pending such investment, it is anticipated that the proceeds will be invested in high grade, short-term securities, credit-linked trust certificates, and/or high yield securities index futures contracts or similar derivative instruments designed to give the Fund market exposure while NACM selects specific securities.

Capitalization

The following table sets forth the unaudited capitalization of the Fund as of , 2003, and as adjusted to give effect to the issuance of the APS offered hereby (including estimated offering expenses and sales load of $).

	Actual	As Adjusted
Auction Preferred Shares, par value $0.00001 per share (no shares issued; shares issued, as adjusted, at $25,000 per share liquidation preference)...	$0	$
Common Shares, par value $0.00001 per share, shares outstanding......	$	$
Undistributed net investment income......................................	$	$
Net realized gain/loss on investment transactions.........................	$	$
Net unrealized appreciation/(depreciation) on investments, swaps and foreign currency transactions...	$	$
Net assets applicable to Common Shares....................................	$	$

Portfolio composition

As of , 2003, approximately % of the market value of the Fund's portfolio was invested in long-term investments and approximately % of the market value of the Fund's portfolio was invested in short-term investments. The following table sets forth certain information with respect to the composition of the Fund's investment portfolio as of , 2003, based on the highest rating assigned.

S&P*	Moody's*	Number of Issues	Value (in Thousands)	Percent
AAA	Aaa		$	%
AA	Aa1, Aa			
A	A1			
BBB	Baa1			
BB	Ba1			
B	B1			
CCC	Caa			
CC	Ca			
C	C			
NR#	NR#			
Cash				
Total				100.0%

* Ratings: Using the higher of S&P's or Moody's ratings on the Fund's portfolio securities. S&P rating categories may be modified further by a plus (+) or minus (-) in AA, A, BBB, BB, B and C ratings. Moody's rating categories may be modified further by a 1, 2, or 3 in Aa, A, Baa, Ba and B ratings.

\# Refers to securities that have not been rated by Moody's or S&P but have been assessed by NACM as being of comparable credit quality to rated securities in which the Fund may invest. See "The Fund's investment objective and strategies."

The Fund's investment objective and strategies

INVESTMENT OBJECTIVE

The Fund's investment objective is to provide total return through a combination of capital appreciation and high current income. The Fund attempts to achieve its investment objective by investing in a diversified portfolio of convertible securities and non-convertible income-producing securities described under "--Portfolio Contents and Other Information" below. In seeking to achieve its investment objective, the Fund expects to invest primarily in "high yield" securities or "junk bonds." The Fund cannot assure you that it will achieve its investment objective.

PORTFOLIO MANAGEMENT STRATEGIES

In selecting investments for the Fund, NACM attempts to identify issuers that successfully adapt to change. NACM uses traditional credit analysis combined with a disciplined, fundamental bottom-up research process that facilitates the early identification of issuers demonstrating an ability to improve their fundamental characteristics. See "--Independent Credit Analysis" below. NACM attempts to identify potential investments that it expects will exceed minimum credit statistics and exhibit the highest visibility of future expected operating performance. NACM's sell discipline is clearly defined and designed to drive the Fund's portfolio continually toward strength. A series of sell alerts triggering

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further verification research, such as changes in credit fundamentals, declines in relative attractiveness to other issues and declines in industry fundamentals, are utilized, and NACM will consider selling a particular security if any of the original reasons for purchase materially changes.

In selecting convertible securities for investment by the Fund, NACM evaluates each convertible security's investment characteristics as an income-producing security, using the techniques described above, as well as its potential for capital appreciation, using techniques that focus on the security's equity characteristics. NACM seeks to capture approximately 70-80% of any increase in the market price of the underlying equities (upside potential) and 50% or less of any decrease in the market price of the underlying equities (downside exposure). In analyzing specific companies for possible investment, NACM ordinarily looks for several of the following characteristics: above-average per share earnings growth; high return on invested capital; a healthy balance sheet; sound financial and accounting policies and overall financial strength; strong competitive advantages; effective research and product development and marketing; development of new technologies; efficient service; pricing flexibility; strong management; and general operating characteristics that will enable the companies to compete successfully in their respective markets. NACM will consider selling a particular convertible security when any of those factors materially changes.

Credit Quality

The Fund may invest without limit in securities that are below investment grade quality, including unrated securities judged to be of comparable quality by NACM, and expects that ordinarily NACM's portfolio strategies will result in the Fund investing primarily in these securities. The Fund may invest in issuers of any credit quality (including securities in the lowest ratings categories). The Fund may purchase distressed securities that are in default or the issuers of which are in bankruptcy. As described under "Portfolio Contents and Other Information--High Yield Securities" below, securities of below investment grade quality are regarded as having predominantly speculative characteristics with respect to capacity to pay interest and repay principal, and are commonly referred to as "high yield" securities or "junk bonds." Securities in the lowest investment grade category also may be considered to possess some speculative characteristics.

Independent Credit Analysis

NACM relies heavily on its own analysis of the credit quality and risks associated with individual securities considered for the Fund, rather than relying exclusively on rating agencies or third-party research. NACM has a devoted team of professionals that conducts fundamental credit research and analysis of individual issuers, industries and sectors and uses analytical tools to assess and monitor credit risk. The team managing the Fund utilizes this information in an attempt to minimize credit risk and identify issuers, industries or sectors that are undervalued or that offer attractive capital appreciation potential or current income relative to NACM's assessment of their credit characteristics.

PORTFOLIO CONTENTS AND OTHER INFORMATION

Under normal circumstances, the Fund will invest at least 80% of its total assets in a diversified portfolio of convertible securities and non-convertible income-producing securities. The portion of the Fund's assets invested in convertible securities, on the one hand, and non-convertible income-producing securities, on the other, will vary from time to time consistent with the Fund's investment objective, although the Fund will normally invest at least 50% of its total assets in convertible securities. In making allocation decisions, NACM will consider factors such as changes in equity prices, changes in interest rates and other economic and market factors. The Fund invests in securities with a broad range of maturities. The weighted average maturity of the Fund will typically range from five to ten years,

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although the weighted average maturity of obligations held by the Fund may be shorter or longer at any time or from time to time depending on market conditions.

The Fund may invest up to 20% of its total assets in securities other than convertible securities and non-convertible income-producing securities. The Fund may invest up to 5% of its total assets in illiquid securities (which is determined using the Securities and Exchange Commission's standard applicable to open-end investment companies, i.e., securities that cannot be disposed of within seven days in the ordinary course of business at approximately the value at which the Fund has valued the securities). The Fund may invest in securities of companies with smaller market capitalizations.

The Fund cannot change its investment objective without the approval of the holders of a "majority of the outstanding" Common Shares and any Preferred Shares (including the APS) voting together as a single class, and of the holders of a "majority of the outstanding" Preferred Shares (including the APS) voting as a separate class. A "majority of the outstanding" shares (whether voting together as a single class or voting as a separate class) means (i) 67% or more of such shares present at a meeting, if the holders of more than 50% of those shares are present or represented by proxy, or (ii) more than 50% of such shares, whichever is less. See "Description of APS--Voting Rights" for additional information with respect to the voting rights of holders of APS.

In addition to the issuance of the APS, the Fund may also leverage the portfolio by borrowing money, issuing debt securities, and utilizing reverse repurchase agreements and other derivative instruments, although these forms of leverage will generally be used as a substitute for, rather than in addition to, the leverage obtained through the issuance of the APS. See "Risks--Leverage."

Upon NACM's recommendation, for temporary defensive purposes and in order to keep the Fund's cash fully invested, including during the period in which the net proceeds of this offering are being invested, the Fund may deviate from its investment objective and policies and invest some or all of its net assets in investments such as high grade, short-term debt securities. The Fund may not achieve its investment objective when it does so.

It is the policy of the Fund not to engage in trading for short-term profits although portfolio turnover rate is not considered a limiting factor in the execution of investment decisions for the Fund. Frequent changes in the Fund's investments (i.e., portfolio turnover), which are more likely in periods of volatile market movements, involve some expense to the Fund, including brokerage commissions or dealer mark-ups and other transaction costs, and may increase the amount of capital gains (and, in particular, short-term gains) realized by the Fund, on which shareholders may pay tax. Please see "Investment Objective and Policies--Portfolio Trading and Turnover Rate" in the Statement of Additional Information for more information regarding portfolio turnover.

The following provides additional information regarding the types of securities and other instruments in which the Fund will ordinarily invest. A more detailed discussion of these and other instruments and investment techniques that may be used by the Fund is provided under "Investment Objective and Policies" in the Statement of Additional Information. The ability of the Fund to use some of the strategies discussed below and in the Statement of Additional Information, such as derivatives, is limited by the Rating Agency guidelines. See "Rating agency guidelines" below.

Convertible Securities

The Fund may invest without limit in convertible securities, and these securities will ordinarily constitute a principal component of the Fund's investment program. Convertible securities are bonds, debentures, notes, preferred stocks or other securities that may be converted or exchanged (by the holder or by the

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issuer) into shares of the underlying common stock (or cash or securities of equivalent value) at a stated exchange ratio or predetermined price (the "conversion price"). A convertible security is designed to provide current income and also the potential for capital appreciation through the conversion feature, which enables the holder to benefit from increases in the market price of the underlying common stock. A convertible security may be called for redemption or conversion by the issuer after a particular date and under certain circumstances (including a specified price) established upon issue. If a convertible security held by the Fund is called for redemption or conversion, the Fund could be required to tender it for redemption, convert it into the underlying common stock or sell it to a third party. Convertible securities have general characteristics similar to both debt securities and equity securities. Although to a lesser extent than with debt obligations, the market value of convertible securities tends to decline as interest rates increase and, conversely, tends to increase as interest rates decline. In addition, because of the conversion feature, the market value of convertible securities tends to vary with fluctuations in the market value of the underlying common stocks and, therefore, it will also react to variations in the general market for equity securities. Depending upon the relationship of the conversion price to the market value of the underlying security, a convertible security may trade more like an equity security than a debt instrument.

Convertible securities are designed to provide for a stable stream of income with generally higher yields than common stocks. There can be no assurance of current income because the issuers of the convertible securities may default on their obligations. Convertible securities, however, generally offer lower interest or dividend yields than non-convertible securities of similar credit quality because of the potential for capital appreciation.

Synthetic Convertible Securities
The Fund also may invest without limit in "synthetic" convertible securities, which combine separate securities that possess the two principal characteristics of a traditional convertible security, i.e., an income-producing security ("income-producing component") and the right to acquire an equity security ("convertible component"). The income-producing component is achieved by investing in non-convertible, income-producing securities such as bonds, preferred stocks and money market instruments. The convertible component is achieved by investing in warrants or options to buy common stock at a certain exercise price, or options on a stock index. A simple example of a synthetic convertible security is the combination of a traditional corporate bond with a warrant to purchase equity securities of the issuer of the bond. The Fund may also purchase synthetic securities created by other parties, typically investment banks or other financial institutions, including convertible structured notes. The income-producing and convertible components of a synthetic convertible security may be issued separately by different issuers and at different times. Unlike a traditional convertible security, which is a single security having a unitary market value, a synthetic convertible comprises two or more separate securities, each with its own market value. Therefore, the market value of a synthetic convertible security is the sum of the values of its debt component and its convertibility component. For this reason, the values of a synthetic convertible and a traditional convertible security may respond differently to market fluctuations. The Fund's holdings of synthetic convertible securities are considered convertible securities for purposes of the Fund's policy to invest at least 50% of its total assets in convertible securities and 80% of its total assets in a diversified portfolio of convertible securities and non-convertible income-producing securities.

Non-Convertible Income-Producing Securities
The Fund will also invest in non-convertible income-producing securities, including, but not limited to, corporate bonds, debentures, notes and other similar types of corporate debt instruments, as well as non-convertible preferred stocks, bank loans and loan participations, commercial paper, REITs and

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commercial and other mortgage-related and asset-backed securities, payment-in-kind securities, credit-linked trust certificates and other securities issued by special purpose or structured vehicles, zero-coupon bonds, bank certificates of deposit, fixed time deposits, bankers' acceptances and U.S. Government securities. The Fund's investments in non-convertible income-producing securities may have fixed or variable principal payments and all types of interest rate and dividend payment and reset terms, including fixed rate, adjustable rate, zero-coupon, contingent, deferred, payment-in-kind and auction-rate features.

High Yield Securities

As noted above, the Fund may invest without limit in securities rated lower than Baa by Moody's or BBB by S&P (including securities in the lowest ratings categories (C by Moody's or S&P)), or in unrated securities judged to be of comparable quality by NACM, and expects that ordinarily NACM's portfolio strategies will result in the Fund investing primarily in these securities. These securities are sometimes referred to as "high yield" securities or "junk bonds." Investing in high yield securities involves greater risks (in particular, greater risk of default) and special risks in addition to the risks associated with investments in investment grade obligations. While offering a greater potential opportunity for capital appreciation and higher yields, high yield securities typically entail greater potential price volatility and may be less liquid than higher-rated securities. High yield securities may be regarded as predominantly speculative with respect to the issuer's continuing ability to meet principal and interest payments. They also may be more susceptible to real or perceived adverse economic and competitive industry conditions than higher-rated securities. The Fund may purchase distressed securities that are in default or the issuers of which are in bankruptcy. Securities in the lowest investment grade category also may be considered to possess some speculative characteristics.

The market values of high yield securities tend to reflect individual developments of the issuer to a greater extent than do higher-quality securities, which tend to react mainly to fluctuations in the general level of interest rates. In addition, lower-quality securities tend to be more sensitive to economic conditions.

Credit Ratings and Unrated Securities

Rating agencies are private services that provide ratings of the credit quality of debt obligations, including convertible securities. Appendix A to this Prospectus describes the various ratings assigned to debt obligations by Moody's and S&P. Ratings assigned by a Rating Agency are not absolute standards of credit quality and do not evaluate market risks. Rating agencies may fail to make timely changes in credit ratings and an issuer's current financial condition may be better or worse than a rating indicates. The Fund will not necessarily sell a security when its rating is reduced below its rating at the time of purchase. As described above under "Portfolio Management Strategies--Independent Credit Analysis," NACM does not rely solely on credit ratings, and develops its own analysis of issuer credit quality. The ratings of a security may change over time. Moody's and S&P monitor and evaluate the ratings assigned to securities on an ongoing basis. As a result, instruments held by the Fund could receive a higher rating (which would tend to increase their value) or a lower rating (which would tend to decrease their value) during the period in which they are held.

The Fund may purchase unrated securities (which are not rated by a Rating Agency). Unrated securities may be less liquid than comparable rated securities and involve the risk that NACM may not accurately evaluate the security's comparative credit rating. Analysis of creditworthiness may be more complex for issuers of high yield securities than for issuers of higher-quality obligations. The Fund expects that ordinarily NACM's portfolio strategies will result in the Fund investing primarily in high yield and/or unrated securities. Therefore, the Fund's success in achieving its investment objective may depend more heavily on NACM's creditworthiness analysis than if the Fund invested exclusively in higher-quality and rated securities.

Foreign (Non-U.S.) Investments and Currencies
The Fund may invest up to 20% of its total assets in U.S. dollar-denominated securities of foreign issuers based in developed countries. For this purpose, foreign securities include, but are not limited to, foreign convertible securities and non-convertible income-producing securities, foreign equity securities (including preferred securities of foreign issuers), foreign bank obligations, and obligations of foreign governments or their subdivisions, agencies and instrumentalities, international agencies and supranational entities. For this purpose, foreign securities do not include ADRs or securities guaranteed by a United States person, but may include foreign securities in the form of GDRs or other securities representing underlying shares of foreign issuers. See "Risks--Foreign (Non-U.S.) Investment Risk."

The U.S. dollar-denominated foreign securities in which the Fund may invest include Eurodollar obligations and "Yankee Dollar" obligations. Eurodollar obligations are U.S. dollar-denominated certificates of deposit and time deposits issued outside the U.S. capital markets by foreign branches of U.S. banks and by foreign banks. Yankee Dollar obligations are U.S. dollar-denominated obligations issued in the U.S. capital markets by foreign banks. Eurodollar and Yankee Dollar obligations are generally subject to the same risks that apply to domestic debt issues, notably credit risk, market risk and liquidity risk. Additionally, Eurodollar (and to a limited extent, Yankee Dollar) obligations are subject to certain sovereign risks. One such risk is the possibility that a sovereign country might prevent capital, in the form of U.S. dollars, from flowing across its borders. Other risks include adverse political and economic developments; the extent and quality of government regulation of financial markets and institutions; the imposition of foreign withholding taxes; and the expropriation or nationalization of foreign issuers.

The Fund also may invest in sovereign debt issued by foreign governments, their agencies or instrumentalities, or other government-related entities. As a holder of sovereign debt, the Fund may be requested to participate in the rescheduling of such debt and to extend further loans to governmental entities. In addition, there are generally no bankruptcy proceedings similar to those in the United States by which defaulted sovereign debt may be collected. The Fund also may invest in Brady Bonds, which are securities created through the exchange of existing commercial bank loans to sovereign entities for new obligations in connection with a debt restructuring. Investments in Brady Bonds may be viewed as speculative. Brady Bonds acquired by the Fund may be subject to restructuring arrangements or to requests for new credit, which may cause the Fund to realize a loss of interest or principal on any of its portfolio holdings.

Please see "Investment Objective and Policies--Foreign (Non-U.S.) Securities" in the Statement of Additional Information for a more detailed description of the types of foreign investments in which the Fund may invest and their related risks.

Rule 144A Securities
The Fund may invest without limit in Rule 144A Securities. Rule 144A under the Securities Act of 1933, as amended, provides a non-exclusive safe harbor exemption from the registration requirements of the Act for the resale of certain "restricted" securities to certain qualified institutional buyers, such

as the Fund. Rule 144A Securities may be deemed illiquid and thus may be subject to the Fund's limit on investments in illiquid securities, although the Fund may determine that certain Rule 144A Securities are liquid in accordance with procedures adopted by the Board of Trustees.

Corporate Bonds

The Fund may invest in a wide variety of bonds of varying maturities issued by U.S. and foreign corporations and other business entities. Bonds are fixed or variable rate debt obligations, including bills,

notes, debentures, money market instruments and similar instruments and securities. Bonds generally are used by corporations as well as governments and other issuers to borrow money from investors. The issuer pays the investor a fixed or variable rate of interest and normally must repay the amount borrowed on or before maturity. Certain bonds are "perpetual" in that they have no maturity date.

