

MATRIX SERVICE CO  
Form 10-K  
August 04, 2006  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**FORM 10-K**

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(Mark One)

**Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**  
For the fiscal year ended May 31, 2006

or

**Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File No. 1-15461

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**MATRIX SERVICE COMPANY**

(Exact name of registrant as specified in its charter)

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**Delaware**  
(State or other jurisdiction of  
incorporation or organization)

**73-1352174**  
(I.R.S. Employer  
Identification No.)

**10701 East Ute Street**

**Tulsa, Oklahoma**  
(Address of Principal Executive Offices)

**74116**  
(Zip Code)

Registrant's telephone number, including area code: (918) 838-8822

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**Securities Registered Pursuant to Section 12(b) of the Act: None**

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

(Title of class)  
**Common Stock, par value \$0.01 per share**

**Preferred Share Purchase Rights**

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Name of Each Exchange On Which Registered: NASDAQ Global Market (Common Stock)

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

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

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

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

Large Accelerated Filer  Accelerated Filer  Non-accelerated Filer

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

The aggregate market value of the registrant's common stock held by non-affiliates computed by reference to the price at which the common stock was last sold as of the last business day of the registrant's most recently completed second quarter was approximately \$161 million.

The number of shares of the registrant's common stock outstanding as of August 1, 2006 was 20,867,857 shares.

**Documents Incorporated by Reference**

Certain sections of the registrant's definitive proxy statement relating to the registrant's 2006 annual meeting of stockholders, which definitive proxy statement will be filed within 120 days of the end of the registrant's fiscal year, are incorporated by reference into Part III of this Form 10-K.

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**PART 1**

**Item 1. Business**

**FORWARD-LOOKING STATEMENTS**

This Annual Report on Form 10-K includes forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. All statements, other than statements of historical facts, included in this Annual Report which address activities, events or developments which we expect, believe or anticipate will or may occur in the future are forward-looking statements. The word believes, intends, expects, anticipates, projects, estimates, predicts and similar expressions are also intended to identify forward-looking statements.

These forward-looking statements include, among others, such things as:

amounts and nature of future revenues from our Construction Services and Repair and Maintenance Services segments;

our ability to generate sufficient cash from operations or to raise cash in order to meet our short- and long-term capital requirements;

our ability to comply with the financial covenants in our credit agreement;

the likely impact of new or existing regulations on the demand for our services; and

expansion and other development trends of the industries we serve.

These statements are based on certain assumptions and analyses we made in light of our experience and our perception of historical trends, current conditions and expected future developments as well as other factors we believe are appropriate in the circumstances. However, whether actual results and developments will conform with our expectations and predictions is subject to a number of risks and uncertainties which could cause actual results to differ materially from our expectations, including:

the risk factors discussed in Item 1A of this Annual Report and listed from time to time in our filings with the Securities and Exchange Commission;

general economic, market or business conditions;

changes in laws or regulations; and

other factors, most of which are beyond our control.

Consequently, all of the forward-looking statements made in this Annual Report are qualified by these cautionary statements and there can be no assurance that the actual results or developments anticipated by us will be realized or, even if substantially realized, that they will have the expected consequences to or effects on us or our business or operations. We assume no obligation to update publicly any such forward-looking statements, whether as a result of new information, future events or otherwise.



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### **BACKGROUND**

We provide construction services in addition to repair and maintenance services primarily to the downstream petroleum and power industries. We also provide these services to other industries including liquefied natural gas (LNG), wastewater, food and beverage and pulp and paper industries.

As a full service industrial contractor, we strive to provide all of our clients the highest degree of safety, quality and service utilizing our qualified professionals, technical expertise, skilled craftsmen, and overall project management.

We are headquartered in Tulsa, Oklahoma, with regional operating facilities located in California, Delaware, Illinois, Michigan, Oklahoma, Pennsylvania, Texas and Washington in the U.S. and Ontario and New Brunswick in Canada. We were incorporated in the State of Delaware in 1989. Our principal executive offices are located at 10701 E. Ute Street, Tulsa, Oklahoma 74116. Our telephone number is (910) 838-8822 and our fax number is (918) 838-8810. Unless the context otherwise requires all references herein to Matrix Service, Matrix Service Company, the Company or to we, our, and us are to Matrix Service Company and its subsidiaries.

To serve clients efficiently and effectively, Matrix Service operates regional offices throughout the U. S. and in Canada. We have separate union and merit subsidiaries; therefore, we can provide our services to customers who require services to be performed on either a union or merit basis.

We have two reportable segments, our Construction Services segment and our Repair and Maintenance Services segment. See Note 16 Segment Information in the Notes to Consolidated Financial Statements for segment and geographic information.

We also provide services where our two business segments combine to provide a combination of services to our customers. Customers use these services to expand their operations, improve operating efficiencies and to comply with stringent environmental and safety regulations.

Our Construction Services include turnkey projects, renovations, upgrades, and expansions for large and small projects. We routinely perform civil and concrete, electrical and instrumentation, mechanical, piping and equipment installations, and tank engineering, design, fabrication and erection, as well as steel, steel plate, vessel and pipe fabrication.

Our Repair and Maintenance Services include outages and turnarounds, plant maintenance, electrical and instrumentation maintenance, tank inspection, repair and maintenance, industrial cleaning, and American Society of Mechanical Engineers (ASME) code repairs.

### **WEBSITE ACCESS TO REPORTS**

Our public internet site is [www.matrixservice.com](http://www.matrixservice.com). We make available free of charge through our internet site, via a link to Edgar Online, our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended, as soon as reasonably practicable after we electronically file such material with, or furnish it to, the Securities and Exchange Commission.

In addition, we currently make available on [www.matrixservice.com](http://www.matrixservice.com) our annual reports to stockholders. You will need to have the Adobe Acrobat Reader software on your computer to view these documents, which are in the PDF format. If you do not have Adobe Acrobat, a link to Adobe Systems Incorporated's internet site, from which you can download the software, is provided.

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### **CONSTRUCTION SERVICES**

Our construction services include turnkey construction, civil construction, structural steel erection, mechanical installation, process piping, electrical and instrumentation, fabrication, vessel and boiler erection, millwrighting, plant modifications, centerline turbine erection, and startup and commissioning. In addition, we offer design, engineering, fabrication and construction of aboveground storage tanks. These services range in size and duration, and originate from either our union or merit-shop based offices, which are strategically located to serve our customers needs.

All projects, large or small, are executed by project teams that are committed to providing the best service available, while continuously seeking innovative ways to safely and effectively improve quality and productivity.

Matrix Service has the support structure necessary to manage and execute both small and large complex projects within strict scheduling and budgetary constraints. Our in-house estimating, scheduling and cost control capabilities are designed to ensure timely and cost-effective execution of the work we undertake. Advanced information technology capabilities allow our project managers to oversee and control projects by accessing project data from any location or job site.

In conjunction with our construction services, Matrix Service has fabrication facilities to support our work throughout the U.S.; staffed with the qualified personnel, utilizing state of the art equipment. Our fabrication facilities specialize in steel plate, structural steel and vessel fabrication. Our Oklahoma fabrication facility, which is our largest fabrication facility, is centrally located in the United States. This 160,000 sq. ft. facility is located on the most inland port in the United States with barging, rail and trucking capabilities. The Oklahoma facility has the capacity to fabricate new tanks, new tank components and all maintenance, retrofit and repair parts, including fixed roofs, floating roofs, seal assemblies, shell plate and tank appurtenances. The Oklahoma facility also provides customized steel plate and pipe fabrication directly to customers for their erection. This facility is qualified to perform services on equipment that requires ASME Code Stamps. This fabrication includes ASME pressure vessels, stacks, scrubber vessels, ducting, heat exchangers, flare stacks and igniter tips. Fabrication materials include carbon steels, stainless steels and specialty alloy materials.

#### **Construction Services Market Overview    Downstream Petroleum**

Our construction experience for the downstream petroleum market includes refineries, pipelines, terminals, petrochemical plants, gas facilities and bulk storage facilities. This includes turnkey construction projects, renovations, upgrades and expansion for large and small projects. We have many long-term relationships with our customers and much of our work is repeat business with these customers.

The downstream petroleum market continues to be strong. A focal point of this market is the refining industry. There are currently 149 refineries in the U.S. with an estimated total refining capacity in 2006 of approximately 17.3 million barrels a day, which is not meeting current and forecasted needs. While it is not expected that any new refineries will be built in the U.S. in the near future, it is anticipated that many existing refineries will focus on expanding and refurbishing their facilities to increase production. Several major refining companies have committed to significant capital expenditures in the coming years to expand production and to continue to meet regulatory requirements.

Pipeline and terminal companies are also expanding existing facilities and constructing new terminals. We have provided turnkey construction services for bulk storage terminals, rail terminals, aviation fueling facilities and marine dock facilities. In addition, we have extensive experience upgrading, expanding, and completing retrofits at terminals and bulk storage facilities all across the U.S. We expect continued interest in our tank and terminal construction capabilities throughout the coming fiscal year.

A large portion of our terminal construction work involves tank construction, which is a cornerstone of our business. Our tank construction services often incorporate engineering, design, fabrication, and shop and/or field erection. In addition, Matrix Service designs, fabricates and field erects new refrigerated and cryogenic liquefied gas storage tanks for the storage of ammonia, butane, carbon dioxide, ethane, methane, argon, nitrogen, oxygen, propane and other products. These tanks are utilized by the chemical, petrochemical and gas industries.

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Clean fuels initiatives continue to cause an increase in capital spending as refineries look for new efficient, cost-effective ways to comply with governmental regulations. Over the last several years, the Environmental Protection Agency (EPA) issued rules that require the sulfur content of diesel fuel to be reduced to 500 parts per million (ppm) with a lower 15-ppm requirement effective June 2006. In addition, refiners must produce low sulfur diesel products for off-road vehicles by 2010. Matrix Service saw some opportunities relating to compliance with clean fuels initiatives, which resulted in projects for our construction services business segment. These projects involved the construction of new process units, modifications to existing units, extensive piping, structural steel and equipment installations. We are still seeing inquiries related to clean diesel fuel at various refineries throughout the U.S. and expect more construction opportunities in the future.

**Construction Services Market Overview Power**

We are currently pursuing two types of opportunities in the electric power industry. Environmental upgrades to existing plants provide the most immediate area of opportunity for potential construction revenue. In March 2005, the EPA issued the Clean Air Interstate Rule (CAIR), which provided the framework to reduce power plant emissions in 28 states and the District of Columbia. We expect by 2010, power plants with generating capacity of approximately 23,900 megawatts will need to install Selective Catalytic Reduction (SCR) equipment for nitrous oxide (NOX) control. By 2015, power plants with a generating capacity of an additional 26,600 megawatts will also have to install SCR equipment for NOX control. The CAIR regulations also mandate reduction in sulfur dioxide (SO<sub>2</sub>) emissions from coal-fired power plants. SO<sub>2</sub> removal is accomplished by the installation of Flue Gas Desulphurization (FGD) equipment. By 2010, power plants with a generating capacity of approximately 39,600 megawatts will have to install or upgrade FGD equipment. By 2015, power plants with an additional generating capacity of approximately 32,400 megawatts will also have to install or upgrade FGD equipment. A single megawatt of power generally supplies electricity for approximately 1,000 homes for a one-year period.

In addition to the opportunity that exists in the engineering, fabrication, construction (EFC) and general construction services related to the installation of SCR and FGD systems, there are additional opportunities in coal-fired power plant flue gas mercury reduction. In March 2005, the EPA issued the Clean Air Mercury Rule (CAMR) establishing mercury limits for coal-fired flue gas that take effect in stages beginning in 2010, with full implementation by 2018. Under current technology, the most effective mercury removal from flue gas is by injection of an activated carbon catalyst and then downstream removal by a fabric filter bag house. Since modern coal-fired power plants generate revenue from the sale of fly ash, most of the planned mercury removal installations will involve the addition of a second bag house located downstream of the existing fly ash removal equipment. This will be necessary since the injection of the activated carbon results in the fly ash no longer being suitable for sale. We believe we are well positioned to provide fabrication, erection and/or general construction services as these mercury removal injection and capture systems are installed.

The EPA estimates that compliance with both the CAIR and CAMR rules will cost the power industry in excess of \$50 billion. We expect that increasing demand for companies to EFC and install the equipment associated with both NOX and mercury removal will result in increasingly higher margins than we are currently experiencing as fabrication facilities develop larger backlogs of work.

As natural gas prices remain at elevated levels, the power industry is once again looking at coal-fired power plant development as well as the development of gas-fired generation using gasified coal, and there is significant activity in the LNG market. All three of these alternative energy sources provide opportunities for the Company to provide EFC and general construction services.



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### **Construction Services Market Overview Other Industries**

There has been a strong resurgence in LNG receiving terminal construction after years of dormancy. The strong demand for clean burning natural gas, resulting in part from the large build up of gas-fired power plants and generally flat to declining domestic production of natural gas, has created an increased demand for LNG. This has created a strong demand for the construction of large LNG tanks, LNG receiving terminals and peak shaving plants. Matrix Service is involved in the EFC of these LNG tanks. There are currently five LNG receiving terminals operating in the United States, 11 terminals permitted by FERC and two terminals permitted by the Coast Guard. There are 12 receiving terminals proposed for FERC approval and eight proposed for Coast Guard approval.

In addition to the LNG market, Matrix Service provides construction services to the food and beverage, water/wastewater, pulp and paper, heavy technologies, and metals and mining industries. We have substantial experience providing turnkey construction, plant expansions, retrofits and modernizations to customers in these industries. We continue to monitor these industries and seek opportunities where we can offer our clients a safe, quality project.

### **REPAIR AND MAINTENANCE SERVICES**

We provide a wide range of routine, preventative and emergency repair and maintenance services. We recognize that being proactive is the key, whether scheduling routine maintenance or planning an emergency response to an unexpected facility or equipment problem. We provide multiple services that allow our clients to select needed services from a single source instead of multiple contractors. Our primary services include refining and petrochemical turnarounds, facility/plant outages, facility maintenance, tank work, including inspection, repair and maintenance, industrial cleaning and ASME code repairs. We provide these services for entire plants and facilities as well as single units or tanks. These services range in duration from short term to ongoing multiple year contracts and originate from either our union or merit shop based offices, which are strategically located to serve our customers' needs.

Turnarounds, outages and shutdowns constitute a core part of our business. We are committed to delivering all services on time, within budget and schedule constraints, and most importantly, without safety incidents. Projects are completed by in-house project managers and superintendents who are supported by qualified, skilled craftsmen in every discipline, utilizing the latest procedures and equipment.

Our tank repair and maintenance services are also a key component of our core business. We are one of the largest tank repair and maintenance contractors in the United States with a solid reputation for quality, safety and reliability. Our personnel are well versed in American Petroleum Institute (API) standards and ASME code work in both atmospheric and pressure storage vessels. We also provide environmentally friendly solutions for secondary containment and leak detection. Our product offerings include dikes and liners, steel internal floating roofs, tank double bottoms, and primary and secondary seals. Every product we offer is engineered to provide our customers with the highest quality.

Many of our repair and maintenance services are performed for clients under alliance contracts. We have built these relationships on years of trust, open communication and a mutual desire to complete projects safely, with a high degree of quality, and on time.

