SKYE INTERNATIONAL, INC
Form 10KSB
April 10, 2007

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-KSB

(Mark One)
x ANNUAL REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 2006

o TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from ____ to _____

Commission File Number: **000-28083**

SKYE INTERNATIONAL, INC.
(Exact name of small business issuer in its charter)

NEVADA	**88-0362112**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

7650 E. Evans Road, Suite C Scottsdale, AZ 85260
(Address of principal executive offices) (Zip Code)

Issuer’s telephone number: **(480) 993-2300**

Securities registered under Section 12(b) of the Exchange Act: **None**

Securities registered under Section 12(g) of the Exchange Act:
Common Stock, $0.001 Par Value

Check whether the issuer is not required to file reports pursuant to Section 13 or 15(d) of the Exchange Act. o

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 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 x No o

Check if there is no disclosure of delinquent filers in response to Item 405 of Regulation S-B contained in this form, and no disclosure will 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-KSB. o

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

State issuer's revenues for its most recent fiscal year. $167,984

The aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the average bid and asked price of the issuer's common stock as of December 31, 2006 was $3,233,626.

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There were approximately 21,622,243 shares of the issuer's common stock outstanding as of December 31, 2006 and the Company had approximately 415 shareholders of record on that date.

If the following documents are incorporated by reference, briefly describe them and identify the part of the Form 10-KSB (e.g., Part I, Part II, etc.) into which the document is incorporated: (1) any annual report to security holders; (2) any proxy or information statement; and (3) any prospectus filed pursuant to Rule 424(b) or (c) of the Securities Act of 1933 ("Securities Act"). The listed documents should be clearly described for identification purposes (e.g., annual report to security holders for fiscal year ended December 24, 1990). None

Transitional Small Business Disclosure Format (Check one): Yeso No x

SKYE INTERNATIONAL INC.
FOR THE FISCAL YEAR ENDED
December 31, 2006

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Forward-Looking Statements

This report contains “forward-looking statements” within the meaning of the Private Securities Litigation Reform Act of 1995. All statements, other than statements of historical fact, are “forward-looking statements” for purposes of federal and state securities laws, including statements regarding, among other items, the Company’s business strategies, continued growth in the Company’s markets, projections, and anticipated trends in the Company’s business and the industry in which it operates. Forward-looking statements generally can be identified by phrases such as the Company or its management “believes,” “expects,” “anticipates,” “foresees,” “forecasts,” “estimates” or other words or phrases of si import. Similarly, statements in this report describe the Company’s business strategy, outlook, objectives, plans, intentions or goals also are forward-looking statements. Although we believe that the expectations reflected in any of our forward-looking statements are reasonable, actual results could differ materially from those projected or assumed in any of our forward-looking statements. Our future financial condition and results of operations, as well as any forward-looking statements, are subject to change and subject to inherent risks and uncertainties. The factors impacting these risks and uncertainties include, but are not limited to: the substantial losses the Company has incurred to date; demand for and market acceptance of new products; successful development of new products; the timing of new product introductions and product quality; the Company’s ability to anticipate trends and develop products for which there will be market demand; the availability of manufacturing capacity; pricing pressures and other competitive factors; changes in product mix; product obsolescence; the ability of our customers to manage inventory; the ability to develop and implement new technologies and to obtain protection for the related intellectual property; the uncertainties of litigation and the demands it may place on the time and attention of company management, general economic conditions and conditions in the markets addressed by the Company; as well as other risks and uncertainties, including those detailed from time to time in our other Securities and Exchange Commission filings. The forward-looking statements are made only as of the date hereof. The Company does not undertake any obligation to update or revise the forward-looking statements, whether as a result of new information, future events or otherwise.

For a detailed description of these and other factors that could cause actual results to differ materially from those expressed in any forward-looking statement, please see “Factors That May Affect Our Results of Operation” in this document.