Preferred Stocks

The Fund may invest in preferred stocks. The Fund's investments in preferred stocks typically will be convertible securities, although the Fund may also invest in non-convertible preferred stocks. Preferred stock represents an equity interest in a company that generally entitles the holder to receive, in preference to the holders of other stocks such as common stocks, dividends and a fixed share of the proceeds resulting from liquidation of the company. Some preferred stocks entitle their holders to receive additional liquidation proceeds on the same basis as holders of a company's common stock, and thus also represent an ownership interest in the company. Some preferred stocks offer a fixed rate of return with no maturity date. Because they never mature, these preferred stocks act like long-term bonds and can be more volatile than other types of preferred stocks and may have heightened sensitivity to changes in interest rates. Other preferred stocks have a variable dividend, generally determined on a quarterly or other periodic basis, either according to a formula based upon a specified premium or discount to the yield on particular U.S. Treasury securities or based on an auction process, involving bids submitted by holders and prospective purchasers of such stocks. Because preferred stocks represent an equity ownership interest in a company, their value usually will react more strongly than bonds and other debt instruments to actual or perceived changes in a company's financial condition or prospects, or to fluctuations in the equity markets.

Investments in Equity Securities

Consistent with its investment objective, the Fund may hold or have exposure to equity securities. The Fund will often have substantial exposure to equity securities by virtue of the equity component of the convertible securities in which the Fund invests. The Fund may also hold equity securities in its portfolio upon conversion of a convertible security or through direct investments in preferred stocks. Equity securities, such as common stock, generally represent an ownership interest in a company. Although equity securities have historically generated higher average returns than debt securities, equity securities have also experienced significantly more volatility in those returns. An adverse event, such as an unfavorable earnings report, may depress the value of a particular equity security held by the Fund. Also, the price of equity securities, particularly common stocks, are sensitive to general movements in the stock market. A drop in the stock market may depress the price of equity securities held by the Fund.

U.S. Government Securities

The Fund may invest in U.S. Government securities, which are obligations of, or guaranteed by, the U.S. Government, its agencies or government-sponsored enterprises. U.S. Government securities include a variety of securities that differ in their interest rates, maturities and dates of issue. Securities issued or guaranteed by agencies or instrumentalities of the U.S. Government may or may not be supported by the full faith and credit of the United States or by the right of the issuer to borrow from the U.S. Treasury.

Derivatives

The Fund may utilize derivative instruments for investment purposes, as well as to leverage its portfolio, generally as a substitute for, rather than in addition to, the APS. Generally, derivatives are financial contracts whose value depends upon, or is derived from, the value of any underlying asset, reference rate or index, and may relate to, among others, individual securities, interest rates and related indexes. The Fund may use derivatives as a component of a synthetic convertible security or to gain exposure to high yield securities and other securities in which the Fund may invest (pending investment of the proceeds of

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this offering). Such derivative instruments include, but are not limited to, warrants, options on common stock or stock indexes, futures contracts and swap agreements. In connection with its investments in synthetic convertible securities, the Fund may purchase warrants, call options on common stock and call options on stock indexes. A warrant is a certificate that gives the holder of the warrant the right to buy, at a specified time or specified times, from the issuer of the warrant, the common stock of the issuer at a specified price. A call option is a contract that gives the holder of the option, in return for a premium, the right to buy from the writer of the option the common stock underlying the option (or the cash value of the index) at a specified exercise price at any time during the term of the option. The Fund may also have exposure to derivatives, such as credit default swaps and interest rate swaps, through investments in credit-linked trust certificates and related instruments. The Fund's use of derivative instruments involves risks different from, or possibly greater than, the risks associated with investment directly in securities and other more traditional investments. See "Risks--Derivatives Risk." Please see "Investment Objective and Policies--Derivative Instruments" in the Statement of Additional Information for additional information about these and other derivative instruments that the Fund may use and the risks associated with such instruments. There is no assurance that these derivative strategies will be available at any time or that NACM will determine to use them for the Fund or, if used, that the strategies will be successful. In addition, the Fund is subject to certain restrictions on its use of derivative strategies imposed by guidelines of Moody's, which issues ratings for the APS.

Credit-Linked Trust Certificates

Among the income-producing securities in which the Fund may invest are credit-linked trust certificates, which are investments in a limited purpose trust or other vehicle formed under State law which, in turn, invests in a basket of derivative instruments, such as credit default swaps, interest rate swaps and other securities, in order to provide exposure to the high yield or another fixed income market.

Subject to the investment limitations described in this Prospectus, the Fund may invest in credit-linked trust certificates during the period when the net proceeds of the Common Share offering and this offering are being invested, and during such period the high yield exposure will be broadly diversified. Thereafter, the Fund may invest up to 5% of its total assets in these instruments.

Like an investment in a bond, investments in these credit-linked trust certificates represent the right to receive periodic income payments (in the form of distributions) and payment of principal at the end of the term of the certificate. However, these payments are conditioned on the trust's receipt of payments from, and the trust's potential obligations to, the counterparties to the derivative instruments and other securities in which the trust invests. For instance, the trust may sell one or more credit default swaps, under which the trust would receive a stream of payments over the term of the swap agreements provided that no event of default has occurred with respect to the referenced debt obligation upon which the swap is based. If a default occurs, the stream of payments may stop and the trust would be obligated to pay to the counterparty the par (or other agreed upon value) of the referenced debt obligation. This, in turn, would reduce the amount of income and principal that the Fund would receive as an investor in the trust. Please see "Investment Objective and Policies--Derivative Instruments" in the Statement of Additional Information for additional information about credit default swaps. The Fund's investments in these instruments are indirectly subject to the risks associated with derivative instruments, including, among others, credit risk, default or similar event risk, interest rate risk, leverage risk and management risk. It is expected that the trusts which issue credit-linked trust certificates will constitute "private" investment companies, exempt from registration under the 1940 Act. Therefore, the certificates will be subject to the risks described under "Other Investment Companies" below, and will not be subject to applicable investment limitations and other regulation imposed by the 1940 Act (although the Fund will remain subject to such limitations and regulation, including with respect to its investments in the

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certificates). Although the trusts are typically private investment companies, they are generally not actively managed such as a "hedge fund" might be. It is also expected that the certificates will be exempt from registration under the Securities Act of 1933. Accordingly, there may be no established trading market for the certificates and they may constitute illiquid investments. See "Risks--Liquidity Risk." If market quotations are not readily available for the certificates, they will be valued by the Fund at fair value as determined by the Board of Trustees or persons acting at its direction. See "Net asset value." The Fund may lose its entire investment in a credit-linked trust certificate. The Fund intends to invest in credit-linked trust certificates mainly as a cash management tool in order to gain exposure to the high yield markets and/or to remain fully invested when more traditional income-producing securities are not available, including during the period when the net proceeds of the Common Share offering and this offering are being invested.

Zero-Coupon Bonds, Step-Ups and Payment-In-Kind Securities

Zero-coupon bonds pay interest only at maturity rather than at intervals during the life of the security. Like zero-coupon bonds, "step up" bonds pay no interest initially but eventually begin to pay a coupon rate prior to maturity, which rate may increase at stated intervals during the life of the security. Payment-in-kind securities ("PIKs") are debt obligations that pay "interest" in the form of other debt obligations, instead of in cash. Each of these instruments is normally issued and traded at a deep discount from face value. Zero-coupon bonds, step-ups and PIKs allow an issuer to avoid or delay the need to generate cash to meet current interest payments and, as a result, may involve greater credit risk than bonds that pay interest currently or in cash. The Fund would be required to distribute the income on these instruments as it accrues, even though the Fund will not receive the income on a current basis or in cash. Thus, the Fund may have to sell other investments, including when it may not be advisable to do so, to make income distributions to its shareholders.

Other Investment Companies

The Fund may invest in securities of other open- or closed-end investment companies to the extent that such investments are consistent with the Fund's investment objective and policies and permissible under the 1940 Act. The Fund may invest in other investment companies either during periods when it has large amounts of uninvested cash, such as the period shortly after the Fund receives the proceeds of the offering of its Common Shares or Preferred Shares, during periods when there is a shortage of attractive convertible securities and non-convertible income-producing securities available in the market, or when NACM believes share prices of other investment companies offer attractive values. The Fund may invest in investment companies that are advised by NACM or its affiliates to the extent permitted by applicable law and/or pursuant to exemptive relief from the Securities and Exchange Commission. As a stockholder in an investment company, the Fund will bear its ratable share of that investment company's expenses, and would remain subject to payment of the Fund's management fees and other expenses with respect to assets so invested. Common Shareholders would therefore be subject to duplicative expenses to the extent the Fund invests in other investment companies. NACM will take expenses into account when evaluating the investment merits of an investment in an investment company relative to available investments in convertible securities and non-convertible income-producing securities. In addition, the securities of other investment companies may also be leveraged and will therefore be subject to the same leverage risks described herein. The net asset value and market value of leveraged shares will be more volatile and the yield to shareholders will tend to fluctuate more than the yield generated by unleveraged shares.

Commercial Paper

Commercial paper represents short-term unsecured promissory notes issued in bearer form by corporations such as banks or bank holding companies and finance companies. The rate of return on commercial paper may be linked or indexed to the level of exchange rates between the U.S. dollar and a foreign currency or currencies.

Bank Obligations
The Fund may invest in certain bank obligations, including certificates of deposit, bankers' acceptances and fixed time deposits. Certificates of deposit are negotiable certificates issued against funds deposited in a commercial bank for a definite period of time and earning a specified return. Bankers' acceptances are negotiable drafts or bills of exchange, normally drawn by an importer or exporter to pay for specific merchandise, which are "accepted" by a bank, meaning, in effect, that the bank unconditionally agrees to pay the face value of the instrument on maturity. Fixed time deposits are bank obligations payable at a stated maturity date and bearing interest at a fixed rate. Fixed time deposits may be withdrawn on demand by the investor, but may be subject to early withdrawal penalties which vary depending upon market conditions and the remaining maturity of the obligation.

Loan Participations and Assignments
The Fund may invest in fixed- and floating-rate loans issued by banks and other corporations, which investments generally will be in the form of loan participations and assignments of portions of such loans. Participations and assignments involve credit risk, interest rate risk, liquidity risk and the risks of being a lender. If the Fund purchases a participation, it may only be able to enforce its rights through the lender, and may assume the credit risk of both the lender and the borrower. Given the current structure of the markets for loan participations and assignments, the Fund expects to treat these securities as illiquid.

REITs and Other Mortgage-Related and Asset-Backed Securities
The Fund may invest REITs, which primarily invest in income-producing real estate or real estate related loans or interests. REITs are generally classified as equity REITs, mortgage REITs or a combination of equity and mortgage REITs. Equity REITs invest the majority of their assets directly in real property and derive income primarily from the collection of rents. Equity REITs can also realize capital gains by selling properties that have appreciated in value. Mortgage REITs invest the majority of their assets in real estate mortgages and derive income from the collection of interest payments. REITs are not taxed on income distributed to shareholders provided they comply with the applicable requirements of the Code. The Fund will indirectly bear its proportionate share of any management and other expenses paid by REITs in which it invests in addition to the expenses paid by the Fund. Debt securities issued by REITs are, for the most part, general and unsecured obligations and are subject to risks associated with REITs.

Other mortgage-related securities include debt instruments which provide periodic payments consisting of interest and/or principal that are derived from or related to payments of interest and/or principal on underlying mortgages. Additional payments on mortgage-related securities may be made out of unscheduled prepayments of principal resulting from the sale of the underlying property, refinancing or foreclosure, net of fees or costs that may be incurred.

The Fund may invest in commercial mortgage-related securities issued by corporations. These are securities that represent an interest in, or are secured by, mortgage loans secured by commercial property, such as industrial and warehouse properties, office buildings, retail space and shopping malls, multifamily properties and cooperative apartments, hotels and motels, nursing homes, hospitals, and senior living centers. They may pay fixed or adjustable rates of interest. The commercial mortgage loans that underlie commercial mortgage-related securities have certain distinct risk characteristics. Commercial mortgage loans generally lack standardized terms, which may complicate their structure. Commercial properties themselves tend to be unique and difficult to value. Commercial mortgage loans tend to have shorter maturities than residential mortgage loans, and may not be fully amortizing, meaning that they may have a significant principal balance, or "balloon" payment, due on maturity. In addition, commercial properties, particularly industrial and warehouse properties, are subject to environmental risks and the burdens and costs of compliance with environmental laws and regulations.

Other mortgage-related securities in which the Fund may invest include mortgage pass-through securities, collateralized mortgage obligations ("CMOs"), mortgage dollar rolls, CMO residuals (other than residual interests in real estate mortgage investment conduits), stripped mortgage-backed securities ("SMBSs") and other securities that directly or indirectly represent a participation in, or are secured by and payable from, mortgage loans on real property.

The Fund may invest in other types of asset-backed securities that are offered in the marketplace, including Enhanced Equipment Trust Certificates ("EETCs"). Although any entity may issue EETCs, to date, U.S. airlines are the primary issuers. An airline EETC is an obligation secured directly by aircraft or aircraft engines as collateral. EETCs tend to be less liquid than corporate bonds. Other asset-backed securities may be collateralized by the fees earned by service providers. The value of asset-backed securities may be substantially dependent on the servicing of the underlying asset pools and are therefore subject to risks associated with the negligence of, or defalcation by, their servicers. In certain circumstances, the mishandling of related documentation may also affect the rights of the security holders in and to the underlying collateral. The insolvency of entities that generate receivables or that utilize the assets may result in added costs and delays in addition to losses associated with a decline in the value of the underlying assets.

Please see "Investment Objective and Policies--REITs" and "Investment Objective and Policies--Mortgage-Related and Other Asset-Backed Securities" in the Statement of Additional Information, and "Risks--REITs and Mortgage-Related Risk" in this Prospectus for a more detailed description of the types of mortgage-related and other asset-backed securities in which the Fund may invest and their related risks.

Variable and Floating Rate Securities
Variable and floating rate securities provide for a periodic adjustment in the interest rate paid on the obligations. The Fund may invest in floating rate debt instruments ("floaters") and engage in credit spread trades. While floaters provide a certain degree of protection against rising interest rates, the Fund will participate in any decline in interest rates as well. A credit spread trade is an investment position relating to a difference in the prices or interest rates of two bonds or other securities, where the value of the investment position is determined by changes in the difference between such prices or interest rates, as the case may be, of the respective securities.

When Issued, Delayed Delivery and Forward Commitment Transactions
The Fund may purchase securities which it is eligible to purchase on a when-issued basis, may purchase and sell such securities for delayed delivery

and may make contracts to purchase such securities for a fixed price at a future date beyond normal settlement time (forward commitments). When-issued transactions, delayed delivery purchases and forward commitments involve a risk of loss if the value of the securities declines prior to the settlement date. The risk is in addition to the risk that the Fund's other assets will decline in value. Therefore, these transactions may result in a form of leverage and increase the Fund's overall investment exposure. Typically, no income accrues on securities the Fund has committed to purchase prior to the time delivery of the securities is made, although the Fund may earn income on securities it has segregated to cover these positions.

Reverse Repurchase Agreements
The Fund may utilize reverse repurchase agreements to leverage its portfolio, generally as a substitute for, rather than in addition to, the leverage obtained through the issuance of the APS. In a reverse repurchase agreement, the Fund sells securities to a bank or broker-dealer and agrees to repurchase the securities at a mutually agreed date and price. Generally, the effect of such a transaction is that the Fund can recover

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and reinvest all or most of the cash invested in the portfolio securities involved during the term of the reverse repurchase agreement and still be entitled to the returns associated with those portfolio securities. Such transactions are advantageous if the interest cost to the Fund of the reverse repurchase transaction is less than the returns it obtains on investments purchased with the cash.

Unless the Fund covers its positions in reverse repurchase agreements (by segregating liquid assets at least equal in amount to the forward purchase commitment), its obligations under the agreements will be subject to the Fund's limitations on borrowings. Reverse repurchase agreements involve leverage risk and also the risk that the market value of the securities that the Fund is obligated to repurchase under the agreement may decline below the repurchase price. In the event the buyer of securities under a reverse repurchase agreement files for bankruptcy or becomes insolvent, the Fund's use of the proceeds of the agreement may be restricted pending a determination by the other party, or its trustee or receiver, whether to enforce the Fund's obligation to repurchase the securities.

Lending of Portfolio Securities
For the purpose of achieving income, the Fund may lend its portfolio securities to brokers, dealers, and other financial institutions provided a number of conditions are satisfied, including that the loan is fully collate **Item 5.**

MARKET FOR REGISTRANT S COMMON EQUITY RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASERS OF EQUITY SECURITIES

Market Information

Our common stock is traded on the Nasdaq Global Market under the symbol SMSI. The high and low sale prices for our common stock as reported by Nasdaq are set forth below for the periods indicated.

	High	Low
YEAR ENDED DECEMBER 31, 2006:		
First Quarter	$12.65	5.87
Second Quarter	16.50	10.85
Third Quarter	16.70	9.01
Fourth Quarter	19.01	13.35
YEAR ENDED DECEMBER 31, 2005:		
First Quarter	9.63	4.65
Second Quarter	5.00	3.44
Third Quarter	7.39	4.02
Fourth Quarter	8.00	5.41

On March 6, 2007, the closing sale price for our common stock as reported by Nasdaq was $15.88.

Stock Performance Graph

The following graph and information compares the cumulative total stockholder return on our Common Stock against the cumulative total return of the S&P Midcap 400 Index and the S&P Midcap Applications Software Index (Peer Group) for the same period.

The graph covers the period from January 1, 2001, through December 31, 2006. The graph assumes that $100 was invested in our Common Stock on January 1, 2001, and in each index, and that all dividends were reinvested. No cash dividends have been declared on our Common Stock. Stockholder returns over the indicated period should not be considered indicative of future stockholder returns.

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COMPARISON OF 5 YEAR CUMULATIVE TOTAL RETURN*
Among Smith Micro Software, Inc., The S & P Midcap 400 Index
And The S & P Midcap Software Application

* $100 invested on 12/31/01 in stock or index-including reinvestment of dividends. Fiscal year ending December 31.

www.researchdatagroup.com/S&P.htm

	12/01	12/02	12/03	12/04	12/05	12/06
Smith Micro Software, Inc.	**100.00**	**43.81**	**189.52**	**852.38**	**557.14**	**1351.43**
S & P Midcap 400	**100.00**	**85.49**	**115.94**	**135.05**	**152.00**	**167.69**
S & P Midcap Software Application	**100.00**	**59.04**	**88.57**	**72.37**	**81.71**	**95.11**

Holders

As of March 6, 2007, there were approximately 123 holders of record of our common stock based on information provided by our transfer agent.

Dividends

We have never paid any cash dividends on our common stock and we have no current plans to do so.

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Recent Sales of Unregistered Securities

None

Purchasers of Equity Securities by the Company

None.

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Item 6. SELECTED CONSOLIDATED FINANCIAL DATA

The following selected consolidated financial data should be read in conjunction with Management s Discussion and Analysis of Financial Condition and Results of Operations and our consolidated financial statements and the related notes thereto appearing elsewhere in this Annual Report. The following selected consolidated statement of operations data for the years ended December 31, 2006, 2005 and 2004, and the consolidated balance sheet data at December 31, 2006 and 2005, have been derived from audited consolidated financial statements included elsewhere in this Annual Report. The consolidated statement of operations data presented below for the years ended December 31, 2003 and 2002, and the consolidated balance sheet data at December 31, 2004, 2003 and 2002 are derived from audited consolidated financial statements that are not included in this Annual Report.