### **Repair and Maintenance Services Market Overview Downstream Petroleum**

One of our primary service lines in Repair and Maintenance is refinery maintenance and turnarounds. We are also seeing an increase in repair and maintenance project opportunities, due in part to the increased number of terminals and bulk storage facilities, many of which are being built to protect refiners from the price volatility of crude oil. According to Industrial Information Resources, petroleum refiners are expanding their annual maintenance turnarounds, doing everything that needs to be done to return facilities to peak performance. Maintenance spending is expected to increase 45% in calendar 2006 and the number of overall turnarounds planned is up by 21%. While routine maintenance activities are a continuous part of every refinery, many of these facilities are now spending additional funds for major maintenance. Our expertise and reputation as a quality turnaround contractor positions us well to take advantage of the additional work. Tank repair and maintenance is also one of the cornerstones of our business and continues to be a significant portion of our repair and maintenance revenue. Matrix Service also provides electrical and instrumentation services to its downstream petroleum customers.

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### **Repair and Maintenance Services Market Overview Power**

Matrix Service provides repair, maintenance, and outage services for the power industry. Our onsite maintenance services include routine maintenance that includes cleaning fans, changing out lube oil coolers and maintaining gas turbines, heat recovery steam generators (HRSGs) and other plant equipment. We also provide turbine disassembly, inspection and repair assistance.

We provide a wide variety of outage services for the power industry for scheduled outages as well as emergency situations that may arise. In addition to providing standard services which include planning and scheduling; tower and vessel repair and installation; fin fan retube and repair; boiler retube and repair; valve installation; carbon steel and alloy pipe fabrication and repair and ASME code work. Matrix Service provides electrical and instrumentation repair and maintenance services for nuclear and fossil fuel power plants.

### **Repair and Maintenance Services Market Overview Other Industries**

We provide repair and maintenance services for other industries, including water/wastewater tank repair and maintenance, infrastructure maintenance for the pulp and paper industry, and tank and equipment repairs for the food and beverage industry; as well as emergency response for these industries. Tank repair and maintenance continues to be a focal point for other industries, and specifically the LNG market. As the construction of LNG terminals increases, we expect to see an increase in the need for repair and maintenance of these facilities. Building on our longstanding reputation as a quality repair and maintenance contractor, we look forward to generating additional revenue from these opportunities.

## **OTHER BUSINESS MATTERS**

### **Customers and Marketing**

Matrix Service derives a significant portion of its revenues from performing construction and repair and maintenance services for major integrated oil and power companies. Matrix Service also performs services for independent petroleum refining and marketing companies, architectural and engineering firms, the food industry, general contractors and several petrochemical companies and serves over 400 customers. In fiscal 2006, one customer accounted for 14% of our consolidated revenues and 27% of our Repair and Maintenance Services revenues. Another customer represented 13% of our Repair and Maintenance Services revenues and a third customer accounted for 13% of our Construction Services revenues. The loss of any of these major customers could have material adverse effect on the Company.

Matrix Service markets its services and products primarily through its marketing and business development personnel, senior professional staff and its operating management. The marketing personnel concentrate on developing new customers and assisting management with existing customers. We enjoy many preferred provider relationships with customers who award us work without competitive bidding through long-term agreements. In addition, we competitively bid many projects. Repair and Maintenance Services projects normally have durations of one week to several months depending on work scope, while Construction Services projects typically range in duration from multiple weeks to three years.

### **Segment Financial Information**

Financial information for operating segments is provided in Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations and in Item 8. Financial Statements and Supplementary Data .

**Table of Contents****Competition**

Matrix Service competes with a large number of regional construction and maintenance companies and a number of national construction and maintenance companies in both the Construction Services and Repair and Maintenance Services segments. Competitors generally vary with the markets we serve with few competitors competing in all of the markets we serve or for all of the services that we provide. Contracts are generally awarded based on price, customer satisfaction, safety record and programs, quality and schedule compliance. We believe that our turnkey capability, expertise, experience and reputation for providing safe and timely quality services allow us to compete effectively.

**Backlog**

At May 31, 2006, the Construction Services segment had an estimated backlog of work under contract of approximately \$230.1 million, as compared to an estimated backlog of approximately \$200.9 million as of May 31, 2005. The increase resulted primarily from an overall increase in activity associated with the Downstream Petroleum market. The estimated backlog at May 31, 2006 and 2005 for the Repair and Maintenance Services segment was approximately \$18.3 million and \$14.6 million, respectively.

Other than an LNG project, virtually all of the projects comprising our backlog are expected to be completed within fiscal year 2007. Because many of our contracts are performed within short time periods after receipt of an order and as backlog amounts exclude time and materials contracts, we do not believe that our level of backlog at the end of any given period is a precise indicator of our future revenues, especially for our Repair and Maintenance Services segment.

The following provides a rollforward of our backlog from May 31, 2005 to May 31, 2006:

|  | Construction<br>Services | Repair and<br>Maintenance<br>Services<br>(In thousands) | Total      |
|--|--------------------------|---|------------|
| Backlog as of May 31, 2005                 | \$ 200,944               | \$ 14,550   | \$ 215,494 |
| New backlog awarded                        | 267,024                  | 88,037  | 355,061    |
| Backlog sold in asset sales or canceled    | (17,881)                 | (13)  | (17,894)   |
| Revenue recognized on contracts in backlog | (219,970)                | (84,243)  | (304,213)  |
| Backlog as of May 31, 2006                 | \$ 230,117               | \$ 18,331   | \$ 248,448 |

The following reconciles revenue recognized on contracts in backlog to total revenue recognized for fiscal 2006:

|  | Construction Services              |        | Repair and<br>Maintenance Services |        | Total      |        |
|--|------------------------------------|--------|------------------------------------|--------|------------|--------|
|  | (In thousands, except percentages) |        |                                    |        |            |        |
| Revenue recognized on contracts in backlog     | \$ 219,970                         | 90.3%  | \$ 84,243                          | 33.7%  | \$ 304,213 | 61.6%  |
| Revenue recognized on contracts not in backlog | 23,755                             | 9.7%   | 165,959                            | 66.3%  | 189,714    | 38.4%  |
| Revenue recognized on contracts in backlog     | \$ 243,725                         | 100.0% | \$ 250,202                         | 100.0% | \$ 493,927 | 100.0% |

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### **Seasonality**

The operating results of the Repair and Maintenance Services segment may be subject to significant quarterly fluctuations, affected primarily by the timing of planned maintenance projects at customers' facilities. As a result, our quarterly operating results can fluctuate materially. In addition, the Construction Services segment typically has a lower level of operating activity during the winter months and early in the new calendar year as many of our customers' capital budgets have not been finalized. Also, the demand for our construction services fluctuates as the demand for storage fluctuates.

### **Raw Material Sources and Availability**

Steel and steel pipe are the primary raw materials used by our Construction Services and Repair and Maintenance Services segments. Supplies of these materials are available throughout the United States from numerous sources. We do not anticipate being unable to obtain adequate amounts of these materials in the foreseeable future. However, the price, quantity available and timing of availability of these materials could change significantly due to various factors, including producer capacity, the level of foreign imports, demand for the materials, tariffs on imported steel and other market conditions.

### **Insurance**

The Company maintains insurance coverage for various aspects of our operations. However, we retain exposure to potential losses through the use of deductibles, coverage limits, self-insured retentions and insurer viability.

Typically our contracts require us to indemnify our customers for injury, damage or loss arising from the performance of our services and provide for warranties for materials and workmanship. The Company may also be required to name the customer as an additional insured under certain insurance policies up to the limits of insurance available to us or the Company may have to purchase special insurance policies or surety bonds for specific customers or provide letters of credit issued under our credit facility in lieu of bonds to satisfy performance and financial guarantees on some projects. Matrix Service generally requires its subcontractors to indemnify the Company and the Company's customer plus name the Company as an additional insured for activities arising out of the subcontractors' presence at the customer's location. Certain subcontractors also have to provide additional insurance policies, including surety bonds in favor of the Company, to secure the subcontractors' work or as required by the subcontract. Matrix Service maintains a performance and payment bonding line of \$54.0 million.

There can be no assurance that our insurance and the additional insurance coverage provided by our subcontractors will protect us against a valid claim or loss under the contracts with our customers.

### **Employees**

As of May 31, 2006, we had 2,092 employees of which 332 were employed in non-field positions and 1,760 were employed in field or shop positions. We operate under collective bargaining agreements with various unions representing different groups of our employees. These agreements provide the union employees with benefits including health and welfare plans, pension plans, training programs and compensation plans. We have not experienced any significant strikes or work stoppages.

Attracting and retaining high quality employees is important to the continued success of our Company. We have reinstated our Professional Development Program for project managers and have added several new craft recruiters in various regions throughout the U.S. Our commitment to hiring, developing and retaining a skilled workforce is our top initiative for the upcoming fiscal year.

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### **Patents and Proprietary Technology**

Matrix Service has been issued several patents, has patents pending and continues to pursue new ideas and innovations to better service our customers in all areas of our business. The Matrix Service patents under the Flex-A-Span<sup>®</sup> and Flex-A-Seal<sup>®</sup> trademarks are utilized to cover seals for floating roof tanks. Our U.S. patent of our ThermoStor<sup>®</sup> diffuser system is for a process that receives, stores and dispenses both chilled and warm water in and from the same storage tank. The Matrix Service patented RS 1000 Tank Mixer<sup>®</sup> controls sludge build-up in crude oil tanks through resuspension. Also, we have a patent on our Flex-A-Swivel<sup>®</sup>, a swivel joint for floating roof drain systems. Finally, Matrix Service holds a United States patent which covers a flexible fluid containment system marketed as the Valve Shield<sup>®</sup>. The Valve Shield<sup>®</sup> captures and contains fluid leaking from pipe and valve connections.

While Matrix Service believes that continued product development and the protection of our patents are important to our business, we do not believe that these patents are essential to our success.

### **Regulation**

#### *Health and Safety Regulations*

The operations of the Company are subject to the requirements of the United States Occupational Safety and Health Act (OSHA), comparable state laws and the Canada's Workers' Compensation Board and its Workplace Health, Safety and Compensation Commission (Agencies). Regulations promulgated by these agencies require employers and independent contractors who perform construction services, including electrical and repair and maintenance, to implement work practices, medical surveillance systems and personnel protection programs in order to protect employees from workplace hazards and exposure to hazardous chemicals. In recognition of the potential for accidents within various scopes of work, these agencies have enacted very strict and comprehensive safety regulations. Therefore, the Company has established comprehensive programs for complying with health and safety regulations. While the Company believes that it operates safely and prudently, there can be no assurance that accidents will not occur or that the Company will not incur substantial liability in connection with the operation of its business.

#### *Environmental*

Matrix Service has fabrication operations which could subject the Company to environmental liability. It is unknown at this time if any such liability exists but based on the types of fabrication and other manufacturing activities performed at these facilities and the environmental monitoring that we undertake, Matrix Service does not believe it has any material environmental liabilities at these locations.

Matrix Service builds aboveground storage tanks (ASTs) and performs maintenance and repairs on existing ASTs. A defect in the manufacturing of new tanks or faulty repair and maintenance on an existing tank could result in an environmental liability if the product stored in the tank leaked and contaminated the environment.

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

The nature of our business activities and operations subjects us to a number of risks and uncertainties. If any of the events described below were to occur, they could have a material adverse effect on our business, financial condition and operating results.

***An inability to attract and retain qualified personnel, and in particular, project managers and skilled craft workers, could impact our ability to perform on our contracts, which could harm our business and impair our future revenues and profitability.***

Our ability to attract and retain qualified engineers, skilled craftsmen and other experienced professionals in accordance with our needs is an important factor in our ability to maintain and increase profitability. The market for these professionals is competitive and the supply extremely limited, and we cannot assure you that we will be successful in our efforts to retain or attract qualified personnel when needed. Therefore, when we anticipate or experience growing demand for our services, we may incur the cost of maintaining a professional staff in excess of our current contract needs in an effort to have sufficient qualified personnel available to address this anticipated demand.

Competent and experienced project managers and craft workers are especially critical to the profitable performance of our contracts, and in particular, on our fixed-price contracts where superior execution of the contract can result in profits greater than originally estimated or where inferior contract execution can reduce or eliminate estimated profits or even produce a loss.

Our project managers are involved in most aspects of contracting and contract performance including:

supervising the bidding process, including providing estimates of significant cost components such as material and equipment needs and the size and composition of the workforce;

negotiating contracts;

supervising contract performance, including performance by our employees, subcontractors and other third party suppliers and vendors;

estimating costs for completion of contracts that is used by us to estimate amounts that can be reported as revenues and earnings on the contract under the percentage-of-completion method of accounting;

negotiating requests for change orders and the final terms of approved change orders; and

determining and documenting claims by us for increased costs incurred due to the failure of customers, subcontractors and other third-party suppliers of equipment and materials to perform on a timely basis and in accordance with contract terms.

***Unsatisfactory safety performance can affect customer relationships, result in higher operating costs, negatively impact employee morale and result in high employee turnover.***

Our workers are subject to the usual hazards associated with providing services on construction sites and industrial facilities. Operating hazards can cause personal injury, loss of life, damage to, or destruction of, property, plant and equipment and environmental damage. We are intensely focused on maintaining a strong safety environment and reducing the risk of accidents to the lowest possible level. However, workplace accidents cannot be eliminated and high accident rates may limit or eliminate potential revenue streams from many of our largest customers and may materially increase our future insurance and other operating costs.

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### ***Work stoppages and other labor problems could adversely affect us.***

Some of our employees are represented by labor unions. A lengthy strike or other work stoppage on any of our projects could have a material adverse effect on our business and results of operations due to an inability to complete contracted projects in a timely manner. From time to time, we have also experienced attempts to unionize certain of our merit employees. While these efforts have achieved only limited success to date, we cannot provide any assurance that we will not experience additional and more successful union activity in the future.

### ***Demand for our products and services is cyclical and is vulnerable to downturns in the industries and markets which we serve as well as conditions in the general economy.***

The demand for our products and services depends significantly upon the existence of construction and repair and maintenance projects in the downstream petroleum, power and other industries in the United States and Canada. These markets historically have been, and will likely continue to be, cyclical in nature and vulnerable to general downturns in the United States and Canadian economies, which could adversely affect the demand for our products and services. Occasionally, the timing of the demand for our products and services in certain of these markets can also be adversely affected during periods of strong economic growth as customers may postpone closing their facilities for maintenance, repair, turnaround or expansion projects while demand for their products remains high.

As a consequence of these and other factors, our results of operations have varied and are likely to continue to vary significantly depending on the demand for future projects from these industries.

### ***We face substantial competition in each of our business segments, which may have a material adverse effect on our business by reducing our ability to increase or maintain profitability.***

We face competition in all aspects of our business from numerous regional, national and international competitors, many of which have greater financial and other resources than we do. Our competitors include well-established, well-financed concerns, both privately and publicly held, including many major power equipment manufacturers, engineering and construction companies and internal engineering departments at utilities and certain of our customers. The markets that we serve require substantial resources and particularly highly skilled and experienced technical personnel. We believe we compete primarily on the basis of price, customer satisfaction, our safety record and programs, the quality of our products and services, and our ability to timely comply with project schedules. We may encounter increased competition from existing competitors or new market entrants in the future, which could have a material adverse effect on our business, financial condition or results of operations.