Throughout this Form 10-KSB, references to “we”, “our”, “us”, “the Company”, and similar terms refer to SKYE Internationa Inc. and its 100% owned Envirotech Systems Worldwide Inc., Valeo Industries Inc. and ION Tankless Inc.

PART I

ITEM 1. DESCRIPTION OF BUSINESS

Business Development

Skye International, Inc., a Nevada corporation ("Skye"), was originally organized on November 23, 1993 as Amexan, Inc. The name was changed on June 1, 1998 to Nostalgia Motorcars, Inc. Prior to the name change, Amexan was an inactive company from the date of incorporation. On June 11, 2002, the name was changed to Elution Technologies, Inc. On June 4, 2003, in connection with the pending acquisition of Envirotech Systems Worldwide, Inc., it changed its name to Tankless Systems Worldwide, Inc. On October 21, 2005, it changed its name to Skye International, Inc., as part of its overall plan to create a brand name for its revised business plan and expanded product lines.

Skye has three subsidiary corporations, all wholly-owned:

- Envirotech Systems Worldwide, Inc., an Arizona corporation ("Envirotech");
- ION Tankless, Inc., an Arizona corporation ("ION"); and
- Valeo Industries, Inc., a Nevada corporation ("Valeo").

On November 7, 2003, Skye acquired Envirotech in a one-for-one share exchange. On that date, Skye issued 8,366,778 shares of its common stock to the Envirotech shareholders. Subsequently, in December 2004, 2,075,000 of those shares were returned to Skye by the former principals of Envirotech and cancelled, and the number of Skye's issued and outstanding shares was correspondingly reduced, pursuant to a settlement of litigation brought by Skye.

In January 2004, Skye formed ION to perform research, development and marketing of new heating technologies. In January 2005, it created Valeo to license ION technologies and to manufacture products using those technologies.

Except as otherwise specified, all references herein to the "Company", "we" our", "us" refer to Skye and its wholly-owned subsidiaries, Envirotech, ION and Valeo. The business office of the Company is located at 7650 E. Evans Road, Suite C Scottsdale, Arizona 85260. The Company's fiscal year ends on December 31.

Envirotech

Envirotech was formed December 9, 1998 and has a limited history of operations. The initial period of its existence involved research and development of a line of electronic, tankless water heaters. The first sales of its products occurred in calendar year 2000.

The United States Patent and Trademark Office granted a patent to Envirotech for its Modular Electronic Tankless Water Heater (ETWH) (Patent No. US 6,389,226). Proprietary rights to the design of the ETWH were Envirotech's principal assets. The existing patent and intellectual property of Envirotech were assigned as collateral security for debts owed by Envirotech for legal services arising prior to the acquisition of Envirotech by Skye.

In 2002, Envirotech was named as a defendant in a patent infringement suit alleging that Envirotech's product infringed upon a patent owned by David Seitz and Microtherm, Inc. (the "Seitz Suit"), discussed more fully in "Item 3. Legal Proceedings, Seitz Suit" below.

Envirotech filed for relief under Chapter 11 of the United States Bankruptcy Code in the United States Bankruptcy Court for the District of Arizona, on August 6, 2004 (the "Chapter 11 Proceedings"). The Seitz Suit was initially stayed pending the disposition of the Chapter 11 Proceedings, but on September 30, 2005, the Court allowed the plaintiff to re-open the suit. On December 5, 2005, the Court issued a preliminary injunction against Envirotech and its affiliated

entities, including Skye, enjoining them from further marketing, advertising or offering for sale, or accepting any orders for (i) the Envirotech ESI 2000 heater, (ii) any other heater, regardless of its model, using parts of the Model ESI 2000 heater, and (iii) any other heater, regardless of model number, utilizing in whole any part (sic) any technology embodied in the Model ESI 2000 heater. At a hearing on May 17, 2006 the Judge issued a direction to Skye requiring it to engage in the discovery process relative to the FORTIS™ and Paradigm™ products developed by Skye and Ion Tankless. Skye has complied with this direction for additional discovery. On May 16, 2006 the U.S. Patent and Trademark Office issued patent no. 7,046,922 to Ion Tankless, Inc. in connection with its modular tankless water heater technology.