	Year Ended December 31,				
	2006	2005	2004	2003	2002
Consolidated Statement of Operations Data:					
Net Revenues:					
Products	$ 53,773	$ 19,637	$ 12,394	$ 6,291	$ 6,029
Services	696	621	922	925	1,102
Total Net Revenues	54,469	20,258	13,316	7,216	7,131
Cost of Revenues:					
Products	19,989	3,818	2,530	1,350	1,420
Services	270	285	380	321	782
Total Cost of Revenues	20,259	4,103	2,910	1,671	2,202
Gross profit	34,210	16,155	10,406	5,545	4,929
Operating expenses:					
Selling and marketing	9,057	3,410	1,519	1,666	2,175
Research and development	7,899	3,963	2,556	2,506	2,162
General and administrative	8,467	4,621	2,868	2,330	2,387
Total operating expenses	25,423	11,994	6,943	6,502	6,724
Operating income (loss)	8,787	4,161	3,463	(957)	(1,795)
Interest Income	1,403	667	53	37	45
Income (Loss) before income taxes	10,190	4,828	3,516	(920)	(1,750)
Income tax expense (benefit)	1,234	104	71	3	(1,062)
Net Income (Loss)	$ 8,956	$ 4,724	$ 3,445	$ (923)	$ (688)
Net income (loss) per share, basic	$ 0.38	$ 0.22	$ 0.20	$ (0.06)	$ (0.04)
Weighted average shares, basic	23,753	21,351	17,267	16,511	16,235
Net income (loss) per share, diluted	$ 0.35	$ 0.21	$ 0.19	$ (0.06)	$ (0.04)
Weighted average shares, diluted	25,330	22,806	18,412	16,511	16,235

	As of December 31,				
	2006	**2005**	**2004**	**2003**	**2002**
Consolidated Balance Sheet Data:					
Total assets	$ 131,026	$ 42,716	$ 12,828	$ 6,587	$ 6,766
Total liabilities	4,969	3,759	1,729	997	1,154
Accumulated deficit	(2,989)	(11,945)	(16,669)	(20,114)	(19,191)
Total stockholders equity	$ 126,057	$ 38,957	$ 11,099	$ 5,590	$ 5,612

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Item 7. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion of our financial condition and results of operations should be read in conjunction with our consolidated financial statements and the related notes and other financial information appearing elsewhere in this Annual Report. Readers are also urged to carefully review and consider the various disclosures made by us which attempt to advise interested parties of the factors which affect our business, including without limitation the disclosures made in Item 1A of Part I of this Annual Report under the caption Risk Factors.

Risk factors that could cause actual results to differ from those contained in the forward-looking statements including but are not limited to: our dependence upon a single customer for a significant portion of our revenues; potential fluctuations in quarterly results; deriving revenues from a small number of products; failure to successfully compete; failure to successfully integrate acquisitions; entry into new markets; failure of our customers to adopt new technologies; dependence upon relationships with carrier customers; declines in gross margins; undetected software defects; changes in technology; delays or failure in deliveries from component suppliers; failure of our products to achieve broad acceptance; failure to protect intellectual property; exposure to intellectual property claims; and loss of key personnel.

Introduction and Overview

Our business model is based primarily upon the design, production and sale of software that supports the wireless data industry. Our products are utilized in major wireless networks throughout the world that support data communications through the use of cell phones or other wireless communication devices such as PC cards. Wireless network providers generally incorporate our products into their accessory products sold directly to individual consumers.

Our business is primarily dependent upon the demand for wireless communications and the corresponding requirements for wireless connectivity software to support this demand. During the last three years, demand for these types of products has fluctuated dramatically, and there continues to be new services launched that utilize the improving wireless broadband networks.

We continue to invest in research and development of wireless software products, and we believe that we have one the industry s leading wireless product lines in terms of performance and features. We believe that our out-of-the-box design technology further differentiates our products.

We also sell eBusiness and utility software and professional consulting services related to eBusiness applications.

During 2006, we have maintained a sharp focus on our operating cost structure while ensuring that we maintain our operating flexibility to support future growth in the industry. We measure success by monitoring our net sales and gross margins and operating cash flow. We believe that there continues to be excellent growth opportunities within the wireless communications software marketplace and we continue to focus on positioning Smith Micro to benefit from these opportunities.

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Results of Operations

The following table sets forth certain consolidated statement of operating data as a percentage of total revenues for the periods indicated:

	Years Ended December 31,		
	2006	2005	2004
Net Revenues:			
Products	98.7%	96.9%	93.1%
Services	1.3%	3.1%	6.9%
Total net revenues	100.0%	100.0%	100.0%
Cost of revenues:			
Products	36.7%	18.9%	19.0%
Services	0.5%	1.4%	2.9%
Total cost of revenues	37.2%	20.3%	21.9%
Gross profit	62.8%	79.7%	78.1%
Operating expenses:			
Selling and marketing	16.6%	16.8%	11.4%
Research and development	14.5%	19.6%	19.2%
General and administrative	15.6%	22.8%	21.5%
Total operating expenses	46.7%	59.2%	52.1%
Operating Income	16.1%	20.5%	26.0%
Interest Income	2.6%	3.3%	0.4%
Income before income taxes	18.7%	23.8%	26.4%
Income tax expense	2.3%	0.5%	0.5%
Net Income	16.4%	23.3%	25.9%

Revenues

Total net revenues were $54.5 million, $20.3 million and $13.3 million in 2006, 2005 and 2004, respectively, with an increase of $34.2 million, or 168.9% from 2005 to 2006 and an increase of $6.9 million, or 52.1% from 2004 to 2005. The increase in our revenues from 2004 through 2006 is attributed to the growth in sales of our wireless products. We acquired Allume Systems in 2005, which also contributed to the year on year sales growth from 2004 to 2005. In late 2005 we entered the wireless music software space which was the largest selling product group for 2006 and largely responsible for the increase in revenues from 2005 to 2006. Sales to individual customers and their affiliates, which amounted to more than 10% of the Company s net revenues, included one OEM customer at 74.4% in 2006, 57.1% in 2005 and 68.4% of revenues in 2004.

We currently operate in two business segments: products and services. In addition, product revenues are broken down into three business units, Wireless and OEM, Consumer and Enterprise. Our Consumer sales represent the sales of Allume products to distributors, retail customers and individuals as well as legacy Smith Micro utility and fax software products. Allume was acquired on July 1, 2005 (See Note 3 of Notes to Consolidated Financial Statements). The Enterprise sales unit includes legacy Smith Micro consulting, fulfillment and hosting revenue.

The following table shows the net revenues and cost of revenues generated by each segment:

	Year Ended December 31,					
	2006		2005		2004	
	Products	Services	Products	Services	Products	Services
Wireless & OEM	$ 43,419	$	$ 13,982	$	$ 11,424	$
Consumer	10,019		5,460		746	
Enterprise	335	696	195	621	224	922
Total Revenues	53,773	696	19,637	621	12,394	922
Cost of revenues	19,989	270	3,818	285	2,530	380
Gross Profit	$ 33,784	$ 426	$ 15,819	$ 336	$ 9,864	$ 542

Products. Net revenues from sales of products were $53.8 million, $19.6 million and $12.4 million for 2006, 2005 and 2004, respectively, representing an increase of $34.1 million, or 173.8% from 2005 to 2006 and an increase of $7.2 million, or 58.4% from 2004 to 2005. Product revenues accounted for 98.7% of total revenues in 2006, 96.9% of total revenues in 2005 and 93.1% of total revenues in 2004. There are two key drivers to the increase in our product revenues from 2004 through 2006. Our core wireless business increased from $11.4 million to $43.4 million. The increase can be attributed to the continued success of the wireless broadband data rollouts by our carrier customers and the rollout of QuickLink Music in 2006. The second key contributor was the increase in the Consumer business unit in 2005 attributed to the Allume acquisition on July 1, 2005. Allume posted revenues of $4.9 million for 2005 and $9.7 million for 2006.

Services. Consulting services revenues were $696,000, $621,000 and $922,000 in 2006, 2005 and 2004, respectively, representing an increase of $75,000, or 12.1% from 2005 to 2006 and a decrease of $301,000, or 32.7% from 2004 to 2005. Services revenue accounted for 1.3% of total revenues in 2006, 3.1% of total revenues in 2005 and 6.9% of total revenues in 2004. We have reduced our focus on consulting services, which was announced in the first quarter of 2002, due to the decrease in demand for such services.

Cost of Revenues and Gross Margin

Cost of Product Revenues. Cost of product revenues was $20.0 million, $3.8 million and $2.5 million in 2006, 2005 and 2004, respectively, representing an increase of $16.2 million, or 423.6% from 2005 to 2006 and an increase of $1.3 million, or 50.9%, from 2004 to 2005. Product gross margin as a percentage of product net revenue was 62.8% for 2006 as compared to 80.6% for 2005 and 79.6% for 2004. Cost of Revenues for the 2006 includes $1.1 million of amortization of intangibles associated with acquisitions as compared to $534,000 in 2005 and $0 in 2004. In addition, there is $33,000 of stock compensation expense included in 2006 which is not present in the earlier years. Factoring out these costs product gross margin was 64.9% in 2006 and 83.3% in 2005. The 18.4% decrease in pro-forma product gross margin percentage from 2005 to 2006 is attributed to the increased sales of lower margin Music Kits. The 4.3% pro-forma increase from 2004 to 2005 is attributed to increased sales of higher margin PC card software product versus lower margin Mobile Office Kit products.

Direct costs of revenues consist primarily of CD replication costs, and the cost of music kit components which include ear phones and a cable that connects the handheld device to the PC. We use a variety of providers located in China, Korea and the United States. We consider CD replication, ear phones and cables to be commodities with little or no risk to supplier fluctuations. We also purchase proprietary cables from Motorola and generic OEM cables from a variety of suppliers.

Cost of Service Revenues. Cost of service revenues was $270,000, $285,000 and $380,000 in 2006, 2005 and 2004, respectively, representing a decrease of $15,000, or 5.3% from 2005 to 2006 and a decrease of $95,000, or 25.0% from 2004 to 2005. Cost of Service revenue as a percentage of Service revenues was 61.2% in 2006, 54.1% in 2005 and 41.2% in 2004. Cost of service revenues includes the cost of our consulting personnel and the cost of any outside consultants contracted to support our staff and vary by contract.

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Operating Expenses

The following table presents a breakdown of our operating expenses by functional category and as a percentage of total net revenues:

	Years Ended December 31,					
	2006		2005		2004	
Operating expenses:						
Selling and marketing	$ 9,057	16.6%	$ 3,410	16.8%	$1,519	11.4%
Research and development	7,899	14.5%	3,963	19.6%	2,556	19.2%
General and administrative	8,467	15.6%	4,621	22.8%	2,868	21.5%
Total operating expenses	$25,423	46.7%	$11,994	59.2%	$6,943	52.1%

Selling and Marketing. Selling and marketing expenses were $9.1 million, $3.4 million and $1.5 million in 2006, 2005 and 2004, respectively, representing an increase of $5.6 million, or 165.6%, from 2005 to 2006 and an increase of $1.9 million, or 124.5%, from 2004 to 2005. Our selling and marketing expenses consist primarily of personnel costs, advertising costs, sales commissions and trade show expenses. These expenses vary significantly from quarter to quarter based on the timing of trade shows and product introductions. While most of the increases in selling and marketing expenses in both years were due to the Allume acquisition, we also had a slight increase in headcount and increases in costs related to product collateral concept and design. Advertising expenses were $379,000, $223,000 and $47,000 for the years ended December 31, 2006, 2005 and 2004, respectively. Selling and marketing expenses were 16.6%, 16.8% and 11.4% of revenues in the years ended December 31, 2006, 2005 and 2004, respectively. Increases in selling and marketing expenses as a percentage of revenues in 2005 and 2006 were caused by the increase in costs as described above. Selling and marketing expenses include $483,000 of amortization expense related to acquisitions in 2006 and $236,000 in 2005 which was not present in 2004. In addition, 2006 selling and marketing expenses include $2.1 million of stock based compensation expense, not included in the prior years. Factoring out amortization and stock based compensation costs, selling and marketing expenses were 11.9% of revenues in 2006 and 15.7% in 2005 due to the increases in revenues over the periods.

Research and Development. Research and development expenses were $7.9 million, $4.0 million and $2.6 million in 2006, 2005 and 2004, respectively, representing increases of $3.9 million, or 99.3% from 2005 to 2006 and $1.4 million, or 55.0%, from 2004 to 2005. Our research and development expenses consist primarily of personnel and equipment costs required to conduct our software development efforts. We remain focused on the development and expansion of our technology, particularly our wireless, multi-media, and compression software technologies. The increase in our research and development expenses in each year was primarily due to the development of new wireless products that were released during the periods, with an accompanying increase in headcount and a refocus of engineering resources from consulting projects to development. Beginning in 2005, the key driver to increased R&D expense was the acquisition of Allume Systems on July 1, 2005 and PhoTags, Inc. on April 3, 2006 along with the associated engineering staffs. Research and development expenses were 14.5%, 19.6% and 19.2% of revenues in the years ended December 31, 2006, 2005 and 2004, respectively. In 2006, research and development expenses include $1.1 million of stock based compensation expenses not present in previous years. Factoring out this expense, research and development expenses were 12.5% of net revenues in 2006. The decrease in research and development expenses as a percentage of revenues from 2005 to 2006 is due to the significant increase in revenues during the period.

General and Administrative. General and administrative expenses were $8.5 million, $4.6 million and $2.9 million in 2006, 2005 and 2004, respectively, representing increases of $3.8 million, or 83.2% from 2005 to 2006 and $1.8 million, or 61.1%, from 2004 to 2005. The increases in general and administrative expenses are primarily

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due to the acquisition of Allume Systems on July 1, 2005 and the assumption of Allume G&A staff and certain integration costs. General and administrative expenses were 15.5%, 22.8% and 21.5% of net revenues in the years ended December 31, 2006, 2005 and 2004, respectively. The decrease in general and administrative expenses as a percentage of revenues from 2005 to 2006 is due to the increase in revenues, partially offset by the absolute dollar increase in expenses. In 2006, general and administrative expenses include $2.3 million of stock based compensation expense and $335,000 write off of goodwill related to our Services segment which were not present in previous years. Factoring out these expenses, general and administrative expenses were 10.8% of net revenues in 2006. The decrease in general and administrative expenses as a percentage of revenues from 2005 to 2006 is due to the significant increase in revenues during the period.

Interest Income. Interest income was $1.4 million, $667,000 and $53,000 in 2006, 2005 and 2004, respectively, representing increases of $736,000, or 110.3% from 2005 to 2006 and $614,000, or 1,158.5% from 2004 to 2005. The differences in our interest income are directly related to the fluctuations in our cash balances during the periods and changing interest rates. We have not changed our investment strategy during the periods being reported, with our excess cash consistently being invested in short term marketable securities. (See Liquidity and Capital Resources for further discussion elsewhere in this report.)

Provision for Income Taxes. The provision for income taxes was $1.2 million, $104,000 and $71,000 in 2006, 2005 and 2004, respectively. The provision in 2006 relates to the release of the valuation allowance previously recorded against our deferred tax assets. The provision in 2005 and 2004 relates to alternative minimum tax liability.

Liquidity and Capital Resources

Since inception, we have financed our operations primarily through cash generated from operations and from net proceeds of $18.1 million generated by our initial public offering in 1995. On February 18, 2005, we entered into a Common Stock Purchase Agreement for the private placement of 3,500,000 shares of our common stock, $0.001 par value, at a price of $6.40 per share, resulting in aggregate gross cash proceeds to the Company of $22,400,000 before deducting commissions and other expenses. Offering costs related to the transaction totaled $1,613,000, comprised of $1,344,000 in commissions and $269,000 cash payments for legal and investment services, resulting in net proceeds to the Company of $20,786,000. The transaction closed simultaneously with the execution of the Purchase Agreement on February 18, 2005. C.E. Unterberg, Towbin LLC, the placement agent for the transaction, received a cash fee equal to 6% of the aggregate gross proceeds of the Private Placement.

On December 14, 2006, we completed a fully marketed secondary, issuing 4,000,000 shares of our common stock, $0.001 par value, at a price of $14.75 per share, resulting in aggregate gross cash proceeds to the Company of $59,000,000 before deducting commissions and other expenses. Offering costs related to the transaction totaled $4,002,000, comprised of $3,304,000 in underwriting discounts and commissions and $698,000 cash payments for legal and investment services, resulting in net proceeds to the Company of $54,998,000.

Net cash provided by operations was $14.8 million in 2006 and $2.5 million in 2005. The primary source of operating cash in both periods was the net income and the increase in accounts payable and accrued liabilities, offset by the collection of accounts receivable.

Cash flows used in investing activities were $2.6 million in 2006 and $11.0 million in 2005. In 2006, $2.2 million was used for the acquisition of PhoTags, Inc. and $362,000 for capital expenditures. In 2005, $10.9 million was used for the purchase of Allume in July, 2005 as well as $142,000 for other capital expenditures. Our capital expenditures in both periods consisted of the purchase of computers and other office equipment.

We received $4.2 million in cash from the exercise of employee stock options in 2006 compared to $369,000 in 2005.

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At December 31, 2006, we had $92.6 million in cash and cash equivalents and $98.8 million of working capital. We have no significant capital commitments, and currently anticipate that capital expenditures will not vary significantly from recent periods. We believe that our existing cash, cash equivalent investment balances and cash flow from operations will be sufficient to finance our working capital and capital expenditure requirements through at least the next twelve months. We may require additional funds to support our working capital requirements or for other purposes and may seek to raise additional funds through public or private equity or debt financing or from other sources. If additional financing is needed, we cannot assure that such financing will be available to us at commercially reasonable terms or at all.

Our corporate headquarters, which includes our principal administrative, sales and marketing, customer support and research and development facilities, is located in Aliso Viejo, California. We have leased this space through May 2009. We also lease approximately 7,700 square feet in Watsonville, California under a new lease that expires September 30, 2010. We are currently working on a new operating lease for our facility in Lee s Summit, Missouri to replace the lease that expired in June 2005.