### ***Our results of operations depend upon the award of new contracts and the timing of those awards.***

Our revenues are derived primarily from contracts awarded us on a project-by-project basis. Generally, it is very difficult to predict whether and when we will be awarded a new contract since many potential contracts involve a lengthy and complex bidding and selection process that may be affected by a number of factors, including changes in existing or assumed market conditions, financing arrangements, governmental approvals and environmental matters. Because our revenues are derived primarily from these contracts, our results of operations and cash flows can fluctuate materially from period to period depending on the timing of contract awards.

The uncertainty associated with the timing of contract awards may increase our cost of doing business over a short period or a comparatively longer term. For example, we may decide to maintain and bear the cost of a workforce in excess of our current contract needs in anticipation of future contract awards. If an expected contract award is delayed or not received, we could incur costs in maintaining an idle workforce that may have a material adverse effect on our results of operations. Or, we may decide that our long term interests are best served by reducing our workforce and incurring increased costs associated with severance and termination benefits which also could have a material adverse effect on our results of operations for the period when incurred. Reducing our workforce could also impact our results of operations if we are unable to adequately staff projects that are awarded subsequent to a workforce reduction.

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### ***The loss of one or more of our significant customers could adversely affect us.***

From time to time due to the size of one or more of our contracts, one or more customers have in the past and may in the future contribute a material portion of our consolidated revenues in any one year. Because these significant customers generally contract with us for specific projects, we may lose these customers from year to year as their projects with us are completed. If we do not replace them with other customers or other projects, our financial condition and results of operations could be materially adversely affected. Additionally, we have long-standing relationships with many significant customers. However, our contracts with these customers are on a project-by-project basis, and these customers may unilaterally reduce or discontinue their use of our services at any time. The loss of business from any one of these customers could have a material adverse effect on our business or results of operations.

### ***The terms of our contracts could expose us to absorbing unforeseen costs and costs not within our control, which may not be recoverable and could adversely affect our results of operations and financial condition.***

Under fixed-price contracts, we agree to perform the contract for a fixed-price and, as a result, can realize our expected profit or improve our expected profit by superior contract performance, productivity, worker safety and other factors resulting in cost savings. However, we could incur cost overruns above the approved contract price, which may not be recoverable. Under certain incentive fixed-price contracts, we may agree to share with a customer a portion of any savings we are able to generate while the customer agrees to bear a portion of any increased costs we may incur up to a negotiated ceiling. To the extent costs exceed the negotiated ceiling price, we may be required to absorb some or all of the cost overruns.

Fixed-price contract prices are established based largely upon estimates and assumptions relating to project scope and specifications and personnel and material needs. These estimates and assumptions may prove inaccurate or conditions may change, sometimes due to factors not within our control, resulting in cost overruns we are required to absorb that could have a material adverse effect on our business, financial condition and results of our operations. In addition, our profits from these contracts could decrease and we could experience losses if we incur difficulties in performing the contracts or are unable to secure fixed-pricing commitments from our manufacturers, suppliers and subcontractors at the time we enter into fixed-price contracts with our customers.

Under cost-plus contracts, we perform our services in return for payment of our agreed upon reimbursable costs plus a profit. The profit component is typically expressed in the contract either as a percentage of the reimbursable costs we actually incur or is factored into the rates we charge for labor or for the cost of equipment and materials, if any, we are required to provide. Some cost-plus contracts provide for the customer's review of the accounting and cost control systems used by us to calculate these labor rates and to verify the accuracy of the reimbursable costs invoiced. These reviews could result in reductions in amounts previously billed to the customer and in an adjustment to amounts previously reported by us as our profit on the contract.

Many of our fixed-price or cost-plus contracts require us to satisfy specified progress milestones or performance standards in order to receive a payment. Under these types of arrangements, we may incur significant costs for labor, equipment and supplies prior to receipt of payment. If the customer fails or refuses to pay us for any reason, there is no assurance we will be able to collect amounts due to us for costs previously incurred. In some cases, we may find it necessary to terminate subcontracts with suppliers engaged by us to assist in performing a contract and we may incur costs or penalties for canceling our commitments to them.

If we are unable to collect amounts owed to us under our contracts, we may be required to record a charge against previously recognized earnings related to the project, and our liquidity, financial condition and results of operations could be adversely affected.



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***We may encounter difficulties during the course of performing our contracts that may result in additional costs to us and in a reduction in our revenues and earnings that could have an adverse effect upon our financial condition and results of operations.***

Many of our construction and repair and maintenance projects are performed over extended periods of time and involve complex design and engineering specifications. In these cases, it is common for us to perform work from time-to-time over the life of the project that is outside the scope of the original contract with the expectation of receiving a signed change order from the customer. Our contracts for these projects also often require us to provide extensive project management and to obtain machinery, equipment, materials and services from third parties or the customer. We may encounter difficulties in obtaining these products and services on a timely basis. In some cases, these third-party provided products may not perform as expected or the services delivered may not meet contract specifications. These performance failures and other factors, some of which are beyond our control, may result in delays and additional costs to us including, in some cases, the cost of procuring alternate product or service providers, which may adversely impact our ability to complete a project on budget and in accordance with the original delivery schedule. To the extent these and the other matters referred to in the next paragraph occur, we may seek to recover any increased costs incurred by us from the responsible party; however, we cannot assure you that we will be successful in recovering all or a part of these costs in any or all circumstances.

In certain circumstances, we guarantee project completion or the achievement of certain acceptance and performance testing levels by a scheduled date. Failure to meet schedule or performance requirements could result in additional costs to us, including the payment of contractually agreed liquidated damages. The amount of such additional costs could exceed our profit margins on the project. While we may seek to recover these amounts as claims from the supplier, vendor, subcontractor or other third party responsible for the delay or for providing non-conforming products or services, we cannot assure you that we will recover all or any part of these costs in all circumstances. Performance problems for existing and future projects could cause our actual results of operations to differ materially from those anticipated by us and could damage our reputation within our industry and our customer base.

***Our use of percentage-of-completion accounting for fixed-price contracts and our reporting of profits for cost-plus contracts prior to contract completion could result in a reduction or elimination of previously reported profits.***

A material portion of our revenues are recognized using the percentage-of-completion method of accounting. The percentage-of-completion accounting practices that we use result in our recognizing fixed-price contract revenues and earnings ratably over the contract term in the proportion that our actual costs bear to our estimated contract costs. The earnings or losses recognized on individual fixed-price contracts are based on estimates of contract revenues, costs and profitability. We review our estimates of contract revenues, costs and profitability on an ongoing basis. Prior to contract completion, we may adjust our estimates on one or more occasions as a result of changes in cost estimates, change orders to the original contract, collection disputes with the customer on amounts invoiced or claims against the customer for increased costs incurred by us due to customer-induced delays and other factors.

Contract losses are recognized in the fiscal period when the loss is determined. Contract profit estimates are also adjusted in the fiscal period in which it is determined that an adjustment is required. No restatements are made to prior periods. Further, a number of our contracts contain various cost and performance incentives and penalties that impact the earnings we realized from our contracts, and adjustments related to these incentives and penalties are recorded in the period when estimable.

As a result of the requirements of the percentage-of-completion method of accounting, the possibility exists, for example, that we could have estimated and reported a profit on a contract over several prior periods and later determine, usually near contract completion, that all or a portion of such previously estimated and reported profits were overstated. If this occurs, the full aggregate amount of the overstatement will be reported for the period in which such determination is made, thereby eliminating all or a portion of any profits from other contracts what would have otherwise been reported in such period or even resulting in a loss being reported for such period.

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Our financial loss exposure on cost-plus contracts is generally limited to a portion of our profit on the contract. However, it is possible that the customer could successfully dispute the costs we believe we incurred on the contract or assert that our costs were excessive for reasons such as poor project management or labor productivity. In addition, some cost-plus contracts contain penalty provisions for failure to achieve certain milestones or performance standards. To the extent we are not able to recover the full amount of our costs under a cost-plus contract, including adjustments under contract penalty provisions, there would be a reduction, or possibly an elimination, of previously recognized and reported earnings. In certain circumstances it is possible that such adjustments could be material to our operating results.

### ***We may incur significant costs in providing services in excess of original project scope without having an approved change order.***

After commencement of a contract, we may perform, without the benefit of an approved change order from the customer, additional services requested by the customer that were not contemplated in our contract price due to customer changes or to incomplete or inaccurate engineering, project specifications and other similar information provided to us by the customer. Our construction contracts generally require the customer to compensate us for additional work or expenses incurred under these circumstances.

A failure to obtain adequate compensation for these matters could require us to record in the current period an adjustment to revenue and profit recognized in prior periods under the percentage-of-completion accounting method. Any such adjustments, if substantial, could have a material adverse effect on our results of operations and financial condition, particularly for the period in which such adjustments are made. We cannot assure you that we will be successful in obtaining, through negotiation, arbitration, litigation or otherwise, approved change orders from customers to pay us amounts adequate to compensate us for our additional work or expenses.

### ***We are involved and are likely to continue to be involved in legal proceedings, which will increase our costs and, if adversely determined, could have a material effect on our financial condition and results of operations.***

We are and will likely continue to be named as a defendant in legal proceedings claiming damages from us in connection with the operation of our business. Most of the actions against us arise out of the normal course of performing services on project sites, and include claims for workers compensation, personal injury and property damage. From time to time, we are also named as a defendant in contract disputes with customers relating to the timeliness and quality of the performance of our services and equipment, materials, design or other services provided by our subcontractors and third-party suppliers. We also are and are likely to continue to be a plaintiff in legal proceedings against customers seeking to recover payment of contractual amounts due to us as well as claims for increased costs incurred by us resulting from, among other things, services performed by us at the request of a customer that are in excess of original project scope that are later disputed by the customer and customer-caused delays in our contract performance.

We maintain insurance against operating hazards in amounts that we believe are customary in our industry. However, our insurance has deductibles and exclusions of coverage so we cannot provide assurance that we are adequately insured against all the types of risks that are associated with the conduct of our business. A successful claim brought against us in excess of, or outside of, our insurance coverage could have a material adverse effect on our financial condition and results of operations.

Litigation, regardless of its outcome, is expensive, typically diverts the efforts of our management away from operations for varying periods of time, and can disrupt or otherwise adversely impact our relationships with current or potential customers and suppliers. Payment and claim disputes with customers also cause us to incur increased interest costs resulting from drawing higher levels of debt under our revolving line of credit or receive less interest income resulting from less funds invested due to the failure to receive payment for disputed claims and accounts.

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*Actual results could differ from the estimates and assumptions that we use to prepare our financial statements.*

To prepare financial statements in conformity with generally accepted accounting principles, management is required to make estimates and assumptions, as of the date of the financial statements, which affect the reported values of assets, liabilities, revenues and expenses and disclosures of contingent assets and liabilities. Areas requiring significant estimation by our management include:

contract expenses and profits and application of percentage-of-completion accounting;

costs and estimated earnings in excess of billings on uncompleted contracts;

provisions for uncollectible receivables and other collection disputes with customers for invoiced amounts;

the amount and collectibility of claims against customers, third-party suppliers, subcontractors and others for increased costs incurred by us that were caused by the actions or inactions of these parties, such as increased costs due to delays in their performance or to the failure of machinery, equipment and supplies provided by them to perform to agreed specifications;

provisions for income taxes and related valuation allowances;

recoverability of goodwill;

valuation of assets acquired and liabilities assumed in connection with business combinations; and

accruals for estimated liabilities, including litigation and insurance reserves.

Our actual results could differ from these estimates.

*We are susceptible to adverse weather conditions in our regions of operation, which may harm our business and financial results.*

Our business may be adversely affected by severe weather in areas where we have significant operations. Repercussions of severe weather conditions may include:

curtailment of services;

suspension of operations;

weather related damage to our facilities;

inability to receive machinery, equipment and materials at jobsites;

inability to meet performance schedules in accordance with contracts; and

loss of productivity.

**OPTION GRANTS IN LAST FISCAL YEAR**

The following table provides information on stock option grants in 2003 to the executive officers named in the Summary Compensation Table.

| Name                 | Options<br>Granted | % of<br>Total<br>Options<br>Granted<br>to<br>Employees<br>in 2003 | Exercise<br>or Base<br>Price | Expiration<br>Date | Potential Realizable Value<br>at Assumed Annual Rates of<br>Stock Price Appreciation for<br>Option Term |            |
|----------------------|--------------------|---|------------------------------|--------------------|---|------------|
|                      |                    |   |                              |                    | 5%  | 10%        |
| Robert C. Strauss    | 100,000            | 10.71%  | \$ 10.45                     | 11/04/2010         | \$ 425,420  | \$ 991,409 |
| Juan A. Mantelle     | 50,000             | 5.36%   | 10.45                        | 11/04/2010         | 212,710   | 495,705    |
| Jeffrey F. Eisenberg | 60,000             | 6.43%   | 10.45                        | 11/04/2010         | 255,252   | 594,846    |
| W. Neil Jones        | 50,000             | 5.36%   | 10.45                        | 11/04/2010         | 212,710   | 495,705    |
| Diane M. Barrett     | 60,000             | 6.43%   | 10.45                        | 11/04/2010         | 255,252   | 594,846    |

**AGGREGATED OPTION EXERCISES IN LAST FISCAL YEAR AND FISCAL YEAR END OPTION VALUES**

The following table sets forth certain information with respect to outstanding stock options held at year end or exercised in 2003 by the executive officers named in the Summary Compensation Table.

| Name                    | Shares<br>Acquired<br>on Exercise (#) | Value Realized<br>(\$)(1) | Number of Securities<br>Underlying Unexercised<br>Options<br>At December 31, 2003 |                      | Value of Unexercised<br>In-the-Money Options at<br>December 31, 2003 |                       |
|-------------------------|---------------------------------------|---------------------------|---|----------------------|--|-----------------------|
|                         |                                       |                           | Exercisable<br>(#)  | Unexercisable<br>(#) | Exercisable<br>(\$)  | Unexercisable<br>(\$) |
| Robert C. Strauss       | 160,001(2)                            | \$ 1,204,438              | 571,374   | 326,125              | 3,724,882  | 837,240               |
| Juan A. Mantelle        | 0                                     | 0                         | 98,750  | 141,250              | 424,268  | 410,283               |
| Jeffrey F.<br>Eisenberg | 0                                     | 0                         | 91,000  | 154,000              | 325,150  | 430,050               |
| W. Neil Jones           | 0                                     | 0                         | 91,750  | 131,250              | 357,578  | 340,853               |
| Diane M. Barrett        | 0                                     | 0                         | 52,000  | 148,000              | 22,600   | 372,000               |

(1)

Value realized is the spread between the market value of Noven's common stock on the date of exercise minus the exercise price.

- (2) Represents exercises of options expiring in 2004 pursuant to a Rule 10b5-1 trading plan adopted by Mr. Strauss in November 2003.