ITEM 1. DESCRIPTION OF BUSINESS - continued

The filing of the petition with the Bankruptcy Court stayed all then-existing litigation, judgments and efforts to collect on judgments entered against Envirotech. With the exception of a guarantee to one critical supplier in the current amount of approximately $42,500, Skye did not assume any liability for the obligations of Envirotech. As of the date of the filing of the Chapter 11 Bankruptcy Petition, Envirotech had liabilities of approximately $1.6 million, which are reflected in the consolidated financial statements. During the pendency of the Chapter 11 Proceedings, Envirotech continued selling its water heater products. Subsequently, in the first quarter of 2005, due to the lack of working capital and other factors, Envirotech ceased production of its products. The Chapter 11 Proceedings were dismissed by the Court, with prejudice, on February 28, 2006, at the request of Envirotech. In connection with incurring legal fees to the law firm of Jennings Strouss & Salmon, PLC (“JSS”), Envirotech granted a security interest in all of its tangible and intangible assets in 2001 and 2002, including its intellectual property (the “Envirotech Security”), to JSS (the “Senior Secured Creditor”). After Envirotech filed for bankruptcy as noted above, JSS sold its claim and the related security interests to Sundance Financial Corporation. On June 1, 2006 Sundance Financial Corporation entered into an agreement with the Company’s subsidiary, ION Tankless, in which it assigned the Envirotech Security to Ion Tankless, Inc. Because Envirotech has ceased operations, its only asset of any anticipated value is its intellectual property, including the patent as discussed above.

ION

Recognizing the dynamic state of the industry and the need for an improved product line, Skye made a decision in early 2004 to pursue its own research and development for new water heating technologies, out of which it could develop a completely new line of products. In January 2004, Skye formed a wholly-owned, non-operating subsidiary, ION Tankless, Inc., through which it has since conducted research and development of alternative heating technologies and products. Skye has invested heavily in a research and development program to develop new and innovative methods of heating water, which has resulted in the filing of several applications for patents with the U.S. Patent and Trademark Office involving dozens of claims. In November 2005, the Company received notice from the USPTO that the first such patent request had been allowed, which was issued after year-end on May 16, 2006 as US Patent No. 7,046,922. While there can be no assurances that the other patents sought will be granted or that the technology will be considered proprietary to Skye or ION, the Company believes that its applications are meritorious and will be granted at least in part.

With the exception of one patent held by Envirotech (discussed above), ION holds all patents and intellectual property of the Company and it may license that property to an affiliated or third party entity for manufacturing and distribution. The assets of ION are included in the consolidated financial statements for the Company.

Valeo

Valeo was formed by Skye in January 2005 as a wholly-owned operating subsidiary. Valeo will license technology from ION and manufacture or contract for the manufacture of several lines of water heating products, as well as other products embodying ION patent technology. Valeo has leased approximately 28,000 square feet of industrial space and has begun to oversee the production and distribution of our two new product lines, FORTIS™ and Paradigm™ , that incorporate innovative technology not previously used in the water heating market. These new products, based on proprietary technology, are expected to serve as the foundation for the future growth of the Company.

ITEM 1. DESCRIPTION OF BUSINESS - continued

Financing

The Company, after the acquisition of Envirotech, has met its financial needs through its limited operations, debt financing and through the sales and issuances of its securities. Since January, 2005, the Company has undertaken the following sales of non-registered securities in a series of private transactions:

- On January 14, 2005 the Company closed the sale of $100,000 principal amount of 10% senior notes due one year from date of issue and 50,000 unregistered common shares of common stock in private placements in connection with such notes. The shares were restricted pursuant to the provisions of Section 144 of the Securities Exchange Act of 1933. The securities were sold only to persons who met the Accredited Investor requirements and other requirements set forth in the offering memorandum.