As of December 31, 2006, we had no debt and no long term liabilities. The following table summarizes our contractual obligations as of December 31, 2006 (in thousands):

	Payments due by period				
Contractual obligations:	Total	Less than 1 year	1-3 years	3-5 years	More than 5 years
Operating Lease Obligations	$ 2,006	$ 679	$ 1,141	$ 186	$
Purchase Obligations	332	332			
Total	$ 2,338	$ 1,011	$ 1,141	$ 186	$

During our normal course of business, we have made certain indemnities, commitments and guarantees under which we may be required to make payments in relation to certain transactions. These include: intellectual property indemnities to our customers and licensees in connection with the use, sale and/or license of our products; indemnities to various lessors in connection with facility leases for certain claims arising from such facility or lease; indemnities to vendors and service providers pertaining to claims based on the negligence or willful misconduct; indemnities involving the accuracy of representations and warranties in certain contracts; and indemnities to directors and officers of the Company to the maximum extent permitted under the laws of the State of Delaware. In addition, we have made contractual commitments to employees providing for severance payments upon the occurrence of certain prescribed events. We may also issue a guarantee in the form of a standby letter of credit as security for contingent liabilities under certain customer contracts. The duration of these indemnities, commitments and guarantees varies, and in certain cases, may be indefinite. The majority of these indemnities, commitments and guarantees may not provide for any limitation of the maximum potential for future payments we could be obligated to make. We have not recorded any liability for these indemnities, commitments and guarantees in the accompanying consolidated balance sheets.

Critical Accounting Policies

Our discussion and analysis of results of operations, financial condition and liquidity are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances. Actual results may materially differ from these estimates under different assumptions or conditions. On an on-going basis, we review our estimates to ensure that the estimates appropriately reflect changes in our business or new information as it becomes available.

We believe the following critical accounting policies affect our more significant estimates and assumptions used in the preparation of our consolidated financial statements:

Revenue Recognition - Software revenue is recognized in accordance with the Statement of Position (SOP) 97-2, *Software Revenue Recognition,* as amended, when persuasive evidence of an arrangement exists, delivery has occurred, the price is fixed and determinable, and collectibility is probable. We recognize revenues from sales of our software to OEM customers or end users as completed products are shipped and title passes; or from royalties generated as authorized customers duplicate our software, if the other requirements of SOP 97-2 are met. If the requirements of SOP 97-2 are not met at the date of shipment, revenue is not recognized until these elements are known or resolved. Returns from OEM customers are limited to defective goods or goods shipped in error. Historically, OEM customer returns have not exceeded the very nominal estimates and reserves. Management reviews available retail channel information and makes a determination of a return provision for sales made to distributors and retailers based on current channel inventory levels and historical return patterns. Certain sales to distributors or retailers are made on a consignment basis. Revenue for consignment sales are not recognized until sell through to the final customer is established. We have few multiple elements agreement for which we have contracted to provide a perpetual license for use of proprietary software, to provide non-recurring engineering, and in some cases to provide software maintenance (post contract support). For multiple element agreements, vendor specific objective evidence for all contract elements is reviewed and the timing of the individual element revenue streams is determined and recognized consistent with SOP 97-2.

Product sales directly to end-users are recognized upon delivery. End users have a thirty day right of return, but such returns are reasonably estimable and have historically been immaterial. We also provide technical support to our customers. Such costs have historically been insignificant.

Service revenues include sales of consulting services, website hosting and fulfillment. We recognize service revenues as services are provided or as milestones are delivered and accepted by our customers.

Accounts Receivable We sell our products worldwide. We perform ongoing credit evaluations of our customers and adjust credit limits based upon payment history, the customer s current credit worthiness and various other factors, as determined by our review of their current credit information. We continuously monitor collections and payments from our customers. We estimate credit losses and maintain a bad debt reserve based upon these estimates. While such credit losses have historically been within our estimated reserves, we cannot guarantee that we will continue to experience the same credit loss rates that we have in the past. If not, this could have an adverse effect on our consolidated financial statements.

Goodwill We have adopted SFAS No. 142, *Goodwill and Other Intangible Assets,* effective January 1, 2002 and no impairment was identified. As a result of the adoption, we are no longer required to amortize goodwill. Prior to the adoption of SFAS 142, goodwill was amortized over 7 years. In accordance with SFAS No. 142, we review the recoverability of the carrying value of goodwill at least annually or whenever events or circumstances indicate a potential impairment. Our annual impairment testing date is December 31. Recoverability of goodwill is determined by comparing the estimated fair value of our reporting units to the carrying value of the underlying net assets in the reporting units. If the estimated fair value of a reporting unit is determined to be less than the fair value of its net assets, goodwill is deemed impaired and an impairment loss is recognized to the extent that the carrying value of goodwill exceeds the difference between the estimated fair value of the reporting unit and the fair value of its other assets and liabilities. At December 31, 2006, we elected to write off all goodwill associated with our services sector, or $335,000. The consulting portion of our services sector has been de-emphasized and is no longer considered a strategic element of our go forward plan. The amount of the write off is included in general and administrative expenses. We determined that we did not have any impairment of goodwill as related to the products sector at December 31, 2006. Estimates of reporting unit fair value are based upon market capitalization and therefore are volatile being sensitive to market fluctuations. To the extent that our market capitalization decreases significantly or the allocation of value to our reporting units change, we could be required to write off some or all of our goodwill.

Deferred Income Taxes - We account for income taxes under SFAS No. 109, *Accounting for Income Taxes*. This statement requires the recognition of deferred tax assets and liabilities for the future consequences of events that have been recognized in our financial statements or tax returns. The measurement of the deferred items is based on enacted tax laws. In the event the future consequences of differences between financial reporting bases and the tax bases of our assets and liabilities result in a deferred tax asset, SFAS No. 109 requires an evaluation of the probability of being able to realize the future benefits indicated by such asset. A valuation allowance related to a deferred tax asset is recorded when it is more likely than not that some portion or all of the deferred tax asset will not be realized. At the end of 2005, we had a full valuation allowance on our deferred tax assets. Based on our assessment of all available evidence, we concluded that it is more likely than not that our deferred tax assets will be fully realized in the future. This conclusion is based primarily on our improving financial performance and projected income in the future years. As a result, we released all of our valuation allowance in 2006. The release of the valuation allowance decreased our tax expense in 2006.

Stock-Based Compensation We currently account for the issuance of stock options to employees using the fair market value method according to SFAS No. 123R, *Share-Based Payment.*

Recent Accounting Pronouncements

In February 2006, the FASB issued Statement SFAS No. 155, *Accounting for Certain Hybrid Financial Instruments*, which amends SFAS No. 133, *Accounting for Derivatives Instruments and Hedging Activities* and SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities*. SFAS No. 155 amends SFAS No. 133 to narrow the scope exception for interest-only and principal-only strips on debt instruments to include only such strips representing rights to receive a specified portion of the contractual interest or principle cash flows. SFAS No. 155 also amends SFAS No. 140 to allow qualifying special-purpose entities to hold a passive derivative financial instrument pertaining to beneficial interests that itself is a derivative instrument. We are currently evaluating the impact this new Standard but believe that it will not have a material impact on our financial position, results of operations, or cash flows.

In March 2006, the FASB issued SFAS No. 156, *Accounting for Servicing of Financial Assets* (SFAS NO. 156), which provides an approach to simplify efforts to obtain hedge-like (offset) accounting. This Statement amends FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, with respect to the accounting for separately recognized servicing assets and servicing liabilities. The Statement (1) requires an entity to recognize a servicing asset or servicing liability each time it undertakes an obligation to service a financial asset by entering into a servicing contract in certain situations; (2) requires that a separately recognized servicing asset or servicing liability be initially measured at fair value, if practicable; (3) permits an entity to choose either the amortization method or the fair value method for subsequent measurement for each class of separately recognized servicing assets or servicing liabilities; (4) permits at initial adoption a one-time reclassification of available-for-sale securities to trading securities by an entity with recognized servicing rights, provided the securities reclassified offset the entity s exposure to changes in the fair value of the servicing assets or liabilities; and (5) requires separate presentation of servicing assets and servicing liabilities subsequently measured at fair value in the balance sheet and additional disclosures for all separately recognized servicing assets and servicing liabilities. SFAS No. 156 is effective for all separately recognized servicing assets and liabilities as of the beginning of an entity s fiscal year that begins after September 15, 2006, with earlier adoption permitted in certain circumstances. The Statement also describes the manner in which it should be initially applied. We do not believe that SFAS No. 156 will have a material impact on our financial position, results of operations or cash flows.

In July 2006, the FASB released FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, an interpretation of FASB Statement No. 109 (FIN 48). FIN 48 clarifies the accounting and reporting for uncertainties in income tax law. This 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. On January 17, 2007, the FASB affirmed its previous decision to make FIN 48 effective for fiscal years beginning after December 15, 2006. Accordingly, we will adopt FIN 48 effective January 1, 2007. Based on a preliminary analysis, we believe that the adoption of FIN 48 will not have a material impact on our results of operation and financial position.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (SFAS 157), which defines the fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. This statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Early adoption is encouraged, provided that we have not yet issued financial statements for that fiscal year, including any financial statements for an interim period within that fiscal year. We are currently in the process of evaluating the impact SFAS 157 may have on our results of operations and financial position.

In September 2006, the FASB issued SFAS No. 158, *Employer s Accounting for Defined Benefit Pension and Other Post Retirement Plans*. SFAS No. 158 requires employers to recognize in its statement of financial position an asset or liability based on the retirement plan s over or under funded status. SFAS No. 158 is effective for fiscal years ending after December 15, 2006. We are currently in the process of evaluating the effect that the application of SFAS No. 158 will have on our results of operations and financial position.

In September 2006, the United States Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* (SAB 108). This SAB provides guidance on the consideration of the effects of prior year misstatements in quantifying current year misstatements for the purpose of a materiality assessment. SAB 108 establishes an approach that requires quantification of financial statement errors based on the effects of each of the company s balance sheets and statement of operations and the related financial statement disclosures. The SAB permits existing public companies to record the cumulative effect of initially applying this approach in the first year ending after November 15, 2006 by recording the necessary correcting adjustments to the carrying values of assets and liabilities as of the beginning of that year with the offsetting adjustment recorded to the opening balance of retained earnings. Additionally, the use of the cumulative effect transition method requires detailed disclosure of the nature and amount of each individual error being corrected through the cumulative adjustment and how and when it arose. We are currently in the process of evaluating the impact SAB 108 may have on our results of operations or financial position.

In October 2006, the Emerging Issues Task Force (EITF) issued EITF 06-3, *How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That is, Gross versus Net Presentation)* to clarify diversity in practice on the presentation of different types of taxes in the financial statements. The Task Force concluded that, for taxes within the scope of the issue, a company may adopt a policy of presenting taxes either gross within revenue or net. That is, it may include charges to customers for taxes within revenues and the charge for the taxes from the taxing authority within cost of sales, or, alternatively, it may net the charge to the customer and the charge from the taxing authority. If taxes subject to EITF 06-3 are significant, a company is required to disclose its accounting policy for presenting taxes and the amounts of such taxes that are recognized on a gross basis. The guidance in this consensus is effective for the first interim reporting period beginning after December 15, 2006 (the first quarter of our fiscal year 2007). We do not expect the adoption of EITF 06-3 will have a material impact on our results of operations, financial position or cash flow.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*. SFAS No. 159 permits entities to choose to measure at fair value many financial instruments and certain other items that are not currently required to be measured at fair value. Subsequent changes in fair value for designated items will be required to be reported in earnings in the current period. SFAS No. 159 also establishes presentation and disclosure requirements for similar types of assets and liabilities measured at fair value. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. We are currently assessing the effect of implementing this guidance, which directly depends on the nature and extent of eligible items elected to be measured at fair value, upon initial application of the standard on January 1, 2008.

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Item 7A. QUALITATIVE AND QUANTITATIVE DISCLOSURES ABOUT MARKET RISK

Our financial instruments include cash and cash equivalents. At December 31, 2006, the carrying values of our financial instruments approximated fair values based on current market prices and rates. Because of their short duration, changes in market interest rates would not have a material effect on fair value.

It is our policy not to enter into derivative financial instruments. We do not currently have any significant foreign currency exposure as we do not transact business in foreign currencies. As such, we do not have significant currency exposure at December 31, 2006.

Item 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

Our consolidated financial statements and schedule appear in a separate section of this Annual Report on Form 10-K beginning on page F-1 and S-1, respectively.

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SUPPLEMENTARY FINANCIAL DATA

SELECTED QUARTERLY FINANCIAL DATA
STATEMENT OF OPERATIONS DATA
(UNAUDITED)

	Three Months Ended:			
2006	March 31,	June 30,	September 30,	December 31,
	(in thousands, except per share amounts)			
Net Revenues	$ 9,885	$12,555	$14,801	$17,228
Gross Profit	6,586	7,250	8,711	11,663
Operating Income	1,627	851	2,137	4,172
Net Income	$ 1,812	$ 1,083	$ 2,450	$ 3,611
Net Income Per Share, Basic	$ 0.08	$ 0.05	$ 0.10	$ 0.14
Weighted Average Shares Outstanding, Basic	22,303	23,635	24,123	24,930
Net Income Per Share, Diluted	$ 0.07	$ 0.04	$ 0.09	$ 0.14
Weighted Average Shares Outstanding, Diluted	24,284	25,598	25,794	26,687

	Three Months Ended:			
2005	March 31,	June 30,	September 30,	December 31,
	(in thousands, except per share amounts)			
Net Revenues	$ 2,030	$ 3,330	$ 6,896	$ 8,002
Gross Profit	1,685	2,785	5,731	5,954
Operating (Loss) Income	(228)	558	1,763	2,068
Net (Loss) Income	$ (128)	$ 764	$ 1,877	$ 2,211
Net (Loss) Income Per Share, Basic	$ (0.01)	$ 0.04	$ 0.09	$ 0.10
Weighted Average Shares Outstanding, Basic	19,665	21,584	22,016	22,106
Net (Loss) Income Per Share, Diluted	$ (0.01)	$ 0.03	$ 0.08	$ 0.09
Weighted Average Shares Outstanding, Diluted	19,665	22,713	23,222	23,900

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Item 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

Not applicable.

Item 9A. CONTROLS AND PROCEDURES

(a) *Evaluation of Disclosure Controls and Procedures*. We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the SEC s rules and forms and that such information is accumulated and communicated to our management including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow for timely decisions regarding required disclosure. Under the supervision and with the participation of our management, including our Chief Executive Officer and our Chief Financial Officer, we evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) or 15d-15(e) under the Exchange Act) as of the end of the period covered in this report. Based upon that evaluation, the Chief Executive Officer and the Chief Financial Officer concluded that, as of the end of the period covered by this report, our disclosure controls and procedures were effective in timely alerting them to the material information related to us (or our consolidated subsidiaries) required to be included in the reports we file or submit under the Exchange Act.

Management s Report on Internal Control Over Financial Reporting

Management is responsible for establishing and maintaining adequate internal control over financial reporting. The Company s internal control framework and processes were designed to provide reasonable assurance to management and the Board of Directors regarding the reliability of financial reporting and the preparation of the Company s consolidated financial statements for external purposes in accordance with accounting principles generally accepted in the United States of America.

Management recognizes its responsibility for fostering a strong ethical climate so that the Company s affairs are conducted according to the highest standards of personal and corporate conduct. The Company s internal control over financial reporting includes those policies and procedures that:

- pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the Company;

- provide reasonable assurance that transactions are recorded properly to allow for the preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the Company are being made only in accordance with authorizations of management and Directors of the Company; and

- provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the Company s assets that could have a material effect on the consolidated financial statements.

Because of its inherent limitations, a system of internal control over financial reporting can provide only reasonable assurance and may not prevent or detect misstatements. Further, because of changing conditions, effectiveness of internal control over financial reporting may vary over time. The Company s processes contain self-monitoring mechanisms, and actions are taken to correct deficiencies as they are identified.

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To comply with the requirements of Section 404 of the Sarbanes-Oxley Act of 2002, the Company designed and implemented a structured and comprehensive compliance process to evaluate its internal control over financial reporting across the enterprise.

Management s Process to Assess the Effectiveness of Internal Control Over Financial Reporting

Management s conclusion on the effectiveness of internal control over financial reporting is based on a thorough and comprehensive evaluation and analysis of the five elements of the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in *Internal Control Integrated Framework*. (shown in italics below), and is based on, but not limited to, the following:

Documentation of entity-wide controls establishing the culture and tone-at-the-top of the organization, in support of the Company s *Control Environment, Risk Assessment* Process, *Information and Communication* policies and the ongoing *Monitoring* of these control processes and systems.

An evaluation of *Control Activities* by work process. Key controls and compensating controls were documented and tested by each work process within the Company, including controls over all relevant financial statement assertions related to all significant accounts and disclosures. Internal control deficiencies were identified and prioritized, and appropriate remediation action plans were defined, implemented and retested.

A centralized review and analysis of all internal control deficiencies across the enterprise to determine whether such deficiencies, either separately or in the aggregate, represented a significant deficiency or material weakness.

An evaluation of any changes in work processes, systems, organization or policy that could materially impact internal control over financial reporting.

Management assessed the effectiveness of the Company s internal control over financial reporting and concluded that, as of December 31, 2006, such internal control is effective. In making this assessment, management used the criteria set forth by COSO. Management s assessment of the effectiveness of our internal control over financial reporting has been audited by Singer Lewak Greenbaum & Goldstein LLP, an independent registered public accounting firm, as stated in their report which is included herein.

(b) *Changes in Internal Controls*. During the most recent fiscal quarter covered by this report, there has been no change in our internal control over financial reporting (as defined in Rule 13a-15(f) or 15d-15(f) under the Exchange Act) that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Item 9B. OTHER INFORMATION

None.

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PART III

Item 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

The following table sets forth certain information regarding our executive officers as of March 1, 2007.

Name	Age	Position
William W. Smith, Jr.	59	Chairman of the Board, President and Chief Executive Officer
Andrew C. Schmidt	45	Chief Financial Officer
David P. Sperling	38	Vice President and Chief Technical Officer
Jonathan Kahn	49	Senior Vice President
William R. Wyand	59	Vice President, Wireless and OEM Sales
Christopher G. Lippincott	36	Vice President, Operations

Mr. Smith co-founded Smith Micro and has served as our Chairman of the Board, President and Chief Executive Officer since inception in 1982. Mr. Smith was employed by Rockwell International Corporation in a variety of technical and management positions from 1975 to 1984. Mr. Smith served with Xerox Data Systems from 1972 to 1975 and RCA Computer Systems Division from 1969 to 1972 in mainframe sales and pre-sale technical roles. Mr. Smith received a B.A. in Business Administration from Grove City College.

Mr. Schmidt joined the Company in June 2005 and serves as the Company s Chief Financial Officer. Prior to joining Smith Micro, Mr. Schmidt was the Chief Financial Officer of Genius Products, Inc., a publicly traded entertainment company from August 2004 to June 2005. From April 2003 to June 2004, he was Vice President (Finance) and acting Chief Accounting Officer of Peregrine Systems, Inc., a publicly held provider of enterprise level software then in Chapter 11 reorganization. From July 2000 to January 2003, he was Executive Vice President and Chief Financial Officer of Mad Catz Interactive, Inc., a publicly traded provider of console video game accessories. He holds a B.B.A. in Finance from the University of Texas and an M.S. in Accountancy from San Diego State University.