**Employment and Severance Agreements**

On November 5, 2003, Noven entered into an amended and restated employment agreement with Robert C. Strauss as President and Chief Executive Officer that replaced Mr. Strauss's former employment agreement. This agreement expires on December 31, 2006 and will continue for

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consecutive one-year terms unless it is terminated by either party under certain conditions. Mr. Strauss's base salary under this agreement is \$522,500 per annum, subject to further increases and incentive compensation at the sole discretion of the Board. Under his agreement, Mr. Strauss receives an auto allowance of \$850 per month, up to \$2,500 of annual financial and tax planning and an annual physical examination. He is also entitled to participate in all incentive, savings and retirement plans, as well as welfare benefit plans that are available to executive officers of Noven. Further, upon termination without cause or for good reason (as defined in the agreement), including, termination after a change of control through (i) the acquisition of 30% or more of the then issued and outstanding shares of common stock of Noven by any person, entity or group (within the meaning of Section 13(d)(3) or 14(d) of the Securities Exchange Act of 1934), (ii) the reconstitution of the Board whereby the existing members cease to constitute at least a majority of the Board (other than a reconstitution approved by the incumbent Board), (iii) the approval of a reorganization or consolidation, where stockholders of Noven do not, immediately thereafter, own more than 51% of the combined voting power of the reorganized, merged or consolidated corporation, (iv) a liquidation or dissolution of Noven, or (v) a sale or distribution of all or substantially all the assets of Noven, Mr. Strauss would be entitled to a lump sum payment of up to 2.75 times his then annual base salary and highest annual bonus (as defined in the agreement). In the event that any payments made in connection with a change in control would be subjected to the excise tax imposed by Section 4999 of the Internal Revenue Code of 1986, as amended, Noven will gross-up Mr. Strauss's compensation for all federal, state and local income and excise taxes and any penalties and interest thereon.

## **Change in Control Agreements**

Noven has entered into change in control employment agreements with certain of its officers, other than Mr. Strauss, including its executive officers named in the Summary Compensation Table above. These agreements are intended to further the interests of Noven's stockholders by providing for continuity of management in the event of a change in control of Noven. The agreements become effective if a change in control occurs during the three-year period that commences on the execution of the agreement. The period may be renewed each year for an additional three years, at the option of Noven, and each of the agreements was extended in 2003.

Under the change in control agreements, a change in control includes any of the following events: (i) the acquisition of 40% or more of Noven's common stock by a person or group, (ii) a change in the majority of the Board (other than a change approved by the incumbent Board), (iii) approval by the stockholders of a reorganization, merger or consolidation, or (iv) approval by the stockholders of a liquidation or dissolution or sale of all or substantially all of the assets of Noven. Exceptions are provided for certain transactions, including those where the existing stockholders of Noven maintain effective control.

Once the agreements become effective upon a change in control, they have a term of two years. Each agreement provides that a covered officer will have the position, responsibilities and authority at least commensurate with those held during the ninety days preceding the change in control. Each agreement also provides that the covered officer will be paid an annual base salary equal to the highest salary received during the twelve months preceding the change in control; will be entitled to an annual bonus equal to the average annual bonus paid during the three years preceding the change

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in control; and will be entitled to continued participation in Noven's benefit plans, fringe benefits, office support and staff, vacation, and expense reimbursement on the same basis as prior to the change in control, and in any case no less favorable than those provided by Noven to peer executives (as defined in the agreements).

If, following a change in control, the officer is terminated for any reason other than death, disability or for cause, or if such officer terminates his employment agreement for good reason (as defined in the agreements), then the officer is entitled to a severance payment equal to two times the officer's annual base salary and highest annual bonus (as defined in the agreements). The agreements also provide that the officer is entitled to continue to participate in Noven's welfare benefit plans for the full two-year employment period.

In the event that any payments made in connection with a change in control would be subjected to the excise tax imposed by Section 4999 of the Internal Revenue Code of 1986, as amended, Noven will gross-up the officer's compensation for all federal, state and local income and excise taxes and any penalties and interest thereon.

**Internal Revenue Code Section 162(m)**

Section 162(m) of the Internal Revenue Code generally disallows a tax deduction to public companies for compensation over \$1,000,000 paid to the Chief Executive Officer and the four other most highly compensated executive officers. Qualifying performance-based compensation is not subject to the deduction limit if certain requirements are met. Noven recognizes that unanticipated future events, such as a change of control of Noven or a change in executive personnel, could result in a disallowance of compensation deductions under Section 162(m). Moreover, the Board or its Compensation and Stock Option Committee may from time to time award compensation that is non-deductible under Section 162(m) when, in the exercise of its business judgment, such award would be in the best interests of Noven.

**COMPLIANCE WITH SECTION 16(a)  
OF THE SECURITIES EXCHANGE ACT OF 1934**

Section 16(a) of the Securities Exchange Act of 1934 and the rules issued thereunder requires Noven's executive officers and directors to file with the Securities and Exchange Commission reports of ownership and changes in ownership of Noven's stock. Copies of these reports are furnished to Noven. Based solely on Noven's review of the copies of such reports furnished to Noven and representations from the persons subject to Section 16(a) with respect to Noven, we believe that during 2003 all of Noven's executive officers and directors complied with the Section 16(a) requirements, with the exception of Mr. Juan Mantelle, who inadvertently failed to include 6,700 shares of common stock in his initial report on Form 3 filed in June 2000.



**Table of Contents****Stockholder Return Performance Graph**

The graph below shows the five-year cumulative total stockholder return assuming the investment of \$100 on December 31, 1998 (and the reinvestment of dividends thereafter) in each of Noven common stock, the Russell 2000 Stock Index and Noven's Peer Group (Value Line Drugs Index).

|                        | <b>1998</b> | <b>1999</b> | <b>2000</b> | <b>2001</b> | <b>2002</b> | <b>2003</b> |
|------------------------|-------------|-------------|-------------|-------------|-------------|-------------|
| Noven Pharmaceuticals  | 100.00      | 333.30      | 742.89      | 352.81      | 183.46      | 302.33      |
| Russell 2000 Index     | 100.00      | 117.84      | 113.25      | 114.41      | 89.72       | 130.43      |
| Value Line Drugs Index | 100.00      | 120.69      | 217.48      | 207.10      | 171.05      | 219.46      |

**Source: Value Line, Inc.**

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**Compensation and Stock Option Committee Report on Executive Compensation**

*Policy*

Noven's executive compensation program is administered by the Compensation and Stock Option Committee (the Committee), which consists of three non-employee directors who are also responsible for establishing Noven's executive compensation policy. The Committee operates under a written charter adopted and approved by the Board of Directors. The Board of Directors, in its business judgment, has determined that each Committee member is independent as such term is defined by the applicable listing standards of the Nasdaq Stock Market. Noven's compensation program is designed to serve Noven's goal of creating long-term stockholder value by allowing Noven to secure and retain the services of high quality executives and by aligning the interests of the executives with those of Noven's stockholders.

Noven's compensation program consists of the following three components: 1) a base salary, 2) annual incentives and 3) long-term incentives. In 2003, Noven's annual incentives were awarded in the form of cash bonuses and long-term incentives were awarded in the form of stock options. Compensation for Noven's executive officers therefore involves a portion of pay that depends upon incentive payments, which are tied to quantitative corporate goals, and stock options, which directly relate a significant portion of long-term compensation to stock price appreciation realized by Noven's stockholders.

In establishing Noven's compensation program, the Committee reviews compensation data for companies that compete with Noven for executive talent. These companies include primarily drug and healthcare companies and are chosen on the basis of sales, market capitalization and geographic location. In 2003, the Committee commissioned an independent executive compensation study to assist in evaluating Noven's program and those of peer companies. The Committee seeks to implement compensation programs that are competitive with those of peer companies.

*Base Salary*

The Committee determines each executive officer's base salary by considering the competitive information described above, the individual's responsibility, the individual's performance and the performance of the business. For executives other than the Chief Executive Officer, the Committee also considers the salary recommendations submitted by the Chief Executive Officer.

*Annual Incentives*

The Committee believes that performance-based annual incentives, in the form of bonuses, should represent a significant component of Noven's executive compensation program. For 2003, the Committee adopted an executive bonus plan that included goals for both company and individual performance, with the greatest weight given to company performance. The plan provides that, in determining the Chief Executive Officer's bonus, the sole measure is company performance. The Committee fixed percentages of base salary as target incentive bonus awards for the executives. The 2003 target bonus was set at 60% of base salary for the Chief Executive Officer and at 45% of base

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salary for each of the other executive officers. The Committee also set targets for both revenues and pre-tax income. To the extent that actual revenues and pre-tax income are equal to, greater than or less than the company performance targets, an executive's bonus award may be equal to, greater than or less than his target award. However, minimum corporate financial performance thresholds must be met before any performance bonus will be paid. The Committee then determines whether each executive other than the Chief Executive Officer has met his individual performance goals in determining his final award. In 2003, Noven met or exceeded each of the revenue and pre-tax income goals, and, in accordance with the plan formula, the bonus awards to each of the executive officers were greater than their initial target awards.

*Long-term Incentives*

Stock options represent a significant portion of total compensation for Noven's executive officers. Options are generally awarded to executive officers at the time that they join Noven and annually thereafter. Stock options are granted at the prevailing market price on the date of grant, and will only have value if the value of Noven's common stock increases. Generally, grants vest over a five-year period and have seven-year terms. Executives must be employed by Noven at the time of vesting in order to exercise the options. The determination of the timing and number of stock options granted to the executive officers is made by reference to ranges that are established based on the competitive information described above as well as the executive's level of responsibility and past performance.

*Chief Executive Officer Compensation*

Mr. Strauss has been Noven's Chief Executive Officer since December 12, 1997 and is subject to an employment contract which was amended and restated in 2003. See "Employment and Severance Agreements" above for a description of Mr. Strauss's employment agreement. In setting the base salary of Mr. Strauss, the Committee evaluates the terms of Mr. Strauss's contract as well as the same factors that it considers in establishing the salary levels of the executive officers generally, including competitive information. In addition, the Committee considers the status of Mr. Strauss as Noven's most senior officer and the important role he has in achieving overall corporate goals. He will receive a base salary in 2004 equal to \$543,400, which represents a 4% increase over his 2003 base salary, which was consistent with increases given to other executives and was considered appropriate based upon Mr. Strauss's efforts and contributions to Noven. In particular, the Committee noted Mr. Strauss's contribution in connection with the strategic licensing of Noven's transdermal methylphenidate delivery system and the filing of an Abbreviated New Drug Application for Noven's transdermal fentanyl delivery system. The Committee also noted Mr. Strauss's continued leadership following the unexpected announcement of the early termination of the Women's Health Initiative Study in 2002 and its continued impact through 2003.

In awarding stock options to Mr. Strauss, the Committee sets guidelines based on the competitive compensation data described above, and then considers overall corporate performance and Mr. Strauss's role in attaining those results.

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In accordance with the bonus plan described above, Mr. Strauss received a bonus for 2003 equal to \$388,087. He was granted stock options for a total of 100,000 shares of Noven common stock in 2003 at an exercise price of \$10.45.

Compensation and Stock Option Committee:

John G. Clarkson, M.D., Chairperson  
Sidney Braginsky  
Lawrence J. DuBow

**PROPOSAL 2 APPROVAL OF AMENDMENTS TO NOVEN PHARMACEUTICALS, INC. 1999  
LONG-TERM INCENTIVE PLAN**

In 1999, Noven stockholders approved Noven Pharmaceuticals, Inc. 1999 Long-Term Incentive Plan (the 1999 Plan ). At the annual meeting, Noven is asking stockholders to approve the following material amendments ( Amendments ) to the 1999 Plan:

to increase the number of shares available for issuance under this plan by 1,000,000 shares;

to increase the minimum automatic annual grant to outside directors from an option to purchase 5,000 shares to an option to purchase 7,500 shares having a ten-year term and immediately exercisable; and

to increase the minimum initial grant to outside directors upon joining the Board from an option to purchase 12,500 shares to an option to purchase 15,000 shares having a ten-year term and immediately exercisable.

Fewer than 655,000 shares of common stock remain available for future grants under the 1999 Plan as of March 1, 2004. In 2003, Noven issued stock options for 956,150 shares of common stock and issued stock awards for 2,776 shares of common stock. The Board believes the amendment to increase the number of shares of common stock under the 1999 Plan by 1,000,000 shares is necessary in order to achieve the purposes of the 1999 Plan, including continuing to attract, retain and motivate Noven s officers and employees.

A copy of the 1999 Plan is attached as Appendix A to this proxy statement. This copy has been black-lined to show the proposed Amendments to the 1999 Plan.

**Noven s Board of Directors recommends a vote FOR the approval of the Amendments to the Noven Pharmaceuticals, Inc. 1999 Long-Term Incentive Plan.**

**Summary of the 1999 Long-Term Incentive Plan**

The 1999 Plan was originally authorized by the Noven Board on March 26, 1999 and was approved by Noven s stockholders at the 1999 Annual Meeting. This following summary is qualified in its entirety by reference to the 1999 Plan attached as Appendix A to this proxy statement.

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*Purposes and Eligibility.* The purposes of the 1999 Plan are to attract, retain and motivate officers and other employees and consultants of Noven and its subsidiaries, to compensate them for their contributions to the growth and profits of Noven and to encourage ownership by them of stock of Noven. The 1999 Plan authorizes the issuance of certain awards ( Awards ) to such individuals ( Eligible Individuals ).

*Effective Date.* The 1999 Plan became effective on June 9, 1999. No Awards may be granted after the tenth anniversary of the Effective Date.

*Shares Available Under the 1999 Plan.* At the annual meeting, Noven is asking stockholders to approve an increase in the number of shares available under the 1999 Plan by 1,000,000 shares. As of March 1, 2004, fewer than 655,000 shares of Noven common stock were available for future grants under the 1999 Plan. A total of 3,768,848 shares of Noven common stock have been authorized for issuance under the 1999 Plan. The 1999 Plan provides that such number of authorized shares may be increased by the number of stock options that have lapsed, expired or otherwise terminated under Noven's 1997 Stock Option Plan (the 1997 Plan ). The adding back of expired stock options from the 1997 Stock Option Plan does not increase stockholder dilution since such options are currently outstanding. As of March 1, 2004, stock options to purchase fewer than 300,000 shares were outstanding under the 1997 Plan and a total of 137,211 shares had been added back to the 1999 Plan pursuant to this provision.

*Administration.* The Compensation and Stock Option Committee, or other committee of directors that are independent within the meaning of the applicable listing standards of the Nasdaq Stock Market (the Committee ) appointed by the Noven Board, administers the 1999 Plan, approves the Eligible Individuals to receive Awards, determines the form and terms of the Awards and has the power to fix and accelerate vesting periods. Subject to certain limitations, the Committee may from time to time delegate some or all of its authority to an administrator consisting of one or more members of the Committee or one or more officers of Noven.

*Awards General.* The 1999 Plan authorizes a broad array of Awards based on Noven's common stock, including (i) stock awards consisting of one or more shares of Noven common stock granted or offered for sale to Eligible Individuals ( Stock Awards ), (ii) stock options ( Stock Options ), (iii) stock appreciation rights ( SARs ), which may be granted in tandem with or independently of Stock Options, (iv) conditional awards which may be earned upon the satisfaction of certain specified performance criteria ( Performance Share Awards ) and (v) other forms of equity-based or equity-related awards which the Committee determines to be consistent with the purposes of the 1999 Plan and the interests of Noven ( Other Awards ). Such Other Awards may also include cash payments which may be based on one or more criteria unrelated to the value of Noven's common stock, as determined by the Committee.