- Between June 1, 2005 and July 28, 2005, the Company issued 1,998,819 shares of common stock at $0.55 per common share in private placements for total gross proceeds of $1,099,900. The shares were restricted pursuant to the provisions of Section 144 of the Securities Exchange Act of 1933. The securities were sold only to persons who met the Accredited Investor requirements and other requirements set forth in the offering memorandum.

- Between July 29, 2005 and August 15, 2005, the Company issued 565,000 shares of common stock at $0.55 per common share in private placements for total gross proceeds of $310,750. The shares were restricted pursuant to the provisions of Section 144 of the Securities Exchange Act of 1933. The securities were sold only to persons who met the Accredited Investor requirements and other requirements set forth in the offering memorandum.

- During 2005, the Company also issued 50,000 shares in connection with Bridge Loan Financing arranged in January 2005, 252,357 registered shares and 400,000 unregistered shares for consulting, legal and other services rendered valued at $651,943, 524,500 unregistered shares as employee stock awards valued at $536,170, 920,578 unregistered shares to retire $515,725 in debt and associated interest. In addition, between September 7, 2005 and December 15, 2005, the Company accepted subscriptions for 470,000 unregistered restricted shares at an average price of $.54 per share for a total of $275,000 and agreed to issue 20,000 shares for outside services rendered valued at $11,000. With the exception of the registered shares, all shares issued were subject to the restrictions set forth in Section 144 of the Securities Exchange Act of 1933.

- On March 22, 2006, the company issued 100,000 shares of common stock at $0.55 per common share in a non-brokered direct private placement for total net proceeds of $55,000. The shares were restricted pursuant to the provisions of Section 144 of the Securities Exchange Act of 1933. The securities were sold only to persons who met the Accredited Investor requirements and other requirements set forth in the offering memorandum.

- During the first nine months of 2006, the Company issued 205,000 shares for consulting and legal services valued at $230,753; 370,000 shares previously subscribed for cash in private placements; 412,902 shares to retire principal and interest on outstanding bridge loans; 1,814,260 shares in private placements for $655,000; 110,000 shares for legal fees valued at $48,000; 600,000 shares for consultants for fees valued at $330,000; 50,000 shares for investment banking fees and services valued at $17,500; 173,750 shares for employees in lieu of pay and for signing bonuses valued at $57,375.

- Between April 10, 2006 and April 25, 2006, the Company issued 1,714,260 shares of common stock at $0.35 per common share in a non-brokered direct private placement for total net proceeds of $600,000. The shares were restricted pursuant to the provisions of Section 144 of the Securities Exchange Act of 1933. The securities were sold only to persons who met the Accredited Investor requirements and other requirements set forth in the offering memorandum. No commissions or other fees were payable in connection with this private placement.

- Between July 15, 2006 and September 30, 2006 the Company accepted loans from five individuals totaling $100,000. On March 1, 2007 these loans were converted into Units being offered by the Company in connection with a private placement of convertible debt securities to accredited investors. The terms of the Units include: one restricted

common share grant for each one dollar loaned to the Company, and a convertible one-year Note bearing interest at the rate of 12% per annum. Each Note is convertible, as to both principal and interest, at the discretion of the holder, into restricted common shares at any time and from time to time during the term of the Note at a floating rate derived by applying a 30% discount to the prevailing 10-day moving average of the company's securities as quoted by Bloomberg Financial Services®. 100,000 shares of common stock will be issued to such persons as the stock grant of the private placement detailed above.