Mr. Sperling joined us in April 1989 and has been our Director of Software Engineering since April 1992. He assumed the Chief Technology Officer position in September 1999. Mr. Sperling began his professional career as a software engineer with us and he currently has three patents pending for various telephony and Internet technologies. Mr. Sperling holds a B.S. degree in Computer Science and an MBA from the University of California, Irvine.

Mr. Kahn joined the company with the acquisition of Allume Systems, Inc. in July 2005. Prior to the acquisition, Mr. Kahn was President of the company. Mr. Kahn was one of the co-founders of Aladdin Systems, Inc. which later became Allume Systems. Mr. Kahn was Chairman, President and Chief Executive Officer of Monterey Bay Tech, Inc (OTC BB:MBYI), a public company from 1999 to May 2005 until its merger with SecureLogic Inc. Mr. Kahn is a member of the Digital River Advisory Board and is a graduate of the University of Rhode Island with a B.A. in Economics.

Mr. Wyand joined us in 1999 when Smith Micro acquired STF Technologies where Mr. Wyand was President and Chief Executive Officer. As General Manager he ran the Macintosh division sales, marketing, engineering and customer support efforts. Later that year, Mr. Wyand moved into the newly created Wireless and Broadband division as General Manager and in 2004 became Vice President, Wireless and OEM Sales. From 1995 to 1999, Mr. Wyand was President and Chief Executive Officer of STF Technologies. From 1984 to 1995, Mr. Wyand held various interim management and consulting positions. From 1977 to 1984, he held various positions with United Telecom Computer Group. From 1973 to 1977, he was a Consultant with Arthur Young & Co. He graduated with a B.S. from Pennsylvania State University and an MBA from Rockhurst College.

Mr. Lippincott joined us in 1993 as a senior sales representative. In 1998 he was appointed Director of North American Sales and in 2000 named General Manager of the Internet Solutions Division, as Vice President, Internet and Direct Sales in 2004 and then Vice President, Operations in 2007. Prior to joining Smith Micro, Mr. Lippincott held several retail sales positions. He attended the University of California at Berkeley majoring in business administration.

Officers are elected by, and serve at the discretion of, the Board of Directors.

For information about our Directors, please see the section titled Directors and Executive Officers appearing in our Proxy Statement for our 2007 Annual Meeting of Stockholders, which is hereby incorporated by reference.

The section titled Corporate Governance appearing in our Proxy Statement for our 2007 Annual Meeting of Stockholders is hereby incorporated by reference.

Audit Committee; Audit Committee Financial Expert

Our Board of Directors has a standing Audit Committee. The members of the Audit Committee are Messrs. Campbell, Gulko and Szabo. Our Board has determined that Mr. Gulko, Chairman of the Audit Committee, is an audit committee financial expert as defined by Item 401(h) of Regulation S-K and that each member of the Audit Committee is independent within the meaning of Nasdaq Marketplace Rule 4200(a)(15).

Section 16(a) Beneficial Ownership Reporting Compliance

Section 16(a) of the Exchange Act requires certain of the company s executive officers, as well as its directors and persons who own more than then percent (10%) of a registered class of the Company s equity securities to file reports of ownership and changes in ownership with the Securities and Exchange Commission.

Based solely on its review of the copies of such forms received by the Company, or written representations from certain reporting person, the Company believes that during the last fiscal year all executive officers and directors complied with their filing requirements under Section 16(a) for all reportable transactions during the year.

Code of Ethics

We have adopted a Code of Ethics that applies to all of our employees, including our principal executive officer, our principal financial officer, and all members of our finance department performing similar functions. Our Code of Ethics was filed as Exhibit 14 to the Annual Report on Form 10-K for the year ended December 31, 2003 which was filed on March 25, 2004. In the event of an amendment to, or a waiver from, certain provisions of our Code of Ethics, we intend, to the extent possible, to satisfy Form 8-K disclosure requirements by disclosing this information on our website at www.smithmicro.com.

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Item 11. EXECUTIVE COMPENSATION

The section titled Executive Compensation and Related Information appearing in our Proxy Statement for our 2007 Annual Meeting of Stockholders is hereby incorporated by reference.

Item 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The section titled Ownership of Securities and Related Stockholder Matters appearing in our Proxy Statement for our 2007 Annual Meeting of Stockholders is hereby incorporated by reference.

Securities Authorized for Issuance Under An Equity Compensation Plan

The following table provides information as of December 31, 2006 with respect to the shares of common stock that may be issued under our existing equity compensation plans.

(In thousands, except per share amounts)	Number of Shares to be Issued Upon Exercise of Outstanding Options	Weighted Average Exercise Price of Outstanding Options	Number of Shares Remaining Available for Future Issuance
Equity Compensation Plan Approved by Shareholders (1)	2,518	$ 4.80	2,151
Equity Compensation Plan Not Approved by Shareholders	0	0	0
Total	2,518	$ 4.80	2,151

(1) The number of shares to be issued upson exercise includes options granted under both the 1995 Stock Option/Stock Issuance Plan and the 2005 Stock Option/Stock Issuance Plan. The number of shares remaining available for future issuance consists only of the 2005 Plan.

Item 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

The section titled Related Party Transactions and Director Independence appearing in our Proxy Statement for our 2007 Annual Meeting of Stockholders is incorporated herein by reference.

Item 14. PRINCIPAL ACCOUNTING FEES AND SERVICES

The section titled Ratification of Appointment of Independent Registered Public Accounting Firm Principal Accountant Fees and Services appearing in our Proxy Statement for our 2007 Annual Meeting of Stockholders is incorporated herein by reference.

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PART IV

Item 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

(a)(1) Financial Statements

Smith Micro s financial statements appear in a separate section of this Annual Report on Form 10-K beginning on the pages referenced below:

(2) Financial Statement Schedule

Smith Micro s financial statement schedule appears in a separate section of this Annual Report on Form 10-K on the pages referenced below. All other schedules have been omitted as they are not applicable, not required or the information is included in the consolidated financial statements or the notes thereto.

(3) Exhibits

Exhibit No.	Title	Method of Filing
2.1	Stock Purchase Agreement, dated July 1, 2005, between Smith Micro Software, Inc. and International Microcomputer Software, Inc. (sole shareholder of Allume Systems, Inc.)	Incorporated by reference to Exhibit 2.1 to the Registrant s Current Report on Form 8-K filed on July 5, 2005.
2.2	Agreement and Plan of Merger, dated April 3, 2006, by and among Smith Micro Software, Inc., Tag Acquisition Corporation, Tag Acquisition Corporation II, Photags, Inc., Harry Fox, and certain stockholders of Photags, Inc.	Incorporated by reference to Exhibit 2.1 to the Registrant s Current Report on Form 8-K filed on April 7, 2006
2.3	Agreement and Plan of Merger, dated January 31, 2007, by and among Smith Micro Software, Inc., TEL Acquisition Corp., Ecutel Systems, Inc., John J. McDonnell, Jr. and certain stockholders of Ecutel Systems, Inc.	Incorporated by reference to Exhibit 2.1 to the Registrant s Current Report on Form 8-K filed on February 6, 2007.

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Exhibit No.	Title	Method of Filing
2.4	Asset Purchase Agreement, dated February 11, 2007, by and among Smith Micro Software, Inc., IS Acquisition Sub, Inc., Insignia Solutions plc, Insignia Solutions Inc. and Insignia Solutions AB.	Incorporated by reference to Exhibit 2.2 to the Registrant s Current Report on Form 8-K filed on February 13, 2007.
3.1	Amended and Restated Certificate of Incorporation of the Registrant.	Incorporated by reference to Exhibit 3.1 to the Registrant s Registration Statement No. 33-95096.
3.1.1	Amendment to the Amended and Restated Certificate of Incorporation of the Registrant.	Incorporated by reference to Exhibit 3.1.1 to the Registrant s Quarterly Report on Form 10-Q for the period ended June 30, 2000.
3.1.2	Certificate of Amendment to Amended and Restated Certificate of Incorporation of Registrant as filed August 18, 2005 with Delaware Secretary of State	Incorporated by reference to Exhibit 3.1.2 to the Registrant s Annual Report on Form 10-K for the period ended December 31, 2005.
3.2	Amended and Restated Bylaws of the Registrant.	Incorporated by reference to Exhibit 3.2 to the Registrant s Registration Statement No. 33-95096.
4.1	Specimen certificate representing shares of Common Stock of the Registrant.	Incorporated by reference to Exhibit 4.1 to the Registrant s Registration Statement No. 33-95096.
10.1	Form of Indemnification Agreement.	Incorporated by reference to Exhibit 10.1 to the Registrant s Registration Statement No. 33-95096.
10.2*	1995 Stock Option/Stock Issuance Plan as Amended and Restated through February 7, 2001.	Incorporated by reference to the Appendix attached to the Definitive Proxy Statement for the 2001 Annual Meeting of Stockholders filed on April 27, 2001.
10.3*	2005 Stock Option / Stock Issuance Plan	

		Incorporated by reference to Appendix A attached to the Definitive Proxy Statement for the 2005 Annual Meeting as filed June 10, 2005.
10.4	Master Software License and Distribution Agreement (Contract No. 220-00-0134) effective as of December 1, 2000, between Cellco Partnership (d/b/a Verizon Wireless) and the Registrant	Incorporated by reference to Exhibit 10.1 to the Registrant s Quarterly Report on Form 10-Q for the quarter ended June 30, 2003.
10.4.1	Amendment of Master Software License and Distribution Agreement (Contract No. 220-00-0134)	Incorporated by reference to Exhibit 10.1.1 to the Registrant s Quarterly Report on Form 10-Q for the quarter ended June 30, 2003.
10.4.2	Amendment No. 2 to the Master Software License and Distribution Agreement (Contract No. 220-00-0134)	Incorporated by reference to Exhibit 10.1.2 to the Registrant s Quarterly Report on Form 10-Q for the quarter ended June 30, 2003.
10.5*	Letter Agreement, dated June 13, 2005, by and between Smith Micro Software, Inc. and Andrew Schmidt	Incorporated by reference to Exhibit 10.5 to the Registrant s Current Report on Form 8-K filed on November 30, 2006.

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Exhibit No.	Title	Method of Filing
10.6*	Employment Agreement dated April 9, 1999 by and between Smith Micro Software, Inc. and William Wyand.	Incorporated by reference to Exhibit 10.6 to the Registrant s Current Report on Form 8-K filed on November 30, 2006.
14.1	Code of Ethics	Incorporated by reference to Exhibit 14.1 to the Registrant s Annual Report on Form 10-K for the fiscal year ended December 31, 2003.
14.1.1	Attachment 1 to Code of Ethics	Incorporated by reference to Exhibit 14.1 to the Registrant s Annual Report on Form 10-K for the fiscal year ended December 31, 2003.
21.1	Subsidiaries	Incorporated by reference to Exhibit 21.1 to the Registrant s Annual Report on Form 10-K for the fiscal year ended December 31, 2000.
23.1	Consent of Independent Registered Public Accounting Firm.	Filed herewith
31.1	Certification of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	Filed herewith
31.2	Certification of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	Filed herewith
32.1	Certifications of the Chief Executive Officer and the Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	Furnished herewith

* Indicates management contract or compensatory plan or arrangement.

Confidential treatment has been granted

with respect to certain confidential portions of this exhibit pursuant to Rule 24b-2 under the Securities Exchange Act of 1934, which confidential portions have been omitted from the exhibit and filed separately with the Securities and Exchange Commission.

(b) Exhibits

The exhibits filed as part of this report are listed above in Item 15(a) (3) of this Form 10-K.

(c) Financial Statement Schedule

The Financial Statement Schedule required by Regulation S-X and Item 8 of this Form are listed above in Item 15(a)(2) of this Form 10-K.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

SMITH MICRO SOFTWARE, INC.

Date: March 30, 2007	By: /s/ William W. Smith, Jr.
	William W. Smith, Jr. Chairman of the Board, President and Chief Executive Officer (Principal Executive Officer)
Date: March 30, 2007	By: /s/ Andrew C. Schmidt
	Andrew C. Schmidt, Chief Financial Officer (Principal Financial and Accounting Officer)

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Signature	Title	Date
/s/ William W. Smith, Jr. William W. Smith, Jr.	Chairman of the Board, President and Chief Executive Officer (Principal Executive Officer)	March 30, 2007
/s/ Andrew C. Schmidt Andrew C. Schmidt	Chief Financial Officer (Principal Financial and Accounting Officer)	March 30, 2007
/s/ Thomas G. Campbell Thomas G. Campbell	Director	March 30, 2007
/s/ Samuel Gulko Samuel Gulko	Director	March 30, 2007
/s/ Ted L. Hoffman Ted L. Hoffman	Director	March 30, 2007
/s/ William C. Keiper William C. Keiper	Director	March 30, 2007
/s/Gregory J. Szabo	Director	March 30, 2007

Gregory J. Szabo

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Audit Committee of
Smith Micro Software, Inc.:

We have audited the consolidated balance sheet of Smith Micro Software, Inc. and subsidiaries (collectively, the Company) as of December 31, 2006 and 2005, and the related consolidated statements of operations, stockholders equity and cash flows for each of the three years in the period ended December 31, 2006. Our audit also included the financial statement schedule of the Company listed in Item 15(a). These financial statements and financial statement schedule are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Smith Micro Software, Inc. and subsidiaries as of December 31, 2006 and 2005, and the results of their operations and their cash flows for each of the three years in the period ended, December 31, 2006, in conformity with U.S. Generally accepted accounting principles. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Smith Micro Software, Inc. and subsidiaries internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and our report dated March 16, 2007 expressed in unqualified opinion on management s assessment of the effectiveness of Smith Micro Software, Inc. s internal control over financial reporting and an unqualified opinion on the effectiveness of Smith Micro Software, Inc. s internal control over financial reporting.

SINGER LEWAK GREENBAUM & GOLDSTEIN LLP
Los Angeles, California
March 16, 2007

To the Audit Committee
Smith Micro Software, Inc.
Aliso Viejo, CA 92656

We have audited management s assessment, included in the accompanying Management s Report on Internal Control over Financial Reporting, that Smith Micro Software, Inc. (the Company) maintained effective internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management s assessment and an opinion on the effectiveness of the Company s internal control over financial reporting based on our audit.

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

A company s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

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

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In our opinion, management s assessment that the Company maintained effective internal control over financial reporting as of December 31, 2006, is fairly stated, in all material respects, based on criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of the Company as of December 31, 2006 and 2005, and the related consolidated statements of operations, shareholders equity and cash flows for each of the three years in the period ended December 31, 2006 of the Company and our report dated March 16, 2007 expressed an unqualified opinion.

SINGER LEWAK GREENBAUM & GOLDSTEIN LLP

Los Angeles, California

March 16, 2007

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SMITH MICRO SOFTWARE INC., AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
AS OF DECEMBER 31, 2006 AND 2005
(In thousands, except share and per share data)

	2006	2005
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 92,564	$ 21,215
Accounts receivable, net of allowances for doubtful accounts and other adjustments of $500 (2006) and $439 (2005)	9,828	6,786
Income tax receivable	122	
Deferred tax asset current	90	
Inventories, net	857	530
Prepaid expenses and other current assets	308	556
Total current assets	103,769	29,087
EQUIPMENT AND IMPROVEMENTS, net	417	241
INTANGIBLE ASSETS, net	3,788	4,093
DEFERRED TAX ASSET LONG TERM	7,786	
GOODWILL	15,266	9,288
OTHER ASSETS, net		7
	$ 131,026	$ 42,716
LIABILITIES AND STOCKHOLDERS EQUITY		
CURRENT LIABILITIES:		
Accounts payable	$ 2,941	$ 2,383
Accrued liabilities	2,028	1,376
Total current liabilities	4,969	3,759
COMMITMENTS AND CONTINGENCIES (Note 6)		
STOCKHOLDERS EQUITY:		
Preferred stock, par value $0.001 per share; 5,000,000 shares authorized; none issued and outstanding		
Common stock, par value $0.001 per share; 50,000,000 shares authorized; 28,444,000 and 22,147,000 shares issued and outstanding	28	22
Additional paid-in capital	129,018	50,880
Accumulated deficit	(2,989)	(11,945)
Total stockholders equity	126,057	38,957
	$ 131,026	$ 42,716

See accompanying notes to consolidated financial statements

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SMITH MICRO SOFTWARE INC., AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
FOR EACH OF THE THREE YEARS
IN THE PERIOD ENDED DECEMBER 31, 2006
(In thousands, except per share data)

	Years ended December 31,		
	2006	**2005**	**2004**
NET REVENUES:			
Products	$ 53,773	$ 19,637	$ 12,394
Services	696	621	922
Total Net Revenues	54,469	20,258	13,316
COST OF REVENUES:			
Products	19,989	3,818	2,530
Services	270	285	380
Total Cost of Revenues	20,259	4,103	2,910
GROSS PROFIT	34,210	16,155	10,406
OPERATING EXPENSES:			
Selling and marketing	9,057	3,410	1,519
Research and development	7,899	3,963	2,556
General and administrative	8,467	4,621	2,868
Total operating expenses	25,423	11,994	6,943
OPERATING INCOME	8,787	4,161	3,463
INTEREST INCOME	1,403	667	53
INCOME BEFORE INCOME TAXES	10,190	4,828	3,516
INCOME TAX EXPENSE	1,234	104	71
NET INCOME	$ 8,956	$ 4,724	$ 3,445
NET INCOME PER SHARE, basic	$ 0.38	$ 0.22	$ 0.20
WEIGHTED AVG SHARES OUTSTANDING, basic	23,753	21,351	17,267
NET INCOME PER SHARE, diluted	$ 0.35	$ 0.21	$ 0.19
WEIGHTED AVG SHARES OUTSTANDING, diluted	25,330	22,806	18,412

See accompanying notes to consolidated financial statements

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SMITH MICRO SOFTWARE INC., AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY
FOR EACH OF THE THREE YEARS
IN THE PERIOD ENDED DECEMBER 31, 2006
(In thousands

	Common stock Shares	Common stock Amount	Additional paid-in capital	Accumulated deficit	Total
BALANCE, December 31, 2003	17,011	$ 17	$ 25,687	$ (20,114)	$ 5,590
Exercise of common stock options	1,000	1	1,995		1,996
Tax benefit related to the exercise of stock options			68		68
Net income				3,445	3,445
BALANCE, December 31, 2004	18,011	18	27,750	(16,669)	11,099
Issuance of common stock in private placement	3,500	4	20,782		20,786
Issuance of common stock in Allume acquisition	398		1,858		1,858
Exercise of common stock options	238		369		369
Tax benefit related to the exercise of stock options			20		20
Non cash compensation recognized on stock options			101		101
Net income				4,724	4,724
BALANCE, December 31, 2005	22,147	22	50,880	(11,945)	38,957
Issuance of common stock in secondary offering, net of offering costs	4,000	4	54,994		54,998
Issuance of common stock in PhoTags acquisition	385		4,730		4,730
Exercise of common stock options	1,462	2	4,185		4,187
Restricted Stock Grants	450		2,020		2,020
Tax benefit related to the exercise of stock options and release of valuation allowance			9,567		9,567
Non cash compensation recognized on stock options			2,642		2,642
Net income				8,956	8,956
BALANCE, December 31, 2006	28,444	$ 28	$ 129,018	$ (2,989)	$ 126,057