The vesting, exercisability, payment and other restrictions applicable to an Award (which may include, without limitation, restrictions on transferability or provision for mandatory resale to Noven) are determined by the Committee. The Committee may accelerate (i) the vesting or payment of any Award, (ii) the lapse of restrictions on any Award or (iii) the date on which any Stock Option or SAR first becomes exercisable. The Committee also has full authority to determine the effect, if any, that a participant's termination of employment will have on the vesting, exercisability, payment or lapse of restrictions applicable to an outstanding Award.

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Noven may require a participant to pay a sum to Noven as may be necessary to cover any taxes or other charges imposed on Noven with respect to property or income received by a participant pursuant to the 1999 Plan. Subject to applicable law, Noven may offer loans to participants to satisfy withholding requirements on such terms as the Committee may determine.

In accordance with the requirements of the regulations under Section 162(m) of the Internal Revenue Code of 1986, as amended (the Code), the 1999 Plan limits the number of shares underlying stock options that may be granted to an individual participant in any fiscal year of Noven to 500,000 shares and the number of shares underlying Section 162(m) Awards (as defined below) that may be granted to Section 162(m) Officers (as defined below) in any fiscal year of Noven to 100,000.

*Awards Stock Awards.* Recipients of Stock Awards are entitled to exercise voting rights and receive dividends with respect to the shares of Noven common stock underlying such Awards upon receipt of such Awards. Stock Awards may be subject to vesting and other restrictions.

*Awards Stock Options.* An award of Stock Options may consist of either nonqualified stock options or incentive stock options. A Stock Option entitles the participant to acquire a specified number of shares of Noven common stock at an exercise price determined by the Committee, which generally may not be less than the fair market value of the shares on the date of award of the Stock Option. The exercise price may be paid in cash or previously owned stock or a combination thereof. In addition, Noven has established a cashless exercise procedure that allows participants the opportunity to sell immediately some or all of the shares underlying the exercised portion of a Stock Option in order to generate sufficient cash to pay the exercise price and/or to satisfy withholding tax obligations related to the Stock Option. Stock Options expire no later than ten years from the date of grant.

*Awards Stock Appreciation Rights.* Recipients of SARs are entitled to receive an amount, if any, equal to the fair market value of a share of Noven common stock on the date of exercise over the SAR exercise price specified in the applicable award agreement. At the discretion of the Committee, payments to a participant upon exercise of an SAR may be made in shares, cash or a combination thereof. A SAR may be granted alone or in addition to other Awards, or in tandem with a Stock Option.

*Awards Performance Share Awards.* A Performance Share Award entitles a participant to receive a specified number of shares, an equivalent amount of cash or a combination thereof upon satisfaction of certain specified performance criteria. Payment in settlement of a Performance Share Award shall be made as soon as practicable following the conclusion of the applicable performance period, or at another time determined by the Committee.

*Awards to Section 162(m) Officers.* Section 162(m) of the Code limits the deductibility of compensation in excess of \$1,000,000 paid to the chief executive officer and the four other most highly compensated officers of a public company, as determined pursuant to the rules of the SEC, unless the payments are made under qualifying performance-based plans and upon the attainment of certain performance goals. The 1999 Plan contains special provisions that are intended to enable the

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Committee, if it so chooses, to make Awards to Noven officers who are subject to Section 162(m) of the Code ( Section 162(m) Officers ) that will qualify as qualified performance-based compensation for purposes of Section 162(m) of the Code. Section 162(m) Awards may consist of Stock Options, SARs, Stock Awards, Performance Share Awards or Other Awards the vesting, exercisability and/or payment of which is conditioned upon the attainment for the applicable performance period of specified performance targets related to designated performance goals for such period selected by the Committee. Performance goals will be selected from among the following performance criteria: (i) net revenue, (ii) net earnings, (iii) operating earnings or income, (iv) absolute and/or relative return on equity or assets, (v) earnings per share, (vi) cash flow, (vii) pretax profits, (viii) earnings growth, (ix) revenue growth, (x) book value per share, (xi) revenues per employee, (xii) earnings per employee and (xiii) performance relative to peer companies, each of which may be established on a corporate-wide basis or established with respect to one or more operating units, divisions, acquired businesses, minority investments, partnerships or joint ventures.

In addition to the foregoing, the Committee may also grant Section 162(m) Officers Stock Options or SARs which may, pursuant to the regulations promulgated under Section 162(m), be qualified as performance-based compensation for Section 162(m) purposes without regard to the foregoing.

*Change in Control.* In the event of a Change in Control of Noven, except as the Committee otherwise determines, all outstanding Stock Options and SARs will become fully exercisable, all restrictions and conditions of all outstanding Stock Awards will lapse, all Performance Share Awards will be deemed to have been fully earned, and, in the case of a Change in Control in which Noven does not survive or becomes a wholly owned subsidiary of another entity, outstanding Stock Options that are not exercised as of the date of the Change in Control will be converted into options to purchase common stock or similar equity interests of the acquiror. A Change in Control will generally be deemed to occur if: (i) any person becomes the owner of 40% or more of Noven's voting securities; (ii) directors who constitute the Noven Board at the beginning of any two-year period, and any new directors whose election or nomination for election was approved by a vote of at least a majority of the directors then in office who either were directors at the beginning of such period or whose election or nomination for election was previously so approved, cease to constitute at least a majority of the Noven Board; (iii) the stockholders of Noven approve a merger or consolidation in which Noven's voting securities do not continue to represent at least a majority of the surviving entity; or (iv) the stockholders approve a reorganization, liquidation, or sale of all or substantially all of Noven's assets.

*Automatic Grants to Outside Directors.* The 1999 Plan currently provides that:

on the day of each annual stockholders meeting, each director who is not then a Noven employee (an Outside Director ), will be granted options to purchase 5,000 shares of Noven common stock, in each case at the price and upon the other terms and conditions specified in the 1999 Plan; and

subject to the availability of shares of Noven common stock under the 1999 Plan, each person first elected to the Board as an Outside Director after the effective date of the 1999 Plan, will be granted, as of the date such individual takes office, options to purchase 12,500 shares of Noven common stock at the price and upon the terms and conditions specified in the 1999 Plan.

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At the annual meeting, Noven is asking stockholders to approve amendments to the 1999 Plan to:

increase the minimum annual grant to Outside Directors from options to purchase 5,000 shares to an option to purchase 7,500 shares having a ten-year term and immediately exercisable; and

increase the minimum initial grant to Outside Directors upon joining the Board from options to purchase 12,500 shares to an option to purchase 15,000 shares having a ten-year term and immediately exercisable.

The options granted to an Outside Director shall be granted at an exercise price equal to 100% of the Fair Market Value of a share of Noven common stock on the date of grant and upon the other terms and conditions specified in the 1999 Plan.

The 1999 Plan does not restrict the ability of the Committee to make discretionary grants of Awards to Outside Directors in addition to the automatic grants described above.

*Amendment.* The Noven Board or the Committee may amend or terminate the 1999 Plan at any time, except that stockholder approval is required by the Nasdaq listing standards to materially amend the 1999 Plan, including any increase the maximum number of shares issuable under the 1999 Plan. No amendment or termination may adversely affect a participant's rights with respect to previously granted Awards without his or her consent.

**Federal Income Tax Consequences**

*Nonqualified Stock Options.* The grant of a nonqualified stock option will not result in the recognition of taxable income by the participant or in a deduction to Noven. Upon exercise, a participant will recognize ordinary income in an amount equal to the excess of the fair market value of the Noven common stock on the date of exercise over the exercise price. Noven is required to withhold tax on the amount of income so recognized, and a tax deduction is allowable equal to the amount of such income (subject to the satisfaction of certain conditions in the case of Stock Options exercised by Section 162(m) Officers). Gain or loss upon a subsequent sale of any Noven common stock received upon the exercise of a nonqualified stock option generally would be taxed as capital gain or loss (long-term or short-term, depending upon the holding period of the stock sold). Certain additional rules apply if the exercise price for an option is paid in shares previously owned by the participant.

*Incentive Stock Options.* Upon the grant or exercise of an incentive stock option within the meaning of Section 422 of the Code, no income will be realized by the participant for federal income tax purposes and Noven will not be entitled to any deduction. However, the excess of the fair market value of the Noven common stock as of the date of exercise over the exercise price will constitute an adjustment to taxable income for purposes of the alternative minimum tax. If the shares of Noven



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common stock are not disposed of within the one-year period beginning on the date of the transfer of such shares to the participant, nor within the two-year period beginning on the date of grant of the Stock Option, any profit realized by the participant upon the disposition of such shares will be taxed as long-term capital gain and no deduction will be allowed to Noven. If the shares of Noven common stock are disposed of within the one-year period from the date of transfer of such shares to the participant or within the two-year period from the date of grant of the Stock Option, the excess of the fair market value of the shares upon the date of exercise or, if less, the fair market value on the date of disposition over the exercise price will be taxable as ordinary income of the participant at the time of disposition, and a corresponding deduction will be allowable to Noven. Certain additional rules apply if the exercise price for an option is paid in shares previously owned by the participant. If a Stock Option intended to qualify as an incentive stock option is exercised by a person who was not continually employed by Noven or certain of its affiliates from the date of grant of such Stock Option to a date not more than three months prior to such exercise (or one year if such person is disabled), then such Stock Option will not qualify as an incentive stock option and will instead be taxed as a nonqualified stock option, as described above.

*Stock Awards.* A participant who is awarded a Stock Award will not be taxed at the time of award unless the participant makes a special election with the IRS pursuant to Section 83(b) of the Code as discussed below. Upon lapse of the risk of forfeiture or restrictions on transferability applicable to the Noven common stock comprising the Stock Award, the participant will be taxed at ordinary income tax rates on the then fair market value of the Noven common stock and a corresponding deduction will be allowable to Noven (subject to the satisfaction of certain conditions in the case of Stock Awards granted to Section 162(m) Officers). In such case, the participant's basis in the Noven common stock will be equal to the ordinary income so recognized. Upon subsequent disposition of such Noven common stock, the participant will realize capital gain or loss (long-term or short-term, depending upon the holding period of the stock sold).

Pursuant to Section 83(b) of the Code, the participant may elect within 30 days of receipt of the Stock Award to be taxed at ordinary income tax rates on the fair market value of the Noven common stock comprising such Stock Award at the time of award (determined without regard to any restrictions which may lapse). In that case, the participant will acquire a basis in such Noven common stock equal to the ordinary income recognized by the participant at the time of award. No tax will be payable upon lapse or release of the restrictions or at the time the Noven common stock first becomes transferable, and any gain or loss upon subsequent disposition will be a capital gain or loss. In the event of a forfeiture of Noven common stock with respect to which a participant previously made a Section 83(b) election, the participant will not be entitled to a loss deduction.

*Performance Share Awards.* A participant who receives a Performance Share Award will be taxed at ordinary income tax rates on the then fair market value of the shares of Noven common stock distributed at the time of payment in settlement of such Performance Share Award and a corresponding deduction will be allowable to Noven at that time (subject to the satisfaction of certain conditions in the case of Performance Share Awards granted to Section 162(m) Officers). The participant's basis in the shares of Noven common stock will be equal to the amount taxed as ordinary income, and on subsequent disposition the participant will realize capital gain or loss (long-term or short-term, depending upon the holding period of the stock sold).

**Table of Contents****New Plan Benefits**

The benefits that Noven's executive officers, directors and employees will receive as a result of the proposed amendment of the 1999 Plan are not determinable because the benefits under the 1999 Plan will depend on the discretion of the Committee and the fair market value of Noven's common stock at various future dates.

The table below shows, as to each of our executive officers named in the Summary Compensation Table and the various indicated groups, the number of options to purchase shares of our common stock granted under the 1999 Plan during the 2003 fiscal year and the weighted average exercise price.

| <b>Name and Position</b>   | <b>Number of<br/>Stock<br/>Options</b> | <b>Number of<br/>Stock<br/>Awards</b> |
|--|--|---------------------------------------|
| Robert C. Strauss<br>President, Chief Executive Officer &<br>Chairman  | 100,000                                | 0                                     |
| Juan A. Mantelle<br>Vice President & Chief Technical Officer   | 50,000                                 | 0                                     |
| Jeffrey F. Eisenberg<br>Vice President - Strategic Alliances, General<br>Counsel & Corporate Secretary                     | 60,000                                 | 0                                     |
| W. Neil Jones<br>Vice President - Marketing & Sales  | 50,000                                 | 0                                     |
| Diane M. Barrett<br>Vice President & Chief Financial Officer   | 60,000                                 | 0                                     |
| All current executive officers as a group (6<br>persons)   | 386,667                                | 0                                     |
| All current directors who are not executive<br>officers as a group (7 persons)   | 30,000                                 | 2,776                                 |
| All participating employees, including all<br>current officers who are not executive<br>officers, as a group (263 persons) | 539,287                                | 0                                     |

**Securities Authorized for Issuance under All Equity Compensation Plans.**

In addition to the 1999 Plan, Noven has granted stock options under our Amended and Restated Stock Option Plan and our 1997 Stock Option Plan. These three plans have been approved by Noven's stockholders. Noven has also made charitable donations to the University of Miami for the years 2000 to 2002 in the form of options to acquire shares of Noven common stock at a price per share equal to the market price of our Common Stock on the date of grant. These options for a total of 22,500 were granted outside of our stockholder-approved stock option plans, vested immediately

and have ten-year terms. One of our non-employee directors serves as Dean of the University of Miami School of Medicine and, during those years, did not accept any compensation for his service on our Board of Directors.

**Table of Contents****Equity Compensation Plan Information**

The following table provides summary information concerning the equity awards under Noven's compensation plans (option and share amounts in thousands) as of December 31, 2003:

| <b>Plan Category</b>                                       | <b>Number of Securities To Be Issued Upon Exercise of Outstanding Options, Warrants and Rights</b> | <b>Weighted Average Exercise Price of Outstanding Options, Warrants and Rights</b> | <b>Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans (excluding Securities Reflected in First Column)</b> |
|--|--|--|--|
| Equity Compensation Plans Approved by Security Holders     | 3,918,673  | \$ 14.51   | 473,317  |
| Equity Compensation Plans Not Approved by Security Holders | 22,500   | \$ 12.58   | --   |
| Total  | 3,941,173  | \$ 14.50   | 473,317  |

### **PROPOSAL 3 RATIFICATION AND APPROVAL OF APPOINTMENT OF INDEPENDENT ACCOUNTANTS**

The Audit Committee of the Board of Directors has appointed Deloitte & Touche LLP as Noven's independent accountants to audit Noven's financial statements for the 2004 fiscal year and will offer a resolution at the annual meeting to ratify the appointment. Deloitte & Touche LLP has served as Noven's independent accountants since 1991 and during the year ended December 31, 2003 provided audit and permissible non-audit services. Noven has been advised that a representative of Deloitte & Touche LLP will be present at the annual meeting and will have an opportunity to make a statement and to respond to appropriate questions raised.

**Fees Paid to Deloitte & Touche LLP**

The following table presents fees for professional audit services rendered by Deloitte & Touche LLP for the audit of Noven's annual financial statements for the years ended December 31, 2003 and December 31, 2002, and fees billed for other services rendered by Deloitte & Touche LLP during those periods.