See accompanying notes to consolidated financial statements

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SMITH MICRO SOFTWARE INC., AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR EACH OF THE THREE YEARS
IN THE PERIOD ENDED DECEMBER 31, 2006
(In thousands)

	Years ended December 31,		
	2006	**2005**	**2004**
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net income	$ 8,956	$ 4,724	$ 3,445
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	2,098	901	146
Provision for doubtful accounts and other adjustments to accounts receivable	468	573	112
Tax benefit related to the exercise of stock options	1,781	20	68
Non cash stock compensation expense	4,662	101	
Release of tax valuation allowance	7,786		
Change in operating accounts:			
Accounts receivable	(3,510)	(4,513)	(1,395)
Deferred Income Taxes	(8,376)		
Income tax receivable	(122)	35	(35)
Inventories	(327)	(246)	(25)
Prepaid expenses and other assets	174	(109)	(30)
Accounts payable and accrued liabilities	1,160	978	732
Net cash provided by operating activities	14,750	2,464	3,018
CASH FLOWS FROM INVESTING ACTIVITIES:			
Acquisition of PhoTags, Inc., net of cash acquired	(2,224)		
Acquisition of Allume Systems, Inc., net of cash acquired		(10,896)	
Capital expenditures	(362)	(142)	(102)
Net cash used in investing activities	(2,586)	(11,038)	(102)
CASH FLOWS FROM FINANCING ACTIVITIES:			
Proceeds from issuance of common stock, net of offering costs	54,998	20,786	1,996
Proceeds from exercise of stock options	4,187	369	
Net cash provided by financing activities	59,185	21,155	1,996
NET CHANGE IN CASH & CASH EQUIVALENTS	71,349	12,581	4,912
CASH AND CASH EQUIVALENTS, beginning of year	21,215	8,634	3,722
CASH AND CASH EQUIVALENTS, end of year	$ 92,564	$ 21,215	$ 8,634
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION -			
Cash paid during the year for income taxes	$ 203	$ 42	$ 38

See accompanying notes to consolidated financial statements

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SMITH MICRO SOFTWARE, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
FOR EACH OF THE THREE YEARS
IN THE PERIOD ENDED DECEMBER 31, 2006

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Description of Business - Smith Micro Software, Inc. and subsidiaries (the Company) is a developer and marketer of communications and utilities software products and services. Our business model is based primarily upon developing and marketing innovative software solutions for the wireless industry. We sell our products and services to some of the world s leading wireless companies as well as to consumers. Our products are primarily directed to wireless data connectivity, including wireless wide area network (WWAN) for CDMA/GPRS networks, and wireless local area network (WLAN) for Wi-Fi. We also provide software to manage music and other multimedia content, including photo and full motion video, on mobile devices. We are also heavily involved in data compression, primarily focused on a unique way of compression to enable enhanced wireless communications. Our software products target the original equipment manufacturers (OEM) market, particularly wireless service providers and mobile device manufacturers, as well as direct to the consumer. Smith Micro s fundamental product design philosophy is to enhance, simplify, and streamline applications to ensure the best possible consumer experience. Since our inception in 1983, we have shipped over 60 million copies of our various software products.

On April 5, 2006, the Company acquired PhoTags, Inc. (PhoTags), a Delaware Corporation with offices in Jerusalem, Israel (see Note 2). PhoTags is a leading developer and marketer of revolutionary photo and music management technology. The company s pioneering product suite known as Active Images turns any JPEG file into a self-contained multimedia messaging system, allowing users to send text messages, music, sound files, documents and more all in a single JPEG file. Among PhoTags product suite was Music Express, now known as QuickLink Music, an innovative music management solution which assists users to enhance the media-rich capabilities of listening to music on their PCs. QuickLink Music allows users to simplify managing their music files, buy music from an online store and manage music files on a PC. PhoTags Inc. s patented Active Images technology is designed to easily add any type of metadata or media file to a JPEG Image. Watermarks, forms, text messages, music, links to Internet sites, voice recordings, portable digital wallet information, and even videos can all be stored in a JPEG image, and accessed on any device that has the Active Image thin client application installed. This technology plays directly into Smith Micro s strategy of broadening its wireless product offerings and provides for the first time that carriers and handset manufacturers can provide enhanced music and photo management technology that can reside directly in the handset and on a consumer s PC. In addition to broadening Smith Micro s family of mobility products, the PhoTags acquisition will help expand Smith Micro s ability to serve OEM customers in Europe and Asia through an international sales and support office based in Jerusalem, Israel that is now renamed Smith Micro Software, Israel.

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SMITH MICRO SOFTWARE, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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On July 1, 2005, the Company acquired Allume Systems (Allume), which was a wholly owned subsidiary of International Microcomputer Software, Inc. (see Note 3). Allume develops and publishes award-winning software solutions that empower users in the area of information access, removal, recovery, security, productivity and online distribution. Allume s flagship product is StuffIt® Deluxe. StuffIt Wireless, a new and advanced technology that is patent pending by Allume Systems, will compress an already compressed JPEG file by up to 30% more without loosing any of the picture quality. This technology is particularly important to mobile phone manufactures who now can store up to 30% more images and carriers who are interested in the reduction of utilized bandwidth. Other award winning products include icSpyware Suite® and Internet Cleanup® which targets spyware and phishing intrusions, and Spring Cleaning® which cleans and optimizes computer operating systems.

Basis of Presentation - The accompanying consolidated financial statements reflect the operating results and financial position of Smith Micro Software, Inc. and its wholly owned subsidiaries in accordance with accounting principles generally accepted in the United States of America. All intercompany amounts have been eliminated in consolidation.

Cash and Cash Equivalents - Cash and cash equivalents generally consist of cash, government securities and money market funds. These securities are primarily held in one financial institution and are uninsured except for minimum FDIC coverage. As of December 31, 2006 and December 31, 2005, balances totaling approximately $93.1 million and $21.4 million, respectively, were uninsured. All have original maturity dates of three months or less.

Accounts Receivable - The Company performs ongoing credit evaluations of its customers and generally does not require collateral. The Company maintains allowances for estimated credit losses, and those losses have been within management s estimates. Allowances for product returns are included in other adjustments to accounts receivable on the accompanying consolidated balance sheets. Product returns are estimated based on historical experience and have also been within management s estimates.

Inventories - Inventories consist principally of cables, CDs, boxes and manuals and are stated at the lower of cost (determined by the first-in, first-out method) or market. The Company regularly reviews its inventory quantities on hand and records a provision for excess and obsolete inventory based primarily on management s estimated forecast of product demand and production requirements. At December 31, 2006 our inventory balance consisted of approximately $95,000 in assembled products and $762,000 million of components.

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SMITH MICRO SOFTWARE, INC. AND SUBSIDIARIES

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
FOR EACH OF THE THREE YEARS
IN THE PERIOD ENDED DECEMBER 31, 2006**

Equipment and Improvements - Equipment and improvements are stated at cost. Depreciation is computed using the straight-line method based on the estimated useful lives of the assets, generally ranging from three to seven years. Leasehold improvements are amortized using the straight-line method over the shorter of the estimated useful life of the asset or the lease term.

Long Lived Assets The Company accounts for the impairment and disposition of long-lived assets in accordance with Statement of Financial Accounting Standards (SFAS) No. 144, *Accounting for Impairment or Disposal of Long-Lived Assets*. This statement addresses financial accounting and reporting for the impairment of long-lived assets and for the disposal of long-lived assets. In accordance with SFAS No. 144, long-lived assets to be held are reviewed for events or changes in circumstances which indicate that their carrying value may not be recoverable. The Company periodically reviews the carrying value of long-lived assets to determine whether or not an impairment to such value has occurred. The Company has determined that there was no impairment at December 31, 2006.

Goodwill - The Company adopted SFAS No. 142, *Goodwill and Other Intangible Assets,* effective January 1, 2002 and no impairment was identified. As a result of the adoption, the Company is no longer required to amortize goodwill. In accordance with SFAS No. 142, the Company reviews the recoverability of the carrying value of goodwill at least annually or whenever events or circumstances indicate a potential impairment. The Company s annual impairment testing date is December 31. Recoverability of goodwill is determined by comparing the fair value of the Company s reporting units to the carrying value of the underlying net assets in the reporting units. If the fair value of a reporting unit is determined to be less than the carrying value of its net assets, goodwill is deemed impaired and an impairment loss is recognized to the extent that the carrying value of goodwill exceeds the difference between the fair value of the reporting unit and the fair value of its other assets and liabilities. At December 31, 2006, we elected to write off all goodwill allocated to the services sector, or $335,000. The consulting portion of our services sector has been de-emphasized and is no longer considered a strategic element of our go forward plan. The amount of the write off is included in general and administrative expenses. We determined that we did not have any impairment of goodwill associated with the products sector at December 31, 2006.

Revenue Recognition - Software revenue is recognized in accordance with the Statement of Position (SOP) 97-2, *Software Revenue Recognition,* as amended, when persuasive evidence of an arrangement exists, delivery has occurred, the price is fixed and determinable, and collection is probable. The Company recognizes revenues from sales of its software to Retail and OEM customers or end users as completed products are shipped and title passes, or from royalties generated as authorized customers duplicate its software, if the other requirements of SOP 97-2 are met. If the requirements of SOP 97-2 are not met at the date of shipment, revenue is not recognized until these elements are known or resolved. Returns from Retail and OEM customers are limited to defective goods or goods shipped in error. Historically, OEM customer returns have not been significant. The Company reviews available retail channel information and makes a determination of a return provision for sales

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SMITH MICRO SOFTWARE, INC. AND SUBSIDIARIES

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
FOR EACH OF THE THREE YEARS
IN THE PERIOD ENDED DECEMBER 31, 2006**

made to distributors and retailers based on current channel inventory levels and historical return patterns. Certain sales to distributors are made on a consignment basis. Revenue for consignment sales is not recognized until sell through to the final customer has occurred. The Company has few multiple elements agreement for which the Company has contracted to provide a perpetual license for use of proprietary software, to provide non-recurring engineering, and in some cases to provide software maintenance (post contract support). For multiple element agreements, vendor specific objective evidence for all contract elements is reviewed and the timing of the individual element revenue streams is determined and recognized consistent with SOP 97-2.

Product sales directly to end users are recognized upon delivery. End users have a thirty day right of return, but such returns are reasonably estimable and have historically been immaterial. The Company also provides technical support to its customers. Such costs have historically been insignificant.

Service revenues include sales of consulting services, web site hosting and fulfillment. Service revenues are recognized as services are provided or as milestones are delivered and accepted by our customers.

Software Development Costs - Development costs incurred in the research and development of new software products and enhancements to existing software products are expensed as incurred until technological feasibility has been established. The Company considers technological feasibility to be established when all planning, designing, coding and testing has been completed according to design specifications. After technological feasibility is established, any additional costs are capitalized. Through December 31, 2006, software has been substantially completed concurrently with the establishment of technological feasibility; and, accordingly, no costs have been capitalized to date.

Sales Incentives - Pursuant to the consensus of EITF 01-09, *Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor s Product),* effective January 1, 2002, the cost of sales incentives the Company offers without charge to customers that can be used in, or that are exercisable by a customer as a result of, a single exchange transaction is accounted for as a reduction of revenue. Total rebates were $307,000, $193,000 and $0 for the years ended December 31, 2006, 2005 and 2004, respectively.

Advertising Expense - Advertising costs are expensed as incurred. Advertising expenses were $379,000, $223,000 and $47,000 for the years ended December 31, 2006, 2005 and 2004, respectively.

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SMITH MICRO SOFTWARE, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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Income Taxes - The Company accounts for income taxes under SFAS No. 109, *Accounting for Income Taxes*. This statement requires the recognition of deferred tax assets and liabilities for the future consequences of events that have been recognized in the Company s financial statements or tax returns. The measurement of the deferred items is based on enacted tax laws. In the event the future consequences of differences between financial reporting bases and the tax bases of the Company s assets and liabilities result in a deferred tax asset, SFAS No. 109 requires an evaluation of the probability of being able to realize the future benefits indicated by such asset. A valuation allowance related to a deferred tax asset is recorded when it is more likely than not that some portion or all of the deferred tax asset will not be realized. The Company reversed all of its valuation allowance on its deferred tax assets during the year ended 2006 as a result of the Company s improving financial performance and projected income in future years.

Stock-Based Compensation - Effective January 1, 2006, the Company adopted Statement of Financial Accounting Standards (SFAS) No. 123(R), *Share-Based Payment* (SFAS 123(R)), which requires the measurement and recognition of compensation expense for all share-based payment awards made to employees and directors, including stock options based on their fair values. SFAS 123(R) supersedes Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* (APB 25), which the Company previously followed in accounting for stock-based awards. In March 2005, the SEC issued *Staff Accounting Bulletin No. 107* (SAB 107) to provide guidance on SFAS 123(R). The Company has applied SAB 107 in its adoption of SFAS 123(R).

The Company adopted SFAS 123(R) using the modified prospective transition method as of and for the year ended December 31, 2006. In accordance with the modified prospective transition method, the Company s financial statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS 123(R). Share-based compensation expense recognized is based on the value of the portion of share-based payment awards that is ultimately expected to vest. Share-based compensation expense recognized in the Company s Consolidated Statement of Operations during the year ended December 31, 2006 includes compensation expense for share-based payment awards granted prior to, but not yet vested as of, December 31, 2005 based on the grant date fair value estimated in accordance with the pro forma provisions of SFAS 123.

In conjunction with the adoption of SFAS 123(R), the Company elected to attribute the value of share-based compensation to expense using the straight-line method, which was previously used for its pro forma information required under SFAS 123. Share-based

SMITH MICRO SOFTWARE, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
FOR EACH OF THE THREE YEARS
IN THE PERIOD ENDED DECEMBER 31, 2006

compensation expense related to stock options and restricted stock grants was $5.5 million for the year ended December 31, 2006, and was recorded in the financial statements as follows (in thousands):

	2006
Cost of Goods Sold	$ 33
Selling and Marketing	2,077
Research and Development	1,088
General and Administrative	2,269
Total Stock Compensation Expense	$ 5,467

The Company s calculations were made using the Black-Scholes option pricing model with the following assumptions: expected life, 12 to 48 months following the grant date; average stock volatility, 84.1% for grants issued in 2006; weighted average risk-free interest rate of 4.86% in the year ended December 31, 2006; and no dividends during the expected term.

In the year ended December 31, 2006 a total of 50,000 shares of Restricted Stock, with a total value of $440,000, were granted to the Board of Directors. This cost will be amortized over 12 months. In addition, 400,000 shares of Restricted Stock, with a total value $4.3 million, were granted to key officers and employees of the Company. This cost will be amortized over 24 months.

During the years ended December 31, 2005 and December 31, 2004, there was no share-based compensation expense related to stock options recognized under the intrinsic value method in accordance with APB 25. In addition, there was no compensation expense for restricted stock grants as the Company had not issued any restricted stock prior to 2006. Had compensation cost for the Company s stock options been recognized based upon the estimated fair value on the grant date under the fair value methodology prescribed by SFAS No. 123, as amended by SFAS No. 148, the Company s net income and income per share would have been as follows:

SMITH MICRO SOFTWARE, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
FOR EACH OF THE THREE YEARS
IN THE PERIOD ENDED DECEMBER 31, 2006

	Year Ended December 31,	
	2005	**2004**
(in thousands, except per share data)		
Net income, as reported	$ 4,724	$ 3,445
Less total stock based compensation	(1,582)	(308)
Pro forma net income	$ 3,142	$ 3,137
Income per Common Share		
As reported, Basic	$ 0.22	$ 0.20
As reported, Diluted	$ 0.21	$ 0.19

Pro forma, Basic	$ 0.15	$ 0.18
Pro forma, Diluted	$ 0.14	$ 0.17

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SMITH MICRO SOFTWARE, INC. AND SUBSIDIARIES

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
FOR EACH OF THE THREE YEARS
IN THE PERIOD ENDED DECEMBER 31, 2006**

The Company s calculations were made using the Black-Scholes option pricing model with the following weighted average assumptions: expected life, 12 to 48 months following grant date; stock volatility, 85% and 127% for grants issued in 2005 and 2004, respectively; risk-free interest rates of 3.98% and 3.47% for 2005 and 2004, respectively; and no dividends during the expected term. As stock-based compensation expense recognized in the consolidated statement of operations pursuant to SFAS No. 123(R) is based on awards ultimately expected to vest, expense for grants beginning upon adoption of SFAS No. 123(R) on January 1, 2006 will be reduced for estimated forfeitures. SFAS No. 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Forfeitures are estimated based on historical experience.

Net Income per Share - Pursuant to SFAS No. 128, *Earnings per Share,* the Company is required to provide dual presentation of basic and diluted earnings per share (EPS). Basic EPS amounts are based upon the weighted average number of common shares outstanding. Diluted EPS amounts are based upon the weighted average number of common and potential common shares outstanding. Potential common shares include stock options using the treasury stock method.

Fulfillment Services - The Company currently holds consigned inventory from a customer, which is used to fulfill orders. As the Company does not hold title to the inventory, it is not recorded in the accompanying consolidated balance sheets. In addition, the Company receives cash for fulfillment orders, which is paid out to the fulfillment customer on a monthly basis. Such cash and the related payable are recorded on a net basis as the amounts are held for the benefit of this fulfillment customer. Revenue is recognized for fulfillment services as services are performed.

Use of Estimates - The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting years. Actual results could differ from those estimates.

Comprehensive Income - Comprehensive income, as defined, includes all changes in equity (net assets) during a period from non-owner sources. For each of the years ended December 31, 2006, 2005 and 2004, there was no difference between net income and comprehensive income.

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SMITH MICRO SOFTWARE, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
FOR EACH OF THE THREE YEARS
IN THE PERIOD ENDED DECEMBER 31, 2006

Fair Value of Financial Instruments The Company s financial instruments consist of cash, cash equivalents and trade receivables and payables. The carrying amounts of these instruments approximate fair value because of their short-term maturities.

New Accounting Pronouncements - In February 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Issues (SFAS) No. 155, *Accounting for Certain Hybrid Financial Instruments*, which amends SFAS No. 133, *Accounting for Derivatives Instruments and Hedging Activities* and SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities*. SFAS 155 amends SFAS No. 133 to narrow the scope exception for interest-only and principal-only strips on debt instruments to include only such strips representing rights to receive a specified portion of the contractual interest or principle cash flows. SFAS 155 also amends SFAS No. 140 to allow qualifying special-purpose entities to hold a passive derivative financial instrument pertaining to beneficial interests that itself is a derivative instrument. The Company is currently evaluating the impact this new Standard but believes that it will not have a material impact on the Company s financial position, results of operations, or cash flows.

In March 2006, the FASB issued SFAS No. 156, *Accounting for Servicing of Financial Assets* (SFAS 156), which provides an approach to simplify efforts to obtain hedge-like (offset) accounting. This Statement amends FASB Statement 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, with respect to the accounting for separately recognized servicing assets and servicing liabilities. The Statement (1) requires an entity to recognize a servicing asset or servicing liability each time it undertakes an obligation to service a financial asset by entering into a servicing contract in certain situations; (2) requires that a separately recognized servicing asset or servicing liability be initially measured at fair value, if practicable; (3) permits an entity to choose either the amortization method or the fair value method for subsequent measurement for each class of separately recognized servicing assets or servicing liabilities; (4) permits at initial adoption a one-time reclassification of available-for-sale securities to trading securities by an entity with recognized servicing rights, provided the securities reclassified offset the entity s exposure to changes in the fair value of the servicing assets or liabilities; and (5) requires separate presentation of servicing assets and servicing liabilities subsequently measured at fair value in the balance sheet and additional disclosures for all separately recognized servicing assets and servicing liabilities. SFAS 156 is effective for all separately recognized servicing assets and liabilities as of the beginning of an entity s fiscal year that begins after September 15, 2006, with earlier adoption permitted in certain circumstances. The Statement also describes the manner in which it should be initially applied. The Company does not believe that SFAS 156 will have a material impact on its financial position, results of operations or cash flows.

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In July 2006, the FASB released FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109 (FIN 48). FIN 48 clarifies the accounting and reporting for uncertainties in income tax law. This 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. On January 17, 2007, the FASB affirmed its previous decision to make FIN 48 effective for fiscal years beginning after December 15, 2006. Accordingly, FIN 48 is effective for the Company on January 1, 2007. The Company is still assessing the impacts of the adoption of FIN 48. Based on a preliminary analysis, management believes that the adoption of FIN 48 will not have a material impact on its results of operations and financial position.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (SFAS 157), which defines the fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. This statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Early adoption is encouraged, provided that we have not yet issued financial statements for that fiscal year, including any financial statements for an interim period within that fiscal year. The Company is currently in the process of evaluating the impact SFAS 157 may have on its results of operations and financial position.

In September 2006, the FASB issued SFAS No. 158, *Employer s accounting for Defined Benefit Pension and Other Post Retirement Plans*. SFAS No. 158 requires employers to recognize in its statement of financial position an asset or liability based on the retirement plan s over or under funded status. SFAS No. 158 is effective for fiscal years ending after December 15, 2006. The Company is currently in the process of evaluating the effect that the application of SFAS No. 158 will have on its results of operations and financial position.

In September 2006, the United States Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* (SAB 108). This SAB provides guidance on the consideration of the effects of prior year misstatements in quantifying current year misstatements for the purpose of a materiality assessment. SAB 108 establishes an approach that requires quantification of financial statement errors based on the effects of each of the company s balance sheets and statement of operations and the related financial statement disclosures. The SAB permits existing public companies to record the cumulative effect of initially applying this approach in the first year ending after November 15, 2006 by recording the necessary correcting adjustments to the carrying values of assets and liabilities as of the beginning of that year with the offsetting adjustment recorded to the opening balance of retained earnings. Additionally, the use of the cumulative effect transition method requires detailed disclosure of the nature and amount of each individual error being corrected through the cumulative adjustment and how and when it arose. The Company is currently in the process of evaluating the impact SAB 108 may have on its results of operations or financial position.

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In October 2006, the Emerging Issues Task Force (EITF) issued EITF 06-3, *How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That is, Gross versus Net Presentation)* to clarify diversity in practice on the presentation of different types of taxes in the financial statements. The Task Force concluded that, for taxes within the scope of the issue, a company may adopt a policy of presenting taxes either gross within revenue or net. That is, it may include charges to customers for taxes within revenues and the charge for the taxes from the taxing authority within cost of sales, or, alternatively, it may net the charge to the customer and the charge from the taxing authority. If taxes subject to EITF 06-3 are significant, a company is required to disclose its accounting policy for presenting taxes and the amounts of such taxes that are recognized on a gross basis. The guidance in this consensus is effective for the first interim reporting period beginning after December 15, 2006 (the first quarter of our fiscal year 2007). The Company does not expect the adoption of EITF 06-3 will have a material impact on its results of operations, financial position or cash flow.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*. SFAS No. 159 permits entities to choose to measure at fair value many financial instruments and certain other items that are not currently required to be measured at fair value. Subsequent changes in fair value for designated items will be required to be reported in earnings in the current period. SFAS No. 159 also establishes presentation and disclosure requirements for similar types of assets and liabilities measured at fair value. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. The Company is currently assessing the effect of implementing this guidance, which directly depends on the nature and extent of eligible items elected to be measured at fair value, upon initial application of the standard on January 1, 2008.

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2. ACQUISITION OF PHOTAGS INC.

On April 3, 2006, the Company entered into an Agreement and Plan of Merger (the Merger Agreement) by and among the Company, Tag Acquisition Corporation, a Delaware corporation and a wholly owned subsidiary of the Company (Merger Sub), Tag Acquisition Corporation II, a Delaware corporation and wholly owned subsidiary of the Company (Merger Sub II), PhoTags, Inc., a Delaware corporation (PhoTags), Harry Fox, as Stockholders Agent, and certain stockholders of PhoTags, that provides for, among other things, the merger of Merger Sub with and into PhoTags and, immediately upon the completion thereof, the merger of PhoTags with and into Merger Sub II pursuant to which PhoTags became a wholly owned subsidiary of the Company (the Merger). The transaction closed on April 5, 2006. In connection with the Merger, the Company acquired the underlying technology of PhoTags, Inc. which includes patented JPEG enhancements. As a result, the Company paid approximately $2,000,000 to PhoTags, Inc. who paid their existing liabilities at closing, and issued 384,897 shares of the Company s common stock with an aggregate fair market value of $4,730,384 (based on a closing share price on the closing date, April 5, 2006, of $12.29) as consideration for the purchase of all of the outstanding shares of PhoTags. In addition, the Company agreed to pay an earn-out payment of up to an additional $3,500,000 in the Company s common stock, if the PhoTags business line achieves certain milestones at the end of the 15-month earn-out period beginning April 1, 2006. As of December 31, 2006, approximately $1.7 million in Wireless & OEM revenues have been attributed to the acquisition toward the earn-out goal of $4.2 million. The Company estimates that $226,000 in direct cash costs (legal and professional services) and $77,000 of non-cash direct costs were incurred to close the transaction.

As part of the transaction, CDI, a company organized under the laws of the State of Israel and a related party of PhoTags (CDI), agreed to grant the Company an option to acquire CDI for a period of ten (10) years following the effective time of the Merger at a purchase price of $3,000.

The Merger is intended to constitute a reorganization under Section 368 of the Internal Revenue Code of 1986, as amended.

As part of the transaction, the Company filed a registration statement with the Securities and Exchange Commission covering the resale of the shares of the Company s common stock

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issued to the stockholders of PhoTags at closing. The registration statement was filed on July 28, 2006 and became effective August 3, 2006.

A copy of the Merger Agreement has been filed under Form 8-K with the Securities and Exchange Commission.

The results of operations of the business acquired have been included in the Company s consolidated financial statements from the date of acquisition. Amortization related to the acquisition was calculated based on an independent valuation for certain identifiable intangibles acquired.

The total purchase price is summarized as follows (in thousands):

Cash consideration	$ 2,000
Common stock	4,730
Deferred taxes	500
Acquisition related costs cash	226
Acquisition related costs non cash	76
Total purchase price	$ 7,532

The Company s allocation of the purchase price is summarized as follows (in thousands):

Assets:	
Cash	$ 2
Accounts Receivable, net	3
Intangible Assets	1,265
Goodwill	6,312
Total Assets	7,582
Liabilities:	
Accrued Liabilities	50
Total Liabilities	50
Total purchase price	$ 7,532

The pro-forma effect of the acquisition on historical results of operations is not material and therefore is not included.

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3. ACQUISITION OF ALLUME INC.

On July 1, 2005, the Company acquired 100% of the issued and outstanding capital stock of Allume, Inc. from International Microcomputer Software, Inc. (IMSI) for $10.6 million in cash and 397,547 restricted shares of its common stock. Allume, Inc. is a leading developer of compression software solutions for JPEG, MPEG and MP3 platforms. A portion of the purchase price, including $1,250,000 cash and shares of common stock having a market value of $750,000 were deposited in an indemnity escrow to secure certain representations and warranties included in the Stock Purchase Agreement. The aggregate purchase price was approximately $12.8 million, which includes $10.6 million cash paid, the 397,547 shares issued, which have been valued using the average closing market price of the Company s common stock over the two-day period before and after the sale was announced, and $316,000 of direct acquisition costs. The direct acquisition costs incurred to date include $116,000 for legal and professional services, as well as a transaction fee of $200,000.

The results of operations of the business acquired have been included in the Company s consolidated financial statements from the date of acquisition. Depreciation and amortization related to the acquisition were calculated based on the estimated fair market values and estimated lives for property and equipment and an independent valuation for certain identifiable intangibles acquired.

The total purchase price is summarized as follows (in thousands):

Cash consideration	$ 10,626
Common stock	1,858
Acquisition related costs	316
Total purchase price	$ 12,800

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The Company s allocation of the purchase price is summarized as follows (in thousands):

Assets:	
Cash	$ 46
Accounts Receivable, net	822
Inventories, net	237
Property & Equipment	67
Other Assets	244
Intangible Assets	4,863
Goodwill	7,573
Total Assets	13,852
Liabilities:	
Accounts Payable	659
Accrued Liabilities	393
Total Liabilities	1,052
Total purchase price	$ 12,800

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Unaudited pro forma consolidated results of operations for the years ended December 31, 2005 and 2004 as if the acquisition had occurred as of January 1, 2004 are as follows (in thousands, except per share data):

	Year Ended December 31, 2005		Year Ended December 31, 2004	
	Historical	Proforma	Historical	Proforma
Net Revenues	$ 20,258	$ 24,647	$ 13,316	$ 22,902
Net Income	$ 4,724	$ 4,288	$ 3,445	$ 2,810
Net Income per share, basic	$ 0.22	$ 0.20	$ 0.20	$ 0.16
Net Income per share, diluted	$ 0.21	$ 0.19	$ 0.19	$ 0.15
Weighted average shares outstanding, basic	21,351	21,549	17,267	17,665
Weighted average shares outstanding, diluted	22,806	23,004	18,412	18,810

Pro forma adjustments have been applied to reflect the addition of amortization related to the intangible assets and the fixed assets acquired and reduction in interest income as if the acquisition had occurred at the beginning of such period presented. The pro forma adjustment for amortization related to intangible assets acquired was $1.5 million and $608,000 for the proforma periods ending December 31, 2004 and 2005, respectively .

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4. EQUIPMENT AND IMPROVEMENTS

Equipment and improvements consist of the following (in thousands):

	December 31,	
	2006	**2005**
Machinery and equipment	$ 1,187	$ 906
Leasehold improvements	443	362
Office furniture and fixtures	72	72
	1,702	1,340
Less accumulated depreciation and amortization	(1,285)	(1,099)
	$ 417	$ 241

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5. GOODWILL AND INTANGIBLE ASSETS

The following table sets forth the acquired intangible assets by major asset class:

(in thousands)	Useful Life (Years)	December 31, 2006 Gross	December 31, 2006 Accumulated Amortization	December 31, 2006 Net Book Value	December 31, 2005 Gross	December 31, 2005 Accumulated Amortization	December 31, 2005 Net Book Value
Amortizing:							
Purchased and Licensed Technology	3	$ 2,260	$ (2,260)	$	$ 2,260	$ (2,260)	$
Capitalized Software	4 - 5	3,849	(1,621)	2,228	2,649	(534)	2,115
Distribution Rights	5	482	(208)	274	482	(76)	406
Customer Lists	5	923	(276)	647	923	(92)	831
Trademarks	10	809	(196)	613	809	(68)	741
Customer Agreements	1.5	65	(39)	26			
Totals		$ 8,388	$ (4,600)	$ 3,788	$ 7,123	$ (3,030)	$ 4,093

Aggregate amortization expense on intangible assets was approximately $1,570,000, $770,000 and $40,000 for the years ended December 31, 2006, 2005 and 2004, respectively. Expected future amortization expense is as follows: $1,696,000 for the year 2007, $1,121,000 for the year 2008, $522,000 for the year 2009 and $449,000 thereafter. Amortization expense related to intangibles acquired in the Allume acquisition is calculated on a discounted cash flow basis over five years for Capitalized Software, Distribution Rights and Customer Lists and ten years for Trademarks. Amortization is calculated on a straight line basis over five years for Customer Lists. Amortization expense related to intangibles acquired in the PhoTags acquisition is calculated on a discounted cash flow basis over four years for Capitalized Software and 18 months for Customer Agreements.

At December 31, 2006, upon review of the goodwill the Company elected to write off all goodwill allocated to the consulting portion of its services sector, or $335,000. The consulting portion of its services sector has been de-emphasized and is no longer considered a strategic element of our go forward plan. The amount of the write off is included in general and administrative expenses. The Company determined that it did not have any impairment of goodwill associated with the products sector at December 31, 2006.

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The carrying amount of the Company s goodwill was $15,266,000 as of December 31, 2006 and $9,288,000 as of December 31, 2005. The Company s reporting units are equivalent to its operating segments. At December 31, 2006 and 2005, the amount of goodwill allocated to the products segment is $15,266,000 and $8,953,000, respectively and the amount of goodwill allocated to the services segment is $0 and $335,000, respectively.

6. ACCRUED LIABILITIES

Accrued liabilities consist of the following (in thousands):

	December 31,	
	2006	**2005**
Salaries and benefits	$ 1,478	$ 1,055
Royalties	270	180
Marketing expenses and rebates	189	103
Deferred revenue	78	
Other	13	38
	$ 2,028	$ 1,376

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7. INCOME TAXES

A summary of the income tax expense (benefit) is as follows (in thousands):

	Year ended December 31,		
	2006	**2005**	**2004**
Current:			
Federal	$ 23	$ 100	$ 68
State		4	3
	23	104	71
Deferred:			
Federal	(58)	1,286	1,025
State	(33)	(197)	427
Tax benefit related to exercise of stock options and release of valuation allowance	9,567		
Purchase price adjustment PhoTags	(500)		
Other adjustments	21		
Change in valuation allowance	(7,786)	(1,089)	(1,452)
	1,211	0	0
	$ 1,234	$ 104	$ 71

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A reconciliation of the provision (benefit) for income taxes to the amount of income tax expense (benefit) that would result from applying the federal statutory rate (35%) to the income (loss) before income taxes is as follows:

	December 31,		
	2006	**2005**	**2004**
Federal statutory rate	34%	35%	35%
State tax, net of federal benefit	6	3	
Nondeductible expense related to acquired intangibles			
Other	3	(1)	(1)
Change in valuation allowance	(31)	(35)	(32)
	12%	2%	2%

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The major components of the Company s deferred tax assets and liabilities are as follows (in thousands):

	December 31,	
	2006	**2005**
Various reserves	$ 91	$ 107
Nondeductible accruals	128	204
State taxes	(592)	(587)
Prepaid expenses	(156)	(99)
Credit carryforwards	1,697	1,687
Net operating loss carryforwards	6,091	6,118
Fixed assets	57	48
Amortization	831	265
Identifiable intangibles acquired	(537)	
Equity based compensation	216	
Other	50	43
Subtotal	7,876	7,786
Valuation allowance	0	(7,786)
	$ 7,876	$ 0

The Company has federal and state net operating loss carryforwards of approximately $14,900,000 and $11,900,000, respectively, at December 31, 2006. These federal and state net operating loss carryforwards will expire in 2007 through 2026.

In addition, the Company has federal and state tax credit carryforwards of approximately $1,115,000 and $581,000, respectively, at December 31, 2006. These tax credits will begin to expire in 2010.

As of December 31, 2005 the Company had recorded a valuation allowance to fully reserve its net deferred tax assets based on the Company s assessment that the realization of the deferred tax assets did not meet the More likely than not criterion under SFAS No. 109, *Accounting for Income Taxes*. The Company reversed all of its valuation allowance on its deferred tax assets during the year ended December 31, 2006 as a result of the Company s improving financial performance and projected income in the future years.

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8. COMMITMENTS AND CONTINGENCIES

Leases - The Company has non-cancelable operating leases for its building facilities in Aliso Viejo, California and Watsonville, California, which expire in May 2009 and September 2010, respectively. The Company also leases space for its facility in Lee s Summit, Missouri on a month to month basis. Future minimum rental commitments consist of the following (in thousands):

Year ending December 31:	
2007	$ 679
2008	703
2009	438
2010	186
Total	$ 2,006

Total rent expense was $573,000, $492,000 and $480,000 for the years ended December 31, 2006, 2005 and 2004, respectively.

Litigation From time to time the Company is subject to litigation in the normal course of business, none of which management believes will likely have a material adverse effect on the Company s consolidated financial condition or results of operations.

Other Contingent Contractual Obligations During its normal course of business, the Company has made certain indemnities, commitments and guarantees under which it may be required to make payments in relation to certain transactions. These include: intellectual property indemnities to the Company s customers and licensees in connection with the use, sale and/or license of Company products; indemnities to various lessors in connection with facility leases for certain claims arising from such facility or lease; indemnities to vendors and service providers pertaining to claims based on the negligence or willful misconduct of the Company; indemnities involving the accuracy of representations and warranties in certain contracts; and indemnities to directors and officers of the Company to the maximum extent permitted under the laws of the State of Delaware. In addition, the Company has made contractual commitments to employees providing for severance payments upon the occurrence of certain prescribed events. The Company may also issue a guarantee in the form of a standby letter of credit as security for contingent liabilities under certain customer contracts. The duration of these indemnities, commitments and guarantees varies, and in

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certain cases, may be indefinite. The majority of these indemnities, commitments and guarantees may not provide for any limitation of the maximum potential for future payments the Company could be obligated to make. The Company has not recorded any liability for these indemnities, commitments and guarantees in the accompanying consolidated balance sheets.

9. SEGMENT INFORMATION

The Company currently operates in two business segments: products and services. In addition, revenues are classified into three markets, Wireless and OEM sales, Consumer sales, and Enterprise sales. Our Enterprise market includes software product sales as well as consulting, fulfillment and hosting revenue.