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|                        | <b>2002</b> | <b>2003</b> |
|------------------------|-------------|-------------|
| Audit Fees (1)         | \$ 166,000  | \$ 209,000  |
| Audit Related Fees (2) | \$ 13,000   | \$ 125,000  |
| Tax Fees (3)           | \$ 62,000   | \$ 9,000    |
| All Other Fees         | _____       | _____       |
| Total                  | \$241,000   | \$343,000   |

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- (1) Audit fees consisted of audit work performed in the preparation of financial statements, as well as work generally only the independent auditor can reasonably be expected to provide.
- (2) Audit-related fees consisted principally of 401(k) plan audit and consulting on financial accounting/reporting standards for transactions and related matters.
- (3) Tax fees consisted principally of work performed with respect to tax compliance.

The Audit Committee has adopted a formal policy on auditor independence requiring the pre-approval by the Audit Committee of all audit and non-audit services from Noven's independent accountants. In determining whether to pre-approve any services from Noven's independent accountants, the Audit Committee assesses, among other things, the impact of that service on the independent accountants.

**The Board recommends a vote FOR ratification and approval of the selection of Deloitte & Touche LLP as the independent accountants of Noven for 2004.** If the appointment is not ratified, the Audit Committee will select other independent accountants.

**REPORT OF THE AUDIT COMMITTEE OF THE BOARD OF DIRECTORS**

The Audit Committee of the Board of Directors is responsible for, among other things, monitoring:

the integrity of Noven's financial statements;

its system of internal controls; and

the independence, qualifications and performance of Noven's independent auditors.

The Audit Committee is composed of five non-employee directors and operates under a written charter adopted and approved by the Board of Directors. The Board of Directors, in its business judgment, has determined that each Audit Committee member is independent as such term is defined by the applicable listing standards of the Nasdaq Stock Market and under Section 10A(m)(3) of the Securities Exchange Act of 1934. Noven has identified each of Prof. Regina E. Herzlinger and Donald A. Denkhaus as an audit committee financial expert as that term is defined in applicable regulations of the Securities and Exchange Commission and the regulations thereunder. The Audit Committee has sole authority to retain, oversee, and terminate Noven's independent auditors, to approve fees and other terms of the engagement, and to approve any permitted non-audit engagements with the independent auditors.

Noven's management is responsible for the preparation, presentation and integrity of Noven's financial statements, Noven's accounting and financial reporting process, including the system of internal control, and procedures to assure compliance with applicable accounting standards and applicable laws and regulations. Noven's independent auditors are responsible for auditing those financial statements and expressing an opinion as to their conformity with generally accepted accounting principles. Our responsibility is to independently monitor and review these processes. However, we are not professionals engaged in the practice of accounting or auditing, including,

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without limitation, with respect to auditor independence. We must rely, without independent verification, on the information provided to us and on the representations made by management and the independent auditors. Accordingly, although we consult with and discuss these matters and our questions and concerns with management and our independent auditors, our oversight cannot provide an independent basis to assure that management has maintained appropriate accounting and financial reporting principles or appropriate internal control and procedures consistent with accounting standards and applicable laws and regulations. Furthermore, our considerations and discussions cannot assure that the audit of Noven's financial statements has been carried out in accordance with generally accepted auditing standards, that the financial statements are presented in accordance with generally accepted accounting principles or that Noven's auditors are in fact independent.

In this context, we held eight meetings during the year ended December 31, 2003. The meetings were designed, among other things, to facilitate and encourage communication among the Audit Committee, management, and Noven's independent auditors, Deloitte & Touche LLP. We discussed with Noven's independent auditors, with and without management present, the results of their examinations and their evaluations of Noven's financial statements.

We have reviewed and discussed the audited financial statements for the fiscal year ended December 31, 2003 with management and Deloitte & Touche LLP.

We also discussed with Deloitte & Touche LLP matters required to be discussed with audit committees under generally accepted auditing standards, including, among other things, matters related to the conduct of the audit of Noven's financial statements and the matters required to be discussed by Statement on Auditing Standards No. 61, as amended (Communication with Audit Committees) by SAS's 89 and 90 and Rule 2-07 of Regulation S-X. Our discussions also included a discussion of the background and experience of the Deloitte & Touche LLP audit team assigned to Noven and the quality control procedures established by Deloitte & Touche LLP.

Deloitte & Touche LLP also provided to us the written disclosures and the letter required by Independence Standards Board Standard No. 1 (Independence Discussions with Audit Committees), and we discussed with the independent auditors their independence from Noven. When considering Deloitte & Touche LLP's independence, we considered whether their provision of services to Noven beyond those rendered in connection with their audit and review of Noven's financial statements was compatible with maintaining their independence. We also reviewed, among other things, the nature of the non-audit services provided and the amount of fees paid to Deloitte & Touche LLP for their audit and non-audit services, both separately and in the aggregate.

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Based on our review and these meetings, discussions and reports, and subject to the limitations on our role and responsibilities referred to above and in the Audit Committee Charter, we recommended to the Board of Directors that Noven's audited financial statements for the year ended December 31, 2003 be included in Noven's Annual Report on Form 10-K.

Audit Committee:

Prof. Regina E. Herzlinger, Chairperson  
Sidney Braginsky  
Donald A. Denkhaus  
Lawrence J. DuBow  
Wayne P. Yetter

**DELIVERY OF VOTING MATERIALS**

To reduce the expenses of delivering duplicate voting materials to our stockholders who may have more than one Noven stock account, we are taking advantage of householding rules that permit us to deliver only one set of the Proxy Statement and the 2003 Annual Report to stockholders who share an address unless otherwise requested. If you share an address with another stockholder and have received only one set of voting materials, you may write or call us to request a separate copy of these materials at no cost to you. For future annual meetings, you may request separate voting materials, or request that we send only one set of voting materials to you if you are receiving multiple copies, by calling us at: (305) 253-5099 or by writing us at: Noven Pharmaceuticals, Inc., 11960 S.W. 144th Street, Miami, Florida 33186, Attn: Corporate Secretary.



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**ADDITIONAL QUESTIONS AND INFORMATION REGARDING  
THE ANNUAL MEETING AND STOCKHOLDER PROPOSALS**

***Q: What happens if additional proposals are presented at the meeting?***

**A:** Other than the three proposals described in this Proxy Statement, we do not expect any matters to be presented for a vote at the annual meeting. If you grant a proxy, the persons named as proxy holders will have the discretion to vote your shares on any additional matters properly presented for a vote at the meeting. If for any unforeseen reason any of Noven's nominees is not available as a candidate for director, the persons named as proxy holders will vote your proxy for such other candidate or candidates as may be nominated by the Board.

***Q: What class of shares is entitled to be voted?***

**A:** Each share of Noven's common stock outstanding as of the close of business on April 7, 2004, the Record Date, is entitled to one vote at the annual meeting. On the Record Date, we had approximately 23,382,382 shares of common stock issued and outstanding.

***Q: What is the quorum requirement for the meeting?***

**A:** The quorum requirement for holding the meeting and transacting business is a majority of the outstanding shares entitled to be voted. The shares may be present in person or represented by proxy at the meeting. Both abstentions and broker non-votes are counted as present for the purpose of determining the presence of a quorum. Generally, broker non-votes occur when shares held by a broker for a beneficial owner are not voted with respect to a particular proposal because (1) the broker has not received voting instructions from the beneficial owner and (2) the broker lacks discretionary voting power to vote such shares.

***Q: Who will bear the cost of soliciting votes for the meeting?***

**A:** Noven will pay the entire cost of preparing, assembling, printing, mailing and distributing these proxy materials. However, if you choose to vote over the Internet you will bear the expenses for your Internet access. In addition to the mailing of these proxy materials, the solicitation of proxies or votes may be made in person, by telephone or by electronic communication by Noven's directors, officers, and employees, who will not receive any additional compensation for such solicitation activities. We have retained the services of Georgeson Shareholder Communications, Inc. (Georgeson) to aid in the solicitation of proxies. We estimate that we will pay Georgeson a fee of \$15,000 for its services (which includes certain consulting services provided by Georgeson related to the Proposal 2 amendment to increase the number of shares under the 1999 Plan) plus per call fees for any individual solicitations and reasonable out-of-pocket expenses. We will also reimburse brokerage houses and other custodians, nominees and fiduciaries for their reasonable out-of-pocket expenses for forwarding proxy and solicitation materials to stockholders.

***Q: May I propose actions for consideration at next year's annual meeting of stockholders or nominate individuals to serve as directors?***

**A:** Yes, you may submit proposals for consideration at future stockholder meetings, including director nominations.

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**Stockholder Proposals for Presentation at Meeting:** Our By-laws govern the submission of nominations for director or other business proposals that a stockholder wishes to have considered at a meeting of stockholders, but which are not included in Noven's Proxy Statement for that meeting. Under our By-laws, nominations for director or other business proposals to be addressed at our next annual meeting may be made by a stockholder entitled to vote who has delivered a notice to the Secretary of Noven no later than the close of business on February 12, 2005 and not earlier than December 13, 2004. The notice must contain the information required by the By-laws.

These advance notice provisions are in addition to, and separate from, the requirements that a stockholder must meet in order to have a proposal included in the Proxy Statement under the rules of the Securities and Exchange Commission.

A proxy granted by a stockholder will give discretionary authority to vote on any matters introduced pursuant to the above advance notice By-law provisions, subject to applicable rules of the Securities and Exchange Commission.

**Stockholder Proposals for Inclusion in Proxy:** In order for a stockholder proposal to be considered for inclusion in Noven's Proxy Statement for next year's annual meeting, the written proposal must be received by Noven's Corporate Secretary no later than December 13, 2004. Such proposals also will need to comply with Securities and Exchange Commission regulations regarding the inclusion of stockholder proposals in company sponsored proxy materials.

**Copy of By-law Provisions:** You may contact Noven's Corporate Secretary at Noven's headquarters for a copy of the relevant By-law provisions regarding the requirements for making stockholder proposals and nominating director candidates.

By Order of the Board of Directors

JEFFREY F. EISENBERG  
*Vice President Strategic Alliances,  
General Counsel & Corporate Secretary*

April 12, 2004

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**APPENDIX A**

Black-lined to Show Proposed Amendments  
to be Considered by Stockholders  
at the 2004 Annual Meeting

**NOVEN PHARMACEUTICALS, INC.**

**1999 LONG-TERM INCENTIVE PLAN  
(as amended and restated)**

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**NOVEN PHARMACEUTICALS, INC.**

**1999 LONG-TERM INCENTIVE PLAN**

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**NOVEN PHARMACEUTICALS, INC.  
1999 LONG-TERM INCENTIVE PLAN**

1. *Purpose.* The purposes of the Noven Pharmaceuticals, Inc. 1999 Long-Term Incentive Plan (the "*Plan*") are to attract, retain and motivate officers and other employees and consultants of Noven Pharmaceuticals, Inc., a Delaware corporation (the "*Company*"), and its Subsidiaries (as hereinafter defined), to compensate them for their contributions to the growth and profits of the Company and to encourage ownership by them of stock of the Company.

2. *Definitions.* For purposes of the Plan, the following terms shall be defined as follows:

*Administrator* means the individual or individuals to whom the Committee delegates authority under the Plan in accordance with Section 3(d).

*Affiliate* and *Associate* have the respective meanings ascribed to such terms in Rule 12b-2 promulgated under the Exchange Act.

*Award* means an award made pursuant to the terms of the Plan to an Eligible Individual in the form of Stock Options, Stock Appreciation Rights, Stock Awards, Performance Share Awards, Section 162(m) Awards or other awards determined by the Committee.

*Award Agreement* means a written agreement or certificate granting an Award. An Award Agreement shall be executed by an officer on behalf of the Company and shall contain such terms and conditions as the Committee deems appropriate and that are not inconsistent with the terms of the Plan. The Committee may in its discretion require that an Award Agreement be executed by the Participant to whom the relevant Award is made.

*Beneficial Owner* has the meaning ascribed to such term in Rule 13d-3 promulgated under the Exchange Act.

*Board* means the Board of Directors of the Company.

A *Change in Control* of the Company shall be deemed to have occurred when:

(a) any Person (other than the Company, any Subsidiary of the Company, any employee benefit plan of the Company or of any Subsidiary of the Company, or any person or entity organized, appointed or established by the Company or any Subsidiary of the Company for or pursuant to the terms of any such plan), alone or together with its Affiliates and Associates (collectively, an "*Acquiring Person*"), shall become the Beneficial Owner of 40 percent or more of the then outstanding shares of Common Stock or the Combined Voting Power of the Company,

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(b) during any period of two consecutive years, individuals who at the beginning of such period constitute the Board, and any new director (other than a director who is a representative or nominee of an Acquiring Person) whose election by the Board or nomination for election by the Company's shareholders was approved by a vote of at least a majority of the directors then still in office who either were directors at the beginning of the period or whose election or nomination for election was previously so approved (collectively, the "Continuing Directors"), cease for any reason to constitute a majority of the Board,

(c) the shareholders of the Company approve a merger or consolidation of the Company with any other corporation, other than a merger or consolidation which would result in the voting securities of the Company outstanding immediately prior thereto continuing to represent (either by remaining outstanding or by being converted into voting securities of the Surviving Entity (as defined in Section 15 hereof) or any Parent of such Surviving Entity) at least a majority of the Combined Voting Power of the Company, such Surviving Entity or the Parent of such Surviving Entity outstanding immediately after such merger or consolidation, or

(d) the shareholders of the Company approve a plan of reorganization (other than a reorganization under the United States Bankruptcy Code) or complete liquidation of the Company or an agreement for the sale or disposition by the Company of all or substantially all of the Company's assets;

*provided, however,* that a Change in Control shall not be deemed to have occurred in the event of

(i) a sale or conveyance in which the Company continues as a holding company of an entity or entities that conduct all or substantially all of the business or businesses formerly conducted by the Company, or

(ii) any transaction undertaken for the purpose of incorporating the Company under the laws of another jurisdiction, if such transaction does not materially affect the beneficial ownership of the Company's capital stock.

*Code* means the Internal Revenue Code of 1986, as amended, and the applicable rulings and regulations thereunder.

*Combined Voting Power* means the combined voting power of the Company's or other relevant entity's then outstanding voting securities.

*Committee* means the Compensation and Stock Option Committee of the Board, any successor committee thereto or any other committee appointed by the Board to administer the Plan.

*Common Stock* means the Common Stock, par value \$.0001 per share, of the Company.

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*Eligible Individuals* means the individuals described in Section 6 who are eligible for Awards under the Plan.

*Exchange Act* means the Securities Exchange Act of 1934, as amended, and the applicable rulings and regulations thereunder.

*Fair Market Value* means, in the event the Common Stock is traded on a recognized securities exchange or quoted by the National Association of Securities Dealers Automated Quotations on National Market Issues, an amount equal to the closing price of the Common Stock on such exchange or such quotation on the date set for valuation or, if no sales of Common Stock were made on said exchange or so quoted on that date, the closing price of the Common Stock on the next preceding day on which sales were made on such exchange or quotations; or, if the Common Stock is not so traded or quoted, that value determined, in its sole discretion, by the Committee.

*Incentive Stock Option* means a Stock Option which is an incentive stock option within the meaning of Section 422 of the Code and is not otherwise designated by the Committee as a non-qualified stock option in an Award Agreement.

*Nonqualified Stock Option* means a Stock Option which is not an Incentive Stock Option.

*Parent* means any corporation which is a parent corporation within the meaning of Section 424(e) of the Code with respect to the relevant entity.