The Company does not separately allocate operating expenses to these segments, nor does it allocate specific assets to these segments. Therefore, segment information reported includes only revenues and cost of revenues.

The following table shows the net revenues and cost of revenues generated by each segment:

	Year Ended December 31,					
	2006		2005		2004	
	Products	Services	Products	Services	Products	Services
Wireless & OEM	$ 43,419	$	$ 13,982	$	$ 11,424	$
Consumer	10,019		5,460		746	
Enterprise	335	696	195	621	224	922
Total Revenues	53,773	696	19,637	621	12,394	922
Cost of revenues	19,989	270	3,818	285	2,530	380
Gross Profit	$ 33,784	$ 426	$ 15,819	$ 336	$ 9,864	$ 542

Sales to individual customers and their affiliates, which amounted to more than 10% of the Company s net revenues, included one OEM customer at 74.4% in 2006, 57.1% in 2005, and 68.4% in 2004. Accounts receivable from this customer was $6.6 million at December 31, 2006, $4.6 million at December 31, 2005 and $1.7 million at December 31, 2004. A decision by this customer to substantially decrease or delay purchases from the Company or the Company s inability to collect receivables from this customer could have a material adverse effect on the Company s consolidated financial condition and results of operations.

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10. PROFIT SHARING

The Company offers its employees a 401(k) plan, in which the Company matches the employee contribution at a rate of 20%, subject to a vesting schedule. Total employer contributions amounted to $125,000, $65,000, and $54,000 for the years ended December 31, 2006, 2005 and 2004, respectively.

11. STOCK-BASED COMPENSATION

On July 28, 2005, the Shareholders approved the 2005 Stock Option / Stock Issuance Plan. The Plan, which became effective the same date, replaced the 1995 Stock Option / Stock Issuance Plan which expired on May 24, 2005. All outstanding options under the 1995 Plan will remain outstanding, but no further grants will be made under that Plan. The 2005 Plan provides for the issuance of non-qualified or incentive stock options to employees, non-employee members of the board and consultants. The exercise price per share is not to be less than the fair market value per share of the Company s common stock on the date of grant. The Board of Directors has the discretion to determine the vesting schedule. Options may be either immediately exercisable or in installments, but generally vest over a four-year period from the date of grant. In the event the holder ceases to be employed by the Company, all unvested options terminate and all vested installment options may be exercised within an installment period following termination. In general, options expire ten years from the date of grant. The maximum number of shares of the Company s Common Stock available for issuance over the term of the 2005 Plan may not exceed 5,000,000 shares, plus that number of additional shares equal to 2.5% of the number of shares of Common Stock outstanding on the last trading day of the calendar year commencing with calendar year 2006 (but not in excess of 750,000 shares).

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Stock option activity under the Plan is as follows:

	Number of options	Weighted average exercise price	Aggregate Intrinsic Value
OUTSTANDING, December 31, 2003 (1,140 options, exercisable at a weighted average exercise price of $2.43)	1,911,000	$ 1.62	
Granted (weighted average fair value of $1.70)	922,000	$ 1.95	
Exercised	(1,000,000)	$ 2.00	
Canceled	(34,000)	$ 1.74	
OUTSTANDING, December 31, 2004 (479,000 options, exercisable at a weighted average exercise price of $2.12)	1,799,000	$ 1.58	
Granted (weighted average fair value of $2.75)	2,371,000	$ 4.94	
Exercised	(238,000)	$ 1.55	
Canceled	(76,000)	$ 5.22	
OUTSTANDING, December 31, 2005 (898,000 options, exercisable at a weighted average exercise price of $1.85)	3,856,000	$ 3.57	
Granted (weighted average fair value of $2.75)	266,000	$ 11.69	
Exercised	(1,462,000)	$ 2.86	
Canceled	(142,000)	$ 4.39	
OUTSTANDING, December 31, 2006	2,518,000	$ 4.80	$ 23,654,000
Exercisable at December 31, 2006	914,000	$ 3.91	$ 9,389,000

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Additional information regarding options outstanding as of December 31, 2006 is as follows:

	Options outstanding			Options exercisable	
Range of exercise prices	Number outstanding	Weighted average remaining contractual life (years)	Weighted average exercise price	Number exercisable	Weighted average exercise price
$0.24 - $0.50	124,000	5.8	$ 0.25	123,000	$ 0.25
$0.51 - $1.00	6,000	4.2	$ 0.88	6,000	$ 0.88
$1.01 - $2.00	518,000	7.4	$ 1.90	186,000	$ 1.89
$2.01 - $4.00	35,000	7.7	$ 3.49	33,000	$ 3.55
$4.01 - $5.00	1,517,000	8.6	$ 4.95	512,000	$ 4.95
$5.01 - $16.00	318,000	9.2	$ 10.79	54,000	$ 9.93
	2,518,000	8.3	$ 4.80	914,000	$ 3.91

During the year ended December 31, 2006 approximately 1,462,000 options have been exercised with an intrinsic value of $16.6 million, resulting in cash proceeds to the Company of $4.2 million. The weighted-average grant-date fair value of options granted during the year ended December 31, 2006 was $7.13. At December 31, 2006 there was $4.5 million of total unrecognized compensation costs related to non-vested stock options granted under the Plan, which will be recognized over a period not to exceed four years. At December 31, 2006, 2,151,000 shares were available for future grants under the Stock Option Plan.

12. RELATED PARTY TRANSACTIONS

In October 2004, the Company entered into a Master Software Services Agreement with Arrange Technology LLC, providing for the development of certain software applications and integration services. A member of the Company s Board of Directors was a principal beneficial owner of Arrange Technology LLC, however, that relationship terminated in 2005. $118,000 and $19,000 was expensed under the terms of the agreement in the years ended December 31, 2005 and 2004, respectively.

In conjunction with the severance agreement, entered into in June 2005, with Robert Scheussler, the former CFO, the Company recognized approximately $230,000 in

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severance related costs which is included in general and administrative expenses in the consolidated statement of operations for the year ended December 31, 2005. As per the agreement, Mr. Scheussler will continue to provide services to the Company as a consultant and, under the terms of the Company s Stock Option Plan, will continue to vest in his existing, unvested option grants (which were not modified) totaling 108,333 options. The unvested portion of these option grants were valued by the Company at approximately $424,000 on July 1, 2005, utilizing the Black Scholes option pricing model. With respect to Mr. Scheussler s employee stock option agreements, the Company expensed approximately $41,000 and $101,000 in the years ended December 31, 2006 and December 31, 2005, respectively.

In September 2004, the Company entered into a severance agreement with a principal stockholder and former officer and director of the Company. The Company has discharged its obligation under the agreement by purchasing a single premium annuity in the amount of $192,000 which is included in general and administrative expenses in the consolidated statement of operations for the year ended December 31, 2004.

13. EQUITY TRANSACTIONS

On February 18, 2005, the Company entered into a Securities Purchase Agreement with certain institutional investors related to the private placement of 3,500,000 shares of our common stock, par value $0.001 per share. The transaction closed on February 18, 2005 and the Company realized gross proceeds of $22.4 million from the financing before deducting commissions and other expenses. Offering costs related to the transaction totaled $1,613,000, comprised of $1,344,000 in commissions and $269,000 cash payments for legal and investment services, resulting in net proceeds of $20,786,000. The Company agreed to register for resale the shares of Common Stock issued in the private placement. Such registration statement became effective on June 17, 2005. The agreement provides for penalties of one percent (1%) of the purchase price per month should effectiveness of the registration not be maintained. C.E. Unterberg, Towbin LLC, the placement agent for the transaction, received a cash fee equal to 6% of the aggregate gross proceeds of the Private Placement.

On July 28, 2005, the Shareholders approved a proposal to amend the Amended and restated Certificate of Incorporation to increase the number of authorized Common Shares from 30,000,000 to 50,000,000. Increasing the number of authorized shares of Common Stock is expected to provide the Company with additional capital resources to finance the long-term growth of the Company and with sufficient shares of Common Stock for stock splits. The additional shares of Common Stock could be issued for acquisitions and in public or private offerings, the proceeds of which could be used to finance the Company s

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growth through increased working capital, expansion of existing businesses and other corporate purposes.

On December 14, 2006, the Company completed a fully marketed secondary, issuing 4,000,000 shares of our common stock, $0.001 par value, at a price of $14.75 per share, resulting in aggregate gross cash proceeds to the Company of $59,000,000 before deducting commissions and other expenses. Offering costs related to the transaction totaled $4,002,000, comprised of $3,304,000 in underwriting discounts and commissions and $698,000 cash payments for legal and investment services, resulting in net proceeds to the Company of $54,998,000 as of December 31, 2006. On January 18, 2007 an additional 387,000 shares were sold under the same agreement, resulting in estimated net proceeds of $5,388,000 to the Company.

14. SHARES SUBJECT TO RESCISSION (UNAUDITED)

Under our 1995 Stock Option / Stock Issuance Plan and 2005 Stock Option / Stock Issuance Plan (the Plans), the Company granted options to purchase shares of common stock to certain of our employees, directors and consultants. The issuances of common stock upon exercise of options that were granted under these Plans between March 2005 and August 2006 may not have been exempt from qualification under certain state securities laws and, as a result, the Company may have potential liability to the individuals who exercised these options.

The Company accounts for shares which have been issued that may be subject to rescission claims as a put liability based on the price to be paid for equity to be repurchased. Since equity instruments subject to rescission are redeemable at the holder s option or upon the occurrence of an uncertain event not solely within the Company s control, such equity instruments are outside the scope of SFAS No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, and its related interpretations. Under the SEC s interpretation of generally accepted accounting principles, reporting such claims outside of stockholders equity is required, regardless of how remote the redemption event may be. However, during the relevant period for which the Plans were not in compliance with certain state securities laws, all of the individuals who exercised options sold all of the shares underlying the options exercised. As such, the Company does not feel that there is a material exposure for rescission of issued shares to those who exercised stock options as they had subsequently sold their shares and at a value greater than the option strike price and no longer hold the shares.

In addition to shares of common stock which were issued upon option exercises, certain option grants made under the Plans between March 2005 and August 2006 which have not yet been exercised may not have been exempt from qualification under certain state securities laws. As a result, we may have potential liability to the individuals who received those option grants but who have not yet exercised those options. We may in the future choose to make a rescission offer to the holders of these outstanding options to give them the opportunity to rescind the grant of their options in exchange for a cash payment.

Prior to the implementation of SFAS 123(R) in January 2006, the Company accounted for share options under APB 25. Since all of the options under the Plans were granted at fair market value at the time of grant, no expense is recorded in our financial statements related to options that were vested prior to January 1, 2006. Under SFAS 123 (R), the first quarter results of 2006 included expense related to options that were granted prior to January 1, 2006 but had not vested at that date. Accordingly, no provision is made in our financial statements for options that were vested as of January 1, 2006, that were granted under the Plans which are not yet exercised, but may be subject to a rescission offer, if and when made. Should any optionees accept the rescission offer and put their options back to the Company, the Company will reflect such offer in our financial statements at that time.

As of March 16, 2007, assuming every eligible holder of unexercised options granted under the Plans during the period in question were to accept a rescission offer, we estimate the total cost to us to complete the rescission for the unexercised options would not be material to our financial condition. Management feels that acceptance of a rescission offer, if made, would be remote, since the weighted average exercise price of these options which were outstanding at March 16, 2007 was $6.40 per share and the market price of the Company s stock was trading at a significantly higher price.

15. SUBSEQUENT EVENTS

Acquisition of Ecutel Systems, Inc.

On February 9, 2007, the Company, TEL Acquisition Corp., a wholly-owned subsidiary of the Company, Ecutel Systems, Inc., John J. McDonnell, Jr. and the Principal Stockholders of Ecutel consummated the merger of Ecutel with and into Acquisition Co. pursuant to the terms of that certain Agreement and Plan of Merger dated as of January 31, 2007.

In connection with the Merger, all outstanding shares of capital stock of Ecutel were converted into the right to receive a portion of the merger consideration. The aggregate merger consideration paid by the Company in connection with the Merger was $8,000,000 in cash, of which $1,000,000 is being withheld as security for satisfaction of certain indemnification obligations pursuant to the terms of the Merger Agreement. The consideration for and the other terms and conditions of the Merger were determined by arms-length negotiations between the Company, Ecutel and the Principal Stockholders of Ectuel.

Intent to Acquire Insignia Solutions, plc.

On February 11, 2007 the Company announced that it had entered into a definitive agreement to acquire substantially all of the assets of Insignia Solutions, including its mobile device management business. The agreement is anticipated to close early in the second quarter.

Restricted Stock Grant.

On February 19, 2007 a total of 50,000 shares of Restricted Stock, with a total value of $627,500, were granted to directors of the Company. This cost will be amortized over

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12 months. In addition, 420,000 shares of Restricted Stock, with a total value of $5.3 million, were granted to officers and key employees of the Company. This cost will be amortized over 24 months.

Stock Option Grants.

As of March 14, 2007, a total of 2,153,500 options have been granted with a weighted average exercise price of $13.55. All options will vest over a four year period.

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SMITH MICRO SOFTWARE, INC. AND SUBSIDIARIES
SCHEDULE II VALUATION AND QUALIFYING ACCOUNTS
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(In thousands)

	Balance at beginning of period	Additions charged to costs and expenses	Deductions	Balance at end of period
Allowance for doubtful accounts and other adjustments (1):				
2006	$ 439	$ 468	$ (407)	$ 500
2005	137	573	(271)	439
2004	33	112	(8)	137

(1) Other adjustments relate principally to sales returns.

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EXHIBIT INDEX

Exhibit No.	Title	Method of Filing
2.1	Stock Purchase Agreement, dated July 1, 2005, between Smith Micro Software, Inc. and International Microcomputer Software, Inc. (sole shareholder of Allume Systems, Inc.)	Incorporated by reference to Exhibit 2.1 to the Registrant s Current Report on Form 8-K filed on July 5, 2005.
2.2	Agreement and Plan of Merger, dated April 3, 2006, by and among Smith Micro Software, Inc., Tag Acquisition Corporation, Tag Acquisition Corporation II, Photags, Inc., Harry Fox, and certain stockholders of Photags, Inc.	Incorporated by reference to Exhibit 2.1 to the Registrant s Current Report on Form 8-K filed on April 7, 2006
2.3	Agreement and Plan of Merger, dated January 31, 2007, by and among Smith Micro Software, Inc., TEL Acquisition Corp., Ecutel Systems, Inc., John J. McDonnell, Jr. and certain stockholders of Ecutel Systems, Inc.	Incorporated by reference to Exhibit 2.1 to the Registrant s Current Report on Form 8-K filed on February 6, 2007.
2.4	Asset Purchase Agreement, dated February 11, 2007, by and among Smith Micro Software, Inc., IS Acquisition Sub, Inc., Insignia Solutions plc, Insignia Solutions Inc. and Insignia Solutions AB.	Incorporated by reference to Exhibit 2.2 to the Registrant s Current Report on Form 8-K filed on February 13, 2007.
3.1	Amended and Restated Certificate of Incorporation of the Registrant.	Incorporated by reference to Exhibit 3.1 to the Registrant s Registration Statement No. 33-95096.
3.1.1	Amendment to the Amended and Restated Certificate of Incorporation of the Registrant.	Incorporated by reference to Exhibit 3.1.1 to the Registrant s Quarterly Report on Form 10-Q for the period ended June 30, 2000.
3.1.2	Certificate of Amendment to Amended and Restated Certificate of Incorporation of Registrant as filed August 18, 2005 with Delaware Secretary of State	Incorporated by reference to Exhibit 3.1.2 to the Registrant s Annual Report on Form 10-K for the period ended December 31, 2005.
3.2	Amended and Restated Bylaws of the Registrant.	Incorporated by reference to Exhibit 3.2 to the Registrant s Registration Statement No. 33-95096.
4.1	Specimen certificate representing shares of Common Stock of the Registrant.	Incorporated by reference to Exhibit 4.1 to the Registrant s Registration Statement No. 33-95096.
10.1	Form of Indemnification Agreement.	

		Incorporated by reference to Exhibit 10.1 to the Registrant s Registration Statement No. 33-95096.
10.2*	1995 Stock Option/Stock Issuance Plan as Amended and Restated through February 7, 2001.	Incorporated by reference to the Appendix attached to the Definitive Proxy Statement for the 2001 Annual Meeting of Stockholders filed on April 27, 2001.
10.3*	2005 Stock Option / Stock Issuance Plan	Incorporated by reference to Appendix A attached to the Definitive Proxy Statement for the 2005 Annual Meeting as filed June 10, 2005.
10.4	Master Software License and Distribution Agreement (Contract No. 220-00-0134) effective as of December 1, 2000, between Cellco Partnership (d/b/a Verizon Wireless) and the Registrant	Incorporated by reference to Exhibit 10.1 to the Registrant s Quarterly Report on Form 10-Q for the quarter ended June 30, 2003.
10.4.1	Amendment of Master Software License and Distribution Agreement (Contract No. 220-00-0134)	Incorporated by reference to Exhibit 10.1.1 to the Registrant s Quarterly Report on Form 10-Q for the quarter ended June 30, 2003.
10.4.2	Amendment No. 2 to the Master Software License and Distribution Agreement (Contract No. 220-00-0134)	Incorporated by reference to Exhibit 10.1.2 to the Registrant s Quarterly Report on Form 10-Q for the quarter ended June 30, 2003.
10.5*	Letter Agreement, dated June 13, 2005, by and between Smith Micro Software, Inc. and Andrew Schmidt	Incorporated by reference to Exhibit 10.5 to the Registrant s Current Report on Form 8-K filed on November 30, 2006.

Exhibit No	Title	Method of Filing
10.6*	Employment Agreement dated April 9, 1999 by and between Smith Micro Software, Inc. and William Wyand.	Incorporated by reference to Exhibit 10.6 to the Registrant s Current Report on Form 8-K filed on November 30, 2006.
14.1	Code of Ethics	Incorporated by reference to Exhibit 14.1 to the Registrant s Annual Report on Form 10-K for the fiscal year ended December 31, 2003.
14.1.1	Attachment 1 to Code of Ethics	Incorporated by reference to Exhibit 14.1 to the Registrant s Annual Report on Form 10-K for the fiscal year ended December 31, 2003.
21.1	Subsidiaries	Incorporated by reference to Exhibit 21.1 to the Registrant s Annual Report on Form 10-K for the fiscal year ended December 31, 2000.
23.1	Consent of Independent Registered Public Accounting Firm.	Filed herewith
31.1	Certification of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	Filed herewith
31.2	Certification of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	Filed herewith
32.1	Certifications of the Chief Executive Officer and the Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	Furnished herewith

* Indicates management contract or compensatory plan or arrangement.

Confidential treatment has been granted with respect to certain confidential portions of this exhibit pursuant to Rule 24b-2 under the Securities Exchange Act of 1934, which confidential portions have been omitted from the exhibit and filed separately with the Securities and Exchange Commission.