*Participant* means an Eligible Individual to whom an Award has been granted under the Plan.

*Performance Period* means a fiscal year of the Company or such other period that may be specified by the Committee in connection with the grant of a Section 162(m) Award.

*Performance Share Award* means a conditional Award of shares of Common Stock granted to an Eligible Individual pursuant to Section 11 hereof.

*Person* means any person, entity or group within the meaning of Section 13(d)(3) or Section 14(d)(2) of the Exchange Act.

*Prior Plan* means the Company's 1997 Stock Option Plan.

*Section 162(m) Participant* means, for a given fiscal year of the Company, any Participant designated by the Committee by not later than 90 days following the start of such year as a Participant (or such other time as may be required or permitted by Section 162(m) of the Code) whose compensation for such fiscal year may be subject to the limit on deductible compensation imposed by Section 162(m) of the Code.

*Stock Appreciation Right* means an Award to receive all or some portion of the appreciation on shares of Common Stock granted to an Eligible Individual pursuant to Section 9 hereof.



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*Stock Award* means an Award of shares of Common Stock granted to an Eligible Individual pursuant to Section 10 hereof.

*Stock Option* means an Award to purchase shares of Common Stock granted to an Eligible Individual pursuant to Section 8 hereof.

*Subsidiary* means (i) any corporation which is a subsidiary corporation within the meaning of Section 424(f) of the Code with respect to the Company or (ii) any other corporation or other entity in which the Company, directly or indirectly, has an equity or similar interest and which the Committee designates as a Subsidiary for the purposes of the Plan.

*Substitute Award* means an Award granted upon assumption of, or in substitution for, outstanding awards previously granted by a company or other entity in connection with a corporate transaction, such as a merger, combination, consolidation or acquisition of property or stock.

*3. Administration of the Plan.*

(a) *Power and Authority of the Committee.* The Plan shall be administered by the Committee, which shall have full power and authority, subject to the express provisions hereof, (i) to select Participants from the Eligible Individuals, (ii) to make Awards in accordance with the Plan, (iii) to determine the number of Shares subject to each Award or the cash amount payable in connection with an Award, (iv) to determine the terms and conditions of each Award, including, without limitation, those related to vesting, forfeiture, payment and exercisability, and the effect, if any, of a Participant's termination of employment with the Company or, subject to Section 15 hereof, of a Change in Control on the outstanding Awards granted to such Participant, and including the authority to amend the terms and conditions of an Award after the granting thereof to a Participant in a manner that is not prejudicial to the rights of such Participant in such Award, (v) to specify and approve the provisions of the Award Agreements delivered to Participants in connection with their Awards, (vi) to construe and interpret any Award Agreement delivered under the Plan, (vii) to prescribe, amend and rescind rules and procedures relating to the Plan, (viii) to vary the terms of Awards to take account of tax, securities law and other regulatory requirements of foreign jurisdictions, (ix) subject to the provisions of the Plan and subject to such additional limitations and restrictions as the Committee may impose, to delegate to one or more officers of the Company some or all of its authority under the Plan, and (x) to make all other determinations and to formulate such procedures as may be necessary or advisable for the administration of the Plan.

(b) *Plan Construction and Interpretation.* The Committee shall have full power and authority, subject to the express provisions hereof, to construe and interpret the Plan.

(c) *Determinations of Committee Final and Binding.* All determinations by the Committee in carrying out and administering the Plan and in construing and interpreting the Plan shall be final, binding and conclusive for all purposes and upon all persons interested herein.

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(d) *Delegation of Authority.* The Committee may, but need not, from time to time delegate some or all of its authority under the Plan to an Administrator consisting of one or more members of the Committee or of one or more officers of the Company; *provided, however,* that the Committee may not delegate its authority (i) to make Awards to Eligible Individuals (A) who are Section 162(m) Participants or (B) who are officers of the Company who are delegated authority by the Committee hereunder, or (ii) under Sections 3(b) and 16 of the Plan. Any delegation hereunder shall be subject to the restrictions and limits that the Committee specifies at the time of such delegation or thereafter. Nothing in the Plan shall be construed as obligating the Committee to delegate authority to an Administrator, and the Committee may at any time rescind the authority delegated to an Administrator appointed hereunder or appoint a new Administrator. At all times, the Administrator appointed under this Section 3(d) shall serve in such capacity at the pleasure of the Committee. Any action undertaken by the Administrator in accordance with the Committee's delegation of authority shall have the same force and effect as if undertaken directly by the Committee, and any reference in the Plan to the Committee shall, to the extent consistent with the terms and limitations of such delegation, be deemed to include a reference to the Administrator.

(e) *Liability of Committee.* No member of the Committee shall be liable for anything whatsoever in connection with the administration of the Plan except such person's own willful misconduct. Under no circumstances shall any member of the Committee be liable for any act or omission of any other member of the Committee. In the performance of its functions with respect to the Plan, the Committee shall be entitled to rely upon information and advice furnished by the Company's officers, the Company's accountants, the Company's counsel and any other party the Committee deems necessary, and no member of the Committee shall be liable for any action taken or not taken in reliance upon any such advice.

4. *Duration of Plan.* The Plan shall remain in effect until terminated by the Board of Directors and thereafter until all Awards granted under the Plan are satisfied by the issuance of shares of Common Stock or the payment of cash or are terminated under the terms of the Plan or under the Award Agreement entered into in connection with the grant thereof. Notwithstanding the foregoing, no Awards may be granted under the Plan after the tenth anniversary of the Effective Date (as defined in Section 17(1)).

5. *Shares of Stock Subject to the Plan.* Subject to adjustment as provided in Section 14(b) hereof, the number of shares of Common Stock that may be issued under the Plan pursuant to Awards shall not exceed, in the aggregate, ~~3,768,848~~ 4,768,848 (the Section 5 Limit). Such shares may be either authorized but unissued shares, treasury shares or any combination thereof. For purposes of determining the number of shares that remain available for issuance under the Plan, the following rules shall apply:

- (a) the number of Shares subject to outstanding Awards shall be charged against the Section 5 Limit; and
- (b) the Section 5 Limit shall be increased by:

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(i) the number of shares subject to an Award (or portion thereof) which lapses, expires or is otherwise terminated without the issuance of such shares or is settled by the delivery of consideration other than shares,

(ii) the number of shares tendered to pay the exercise price of a Stock Option or other Award,

(iii) the number of shares withheld from any Award to satisfy a Participant's tax withholding obligations or, if applicable, to pay the exercise price of a Stock Option or other Award, and

(iv) the number of shares subject to a stock option award (or portion thereof) under the Prior Plan which lapses, expires or is otherwise terminated without the issuance of such shares.

In addition, any shares underlying Substitute Awards shall not be counted against the Section 5 Limit set forth in the first sentence of this Section 5.

6. *Eligible Individuals.*

(a) *Eligibility Criteria.* Awards may be granted by the Committee to individuals (*Eligible Individuals*) who are directors, officers or other employees or consultants of the Company or a Subsidiary with the potential to contribute to the future success of the Company or its Subsidiaries. An individual's status as an Administrator or a member of the Committee will not affect his or her eligibility to participate in the Plan. Incentive Stock Options may only be granted to employees of the Company or a Subsidiary.

(b) *Maximum Number of Shares per Eligible Individual.* In accordance with the requirements under Section 162(m) of the Code, no Eligible Individual shall receive grants of Awards of Stock Options with respect to an aggregate of more than 500,000 shares of Common Stock in respect of any fiscal year of the Company, and no Section 162(m) Participant shall receive grants of Section 162(m) Awards with respect to an aggregate of more than 100,000 shares of Common Stock in respect of any fiscal year of the Company. For purposes of the preceding sentence, any Award that is made as bonus compensation, or is made in lieu of compensation that otherwise would be payable to an Eligible Individual, shall be considered made in respect of the fiscal year to which such bonus or other compensation relates or otherwise was earned.

(c) *Outside Directors.* On the day of each annual meeting of the stockholders of the Company, each director who is not then an employee of the Company or any of its subsidiaries (an *Outside Director*), shall be granted an Option to purchase ~~5,000~~ 7,500 shares of Common Stock, in each case having a ten-year term, immediate vesting and at the price and upon ~~the~~ such other terms and conditions specified in the Plan. In addition, subject to the availability of shares of Common Stock under the Plan, each person first elected to the Board as an Outside Director after the effective date of the Plan, shall be granted, as of the date such individual takes office, an Option to purchase ~~12,500~~ 15,000 shares of Common Stock having a ten-year term, immediate vesting and at the price and upon the terms and conditions specified in the Plan. Each Option granted to an Outside Director shall be granted at an exercise price equal to 100 percent of the Fair Market Value of a share of Common Stock on the date of grant and upon the other terms and conditions specified in the Plan.

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7. *Awards Generally.* Awards under the Plan may consist of Stock Options, Stock Appreciation Rights, Stock Awards, Performance Share Awards, Section 162(m) Awards or other awards determined by the Committee. The terms and provisions of an Award shall be set forth in a written Award Agreement approved by the Committee and delivered or made available to the Participant as soon as practicable following the date of the award. The vesting, exercisability, payment and other restrictions applicable to an Award (which may include, without limitation, restrictions on transferability or provision for mandatory resale to the Company) shall be determined by the Committee and set forth in the applicable Award Agreement. Notwithstanding the foregoing, the Committee may accelerate (i) the vesting or payment of any Award, (ii) the lapse of restrictions on any Award or (iii) the date on which any Option or Stock Appreciation Right first becomes exercisable. The date of a Participant's termination of employment for any reason shall be determined in the sole discretion of the Committee. The Committee shall also have full authority to determine and specify in the applicable Award Agreement the effect, if any, that a Participant's termination of employment for any reason will have on the vesting, exercisability, payment or lapse of restrictions applicable to an outstanding Award. Notwithstanding anything to the contrary set forth herein or in any Award Agreement, (i) if any Participant ceases for any reason to be employed by the Company but continues to serve as an Outside Director of the Company, such Participant shall retain his or her Awards upon the original terms and conditions thereof; provided, however, that if such Participant thereafter ceases to serve as an Outside Director of the Company then the provisions of this Section shall no longer apply and such Award shall thereafter be subject to the post-separation exercise provisions applicable to such Award, with the applicable post-separation exercise period commencing as of the date such Participant ceases to be an Outside Director, and (ii) if any Participant who is not an employee thereafter becomes an employee, such Participant shall retain his or her Award upon the original terms thereof.

8. *Stock Options.*

(a) *Terms of Stock Options Generally.* Subject to the terms of the Plan and the applicable Award Agreement, each Stock Option shall entitle the Participant to whom such Stock Option was granted to purchase the number of shares of Common Stock specified in the applicable Award Agreement and shall be subject to the terms and conditions established by the Committee in connection with the Award and specified in the applicable Award Agreement. Upon satisfaction of the conditions to exercisability specified in the applicable Award Agreement, a Participant shall be entitled to exercise the Stock Option in whole or in part and to receive, upon satisfaction or payment of the exercise price or an irrevocable notice of exercise in the manner contemplated by Section 8(d) below, the number of shares of Common Stock in respect of which the Stock Option shall have been exercised. Stock Options may be either Nonqualified Stock Options or Incentive Stock Options.

(b) *Exercise Price.* The exercise price per share of Common Stock purchasable under a Stock Option shall be determined by the Committee at the time of grant and set forth in the Award Agreement, *provided*, that the exercise price per share shall be no less than 100% of the Fair Market Value per share on the date of grant. Notwithstanding the foregoing, the exercise price per share of a Stock Option that is a Substitute Award may be less than the Fair Market Value per share on the date of award, provided that the excess of:

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(i) the aggregate Fair Market Value (as of the date such Substitute Award is granted) of the shares subject to the Substitute Award, over

(ii) the aggregate exercise price thereof, does not exceed the excess of:

(iii) the aggregate fair market value (as of the time immediately preceding the transaction giving rise to the Substitute Award, such fair market value to be determined by the Committee) of the shares of the predecessor entity that were subject to the award assumed or substituted for by the Company, over

(iv) the aggregate exercise price of such shares.

(c) *Option Term.* The term of each Stock Option shall be fixed by the Committee and set forth in the Award Agreement; *provided, however,* that a Stock Option shall not be exercisable after the expiration of ten (10) years after the date the Stock Option is granted.

(d) *Method of Exercise.* Subject to the provisions of the applicable Award Agreement, the exercise price of a Stock Option may be paid in cash or previously owned shares or a combination thereof. In accordance with the rules and procedures established by the Committee for this purpose, the Stock Option may also be exercised through a cashless exercise procedure approved by the Committee involving a broker or dealer approved by the Committee, that affords Participants the opportunity to sell immediately some or all of the shares underlying the exercised portion of the Stock Option in order to generate sufficient cash to pay the Stock Option exercise price and/or to satisfy withholding tax obligations related to the Stock Option. In the event of a cashless exercise, the exercise date shall be deemed to be the date on which the shares underlying the Stock Option are sold by the broker. When payment of the exercise price for a Stock Option consists of shares of the Company's capital stock, such shares will not be accepted as payment unless the Participant has held such shares for the requisite period necessary to avoid a charge to the Company's earnings for financial reporting purposes.

9. *Stock Appreciation Rights.* Stock Appreciation Rights shall be subject to the terms and conditions established by the Committee in connection with the Award thereof and specified in the applicable Award Agreement. Upon satisfaction of the conditions to the payment specified in the applicable Award Agreement, each Stock Appreciation Right shall entitle a Participant to an amount, if any, equal to the Fair Market Value of a share of Common Stock on the date of exercise over the Stock Appreciation Right exercise price specified in the applicable Award Agreement. At the discretion of the Committee, payments to a Participant upon exercise of a Stock Appreciation Right may be made in Shares, cash or a combination thereof. A Stock Appreciation Right may be granted alone or in addition to other Awards, or in tandem with a Stock Option. If granted in tandem with a Stock Option, a Stock Appreciation Right shall cover the same number of shares of Common Stock as covered by the Stock Option (or such lesser number of shares as the Committee may determine)

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and shall be exercisable only at such time or times and to the extent the related Stock Option shall be exercisable, and shall have the same term and exercise price as the related Stock Option. Upon exercise of a Stock Appreciation Right granted in tandem with a Stock Option, the related Stock Option shall be cancelled automatically to the extent of the number of shares covered by such exercise; conversely, if the related Stock Option is exercised as to some or all of the shares covered by the tandem grant, the tandem Stock Appreciation Right shall be cancelled automatically to the extent of the number of shares covered by the Stock Option exercised.

10. *Stock Awards.* Stock Awards shall consist of one or more shares of Common Stock granted or offered for sale to an Eligible Individual, and shall be subject to the terms and conditions established by the Committee in connection with the Award and specified in the applicable Award Agreement. The shares of Common Stock subject to a Stock Award may, among other things, be subject to vesting requirements or restrictions on transferability.

11. *Performance Share Awards.* Performance Share Awards shall be evidenced by an Award Agreement in such form and containing such terms and conditions as the Committee deems appropriate and which are not inconsistent with the terms of the Plan. Each Award Agreement shall set forth the number of shares of Common Stock to be earned by a Participant upon satisfaction of certain specified performance criteria and subject to such other terms and conditions as the Committee deems appropriate. Payment in settlement of a Performance Share Award shall be made as soon as practicable following the conclusion of the applicable performance period, or at such other time as the Committee shall determine, in shares of Common Stock, in an equivalent amount of cash or in a combination of Common Stock and cash, as the Committee shall determine.

12. *Other Awards.* The Committee shall have the authority to specify the terms and provisions of other forms of equity-based or equity-related Awards not described above which the Committee determines to be consistent with the purpose of the Plan and the interests of the Company, which Awards may provide for cash payments based in whole or in part on the value or future value of Common Stock, for the acquisition or future acquisition of Common Stock, or any combination thereof. Other Awards shall also include cash payments (including the cash payment of dividend equivalents) under the Plan which may be based on one or more criteria determined by the Committee which are unrelated to the value of Common Stock and which may be granted in tandem with, or independent of, other Awards under the Plan.

13. *Section 162(m) Awards.*

(a) *Terms of Section 162(m) Awards Generally.* In addition to any other Awards under the Plan, the Company may make Awards that are intended to qualify as qualified performance-based compensation for purposes of Section 162(m) of the Code ( "*Section 162(m) Awards*"). Section 162(m) Awards may consist of Stock Options, Stock Appreciation Rights, Stock Awards, Performance Share Awards or Other Awards the vesting, exercisability and/or payment of which is conditioned upon the attainment for the applicable Performance Period of specified performance targets related to designated performance goals for such period selected by the Committee from among the performance goals specified in Section 13(b) below. Section 162(m) Awards will be made in accordance with the procedures specified in applicable treasury regulations for compensation intended to be qualified performance-based compensation.

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(b) *Performance Goals.* For purposes of this Section 13, performance goals shall be limited to one or more of the following: (i) net revenue, (ii) net earnings, (iii) operating earnings or income, (iv) absolute and/or relative return on equity or assets, (v) earnings per share, (vi) cash flow, (vii) pretax profits, (viii) earnings growth, (ix) revenue growth, (x) book value per share, (xi) revenues per employee, (xii) earnings per employee and (xiii) performance relative to peer companies, each of which may be established on a corporate-wide basis or established with respect to one or more operating units, divisions, acquired businesses, minority investments, partnerships or joint ventures.

(c) *Other Performance-Based Compensation.* The Committee's decision to make, or not to make, Section 162(m) Awards within the meaning of this Section 13 shall not in any way prejudice the qualification of any other Awards as performance-based compensation under Section 162(m). In particular, Awards of Stock Options may, pursuant to applicable regulations promulgated under Section 162(m), be qualified as performance-based compensation for Section 162(m) purposes without regard to this Section 13.

14. *Recapitalization or Reorganization.*

(a) *Authority of the Company and Shareholders.* The existence of the Plan, the Award Agreements and the Awards granted hereunder shall not affect or restrict in any way the right or power of the Company or the shareholders of the Company to make or authorize any adjustment, recapitalization, reorganization or other change in the Company's capital structure or its business, any merger or consolidation of the Company, any issue of stock or of options, warrants or rights to purchase stock or of bonds, debentures, preferred or prior preference stocks whose rights are superior to or affect the Common Stock or the rights thereof or which are convertible into or exchangeable for Common Stock, or the dissolution or liquidation of the Company, or any sale or transfer of all or any part of its assets or business, or any other corporate act or proceeding, whether of a similar character or otherwise.

(b) *Change in Capitalization.* Notwithstanding any provision of the Plan or any Award Agreement, in the event of any change in the outstanding Common Stock by reason of a stock dividend, recapitalization, reorganization, merger, consolidation, stock split, combination or exchange of shares or any other significant corporate event affecting the Common Stock, the Committee, in its discretion, may make (i) such proportionate adjustments it considers appropriate (in the form determined by the Committee in its sole discretion) to prevent diminution or enlargement of the rights of Participants under the Plan with respect to the aggregate number of shares of Common Stock for which Awards in respect thereof may be granted under the Plan, the number of shares of Common Stock covered by each outstanding Award, and the exercise or Award prices in respect thereof and/or (ii) such other adjustments as it deems appropriate. The Committee's determination as to what, if any, adjustments shall be made shall be final and binding on the Company and all Participants.

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15. *Change in Control.* In the event of a Change in Control, (i) all Stock Options or Stock Appreciation Rights then outstanding shall become fully exercisable as of the date of the Change in Control, whether or not then exercisable, (ii) all restrictions and conditions of all Stock Awards then outstanding shall lapse as of the date of the Change in Control, (iii) all Performance Share Awards shall be deemed to have been fully earned as of the date of the Change in Control, and (iv) in the case of a Change in Control involving a merger of, or consolidation involving, the Company in which the Company is (A) not the surviving corporation (the "Surviving Entity") or (B) becomes a wholly owned subsidiary of the Surviving Entity or any Parent thereof, each outstanding Stock Option granted under the Plan and not exercised (a "Predecessor Option") will be converted into an option (a "Substitute Option") to acquire common stock of the Surviving Entity or its Parent, which Substitute Option will have substantially the same terms and conditions as the Predecessor Option, with appropriate adjustments as to the number and kind of shares and exercise prices.

16. *Amendment of the Plan.* The Board or Committee may at any time and from time to time terminate, modify, suspend or amend the Plan in whole or in part; *provided, however,* that no such termination, modification, suspension or amendment shall be effective without shareholder approval if such approval is required to comply with any applicable law or stock exchange rule; and *provided, however,* that the Board or Committee may not, without shareholder approval, increase the maximum number of shares issuable under the Plan. No termination, modification, suspension or amendment of the Plan shall, without the consent of a Participant to whom any Awards shall previously have been granted, adversely affect his or her rights under such Awards. Notwithstanding any provision herein to the contrary, the Board or Committee shall have broad authority to amend the Plan or any Stock Option to take into account changes in applicable tax laws, securities laws, accounting rules and other applicable state and federal laws.

17. *Miscellaneous.*

(a) *Tax Withholding.* No later than the date as of which an amount first becomes includable in the gross income of the Participant for applicable income tax purposes with respect to any award under the Plan, the Participant shall pay to the Company or make arrangements satisfactory to the Committee regarding the payment of any federal, state or local taxes of any kind required by law to be withheld with respect to such amount. Unless otherwise determined by the Committee, in accordance with rules and procedures established by the Committee, the minimum required withholding obligations may be settled with Common Stock, including Common Stock that is part of the award that gives rise to the withholding requirement. The obligation of the Company under the Plan shall be conditioned upon such payment or arrangements and the Company shall, to the extent permitted by law, have the right to deduct any such taxes from any payment of any kind otherwise due to the Participant.

(b) *Loans.* On such terms and conditions as shall be approved by the Committee, the Company may directly or indirectly lend money to a Participant to accomplish the purposes of the Plan, including to assist such Participant to acquire or carry shares of Common Stock acquired upon the exercise of Stock Options granted hereunder, and the Committee may also separately lend money to any Participant to pay taxes with respect to any of the transactions contemplated by the Plan.



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(c) *No Right to Grants or Employment.* No Eligible Individual or Participant shall have any claim or right to receive grants of Awards under the Plan. Nothing in the Plan or in any Award or Award Agreement shall confer upon any employee of the Company or any Subsidiary any right to continued employment with the Company or any Subsidiary, as the case may be, or interfere in any way with the right of the Company or a Subsidiary to terminate the employment of any of its employees at any time, with or without cause.

(d) *Unfunded Plan.* The Plan is intended to constitute an unfunded plan for incentive compensation. With respect to any payments not yet made to a Participant by the Company, nothing contained herein shall give any such Participant any rights that are greater than those of a general creditor of the Company. In its sole discretion, the Committee may authorize the creation of trusts or other arrangements to meet the obligations created under the Plan to deliver Common Stock or payments in lieu thereof with respect to awards hereunder.

(e) *Other Employee Benefit Plans.* Payments received by a Participant under any Award made pursuant to the provisions of the Plan shall not be included in, nor have any effect on, the determination of benefits under any other employee benefit plan or similar arrangement provided by the Company.

(f) *Securities Law Restrictions.* The Committee may require each Eligible Individual purchasing or acquiring shares of Common Stock pursuant to a Stock Option or other Award under the Plan to represent to and agree with the Company in writing that such Eligible Individual is acquiring the shares for investment and not with a view to the distribution thereof. All certificates for shares of Common Stock delivered under the Plan shall be subject to such stock-transfer orders and other restrictions as the Committee may deem advisable under the rules, regulations, and other requirements of the Securities and Exchange Commission or any exchange upon which the Common Stock is then listed, and any applicable federal or state securities law, and the Committee may cause a legend or legends to be put on any such certificates to make appropriate reference to such restrictions. No shares of Common Stock shall be issued hereunder unless the Company shall have determined that such issuance is in compliance with, or pursuant to an exemption from, all applicable federal and state securities laws.

(g) *Compliance with Rule 16b-3.*

(i) The Plan is intended to comply with Rule 16b-3 under the Exchange Act or its successors under the Exchange Act and the Committee shall interpret and administer the provisions of the Plan or any Award Agreement in a manner consistent therewith. To the extent any provision of the Plan or Award Agreement or any action by the Committee fails to so comply, it shall be deemed null and void, to the extent permitted by law and deemed advisable by the Committee. Moreover, in the event the Plan or an Award Agreement does not include a provision required by Rule 16b-3 to be stated therein, such provision (other than one relating to eligibility requirements, or the price and amount of Awards) shall be deemed automatically to be incorporated by reference into the Plan or such Award Agreement insofar as Participants subject to Section 16 of the Exchange Act are concerned.

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(ii) Notwithstanding anything contained in the Plan or any Award Agreement to the contrary, if the consummation of any transaction under the Plan would result in the possible imposition of liability on a Participant pursuant to Section 16(b) of the Exchange Act, the Committee shall have the right, in its sole discretion, but shall not be obligated, to defer such transaction to the extent necessary to avoid such liability.

(h) *Non-transferability.* No Award granted under the Plan or any rights or interests therein shall be sold, transferred, assigned, pledged or otherwise encumbered or disposed of except by will or by the laws of descent and distribution or pursuant to a qualified domestic relations order ( QDRO ) as defined in the Code or Title I of the Employee Retirement Income Security Act of 1974, as amended, and the rules and regulations thereunder; provided, however, that the Committee may, subject to such terms and conditions as the Committee shall specify, permit the transfer of an Award to a Participant's family members or to one or more trusts established in whole or in part for the benefit of one or more of such family members; provided, however, that the restrictions in this sentence shall not apply to the shares received in connection with an Award after the date that the restrictions on transferability of such shares set forth in the applicable Award Agreement have lapsed. During the lifetime of a Participant, a Stock Option or Stock Appreciation Right shall be exercisable only by, and payments in settlement of Awards shall be payable only to, the Participant or, if applicable, the alternate payee under a QDRO or the family member or trust to whom such Stock Option, Stock Appreciation Right or other Award has been transferred in accordance with the previous sentence.

(i) *Award Agreement.* In the event of any conflict or inconsistency between the Plan and any Award Agreement, the Plan shall govern, and the Award Agreement shall be interpreted to minimize or eliminate any such conflict or inconsistency.

(j) *Expenses.* The costs and expenses of administering the Plan shall be borne by the Company.

(k) *Applicable Law.* Except as to matters of federal law, the Plan and all actions taken thereunder shall be governed by and construed in accordance with the laws of the State of Florida without giving effect to conflicts of law principles.

(l) *Effective Date.* The Plan shall be effective as of June 9, 1999 (the Effective Date ), subject to approval of the Plan at the Company's 1999 annual meeting of shareholders.

(m) *Effect on Prior Plan.* Subject to approval of the Plan by the Company's shareholders, this Plan shall supersede the Prior Plan and no further stock option awards may be granted under the Prior Plan after the Effective Date.

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**NOVEN PHARMACEUTICALS, INC.**

**PROXY FOR ANNUAL MEETING OF STOCKHOLDERS  
TO BE HELD MAY 18, 2004**

**This Proxy is solicited on behalf of the Board of Directors of Noven Pharmaceuticals, Inc.**

The signer(s) hereby appoint(s) Robert C. Strauss, Diane M. Barrett and Jeffrey F. Eisenberg, or any one of them, with power of substitution in each, proxies to vote all Common Stock of the signer(s) in Noven Pharmaceuticals, Inc. at the Annual Meeting of Stockholders, to be held May 18, 2004, and at all adjournments thereof, as specified on the matters indicated hereon, and in their discretion on any other business that may properly come before such Meeting.

The shares represented by this Proxy will be voted as directed by the Stockholder(s) on the reverse side hereof. **If this Proxy is signed and returned but no direction is indicated, this Proxy will be voted FOR the election of each of the nominees named above and FOR Item 2 and Item 3 as set forth in the Proxy Statement dated April 12, 2004.**

**(Continued and to be signed on the reverse side)**

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**ANNUAL MEETING OF STOCKHOLDERS OF  
NOVEN PHARMACEUTICALS, INC.**

**May 18, 2004**

Please date, sign and mail  
your proxy card in the  
envelope provided as soon  
as possible.

6 Please detach along perforated line and mail in the envelope provided. 6

**THE BOARD OF DIRECTORS RECOMMENDS A VOTE FOR ALL NOMINEES AND FOR ITEMS 2 AND 3.**

**PLEASE SIGN, DATE AND RETURN PROMPTLY IN THE ENCLOSED ENVELOPE. PLEASE MARK YOUR VOTE IN BLUE OR BLACK INK AS SHOWN HERE x**

- |   |   | <b>FOR</b> | <b>AGAINST</b> | <b>ABSTAIN</b> |
|---|---|------------|----------------|----------------|
| 1. ELECTION OF DIRECTORS: To elect six directors for a term of one year as indicated below: |   | o          | o              | o              |
| o FOR ALL NOMINEES  | <b>NOMINEES:</b><br>; Sidney Braginsky<br>; John G. Clarkson, M.D.  |            |                |                |
| o WITHHOLD AUTHORITY FOR ALL NOMINEES   | ; Donald A. Denkhaus<br>; Robert G. Savage<br>; Robert C. Strauss<br>; Wayne P. Yetter                          |            |                |                |
| o FOR ALL EXCEPT (See instructions below)   |   |            |                |                |
|   | 2. PROPOSAL TO APPROVE AMENDMENTS TO NOVEN S 1999 LONG-TERM INCENTIVE PLAN.                                     |            |                |                |
|   | 3. PROPOSAL TO RATIFY AND APPROVE APPOINTMENT OF DELOITTE & TOUCHE LLP AS THE INDEPENDENT ACCOUNTANTS FOR 2004. | o          | o              | o              |

**INSTRUCTION:** To withhold authority to vote for any individual nominee(s), mark **FOR ALL EXCEPT** and fill in the circle next to each nominee you wish to withhold, as shown here: 1

To change the address on your account,  please check the box at right and indicate your new address in the address space above. Please note that changes to the registered name(s) on the account may not be submitted via this method.

Signature of Stockholder: \_\_\_\_\_ Date: \_\_\_\_\_ Signature of Stockholder: \_\_\_\_\_ Date: \_\_\_\_\_

**Note:** Please sign exactly as your name or names appear on this Proxy. When shares are held jointly, each holder should sign. When signing as executor, administrator, attorney, trustee or guardian, please give full title as such. If the signer is a corporation, please sign full corporate name by duly authorized officer, giving full title as such. If signer is a partnership, please sign in partnership name by authorized person.