ITEM 1. DESCRIPTION OF BUSINESS - continued

Business of the Company

The Company is in the business of designing, developing, manufacturing and marketing consumer lifestyle products, including, initially, several models of an electronic, tankless water heater. The tankless water heater is small, easy to install and supplies virtually endless amounts of hot water with energy savings. The unit is a microprocessor controlled electric water heater contained in a compact unit, eliminating the space demands of conventional water heaters. It incorporates automatic, precise temperature controls. It saves energy, space, and water and is suitable to most areas of the U.S. and worldwide. Prior to the development of new technology, which is discussed later in this section, the Company was dependent upon the operations of Envirotech for its revenue. Beginning in 2004 and continuing throughout 2005, Envirotech's production and sales steadily declined while the Company embarked on an aggressive research and development program to develop new technologies and products for the tankless water heater market. In January 2004, SKYE formed ION through which it has since conducted research and development on alternative heating technologies and products. SKYE has invested heavily in a concerted R&D program to develop new and innovative methods of heating water which has resulted in the filing of applications for several patents involving dozens of claims. As a result of the 20 month research and development program, several patents have been issued and other patent applications are pending, and new products have been developed and will be ready for limited production in mid-2007.

The Company has ceased to manufacture the ESI-2000 water heater line of products developed by Envirotech. Our *FORTIS*™ brand product line, which is expected to be delivered to the market during mid-2007, is the result of the R&D program discussed above. SKYE's *FORTIS*™ series is scalable from 40 amps to 120 amps of heating power and is a microprocessor-controlled electric water heater contained in a compact unit, which is designed to operate in most any climate. SKYE's new and innovative way of heating water for home and business is contained in a small and easy to install unit. Not only does it supply virtually endless amounts of hot water, but it also offers substantial energy savings to most users. The *FORTIS*™ series saves energy, space, water, and is suitable for most areas of the world. SKYE uses advanced technology and high quality parts in the construction of the *FORTIS*™ series, which provides reliability and longevity. Most anywhere hot water is now being used, SKYE's electric instantaneous water heaters can likely perform the task more effectively than most other appliances. The *FORTIS*™ series will heat water only as long as you require hot water, and only at the temperature you desire. Electricity is only used when heated water is required, therefore the cost of heating water could be calculated to be reduced by as much as 20% - 40%. Because the *FORTIS*™ series is compact it can be easily installed close to where hot water is being used, and it is ideal for hotels, motels, apartments, and homes where space is at a premium. SKYE believes its *FORTIS*™ series heaters offers one of the most efficient solutions for on-demand endless hot water available today.

The Company has expended considerable efforts in working with its contract manufacturer, Jabil Circuit, Inc., in order to begin the production of the *FORTIS*™ line of products. The Company expects that the first *FORTIS*™ units will be produced in 2007 with sales and delivery to also commence sometime thereafter. Despite commencing production, the Company expects that it may take up to one year for the production design and processes to stabilize. Once the production and processes have stabilized the Company anticipates that it will seek to move production of the *FORTIS*™ to a lower cost center in Mexico or China in order to gain additional margin.

ITEM 1. DESCRIPTION OF BUSINESS - continued

Additionally, the Company has continued to focus development efforts on the commercialization of its new *Paradigm*™ technology. Although we have been very excited about the functionality that the *Paradigm*™ technology offers, we have not been successful in developing a cost effective means to commercialize the technology into a consumer product line. We are currently negotiating with a critical supplier to jointly complete the engineering and commercialization process, and then subsequently the engineering for manufacturing phase. In the event we are successful in concluding a strategic relationship in this regard the Company expects that it will have first delivery of product utilizing the *Paradigm*™ technology by late 2007 or early 2008. As we have not yet completed our negotiations there can be no assurance that we will finalize any such agreement, or if we do finalize the agreement, that we will be successful in the completion of a commercialized product for distribution within a reasonable period of time.

We have expended considerable efforts to develop a sales and distribution network in the United States and beyond. We have chosen to sell our products through wholesale distribution utilizing manufacturer's representatives. As of December 31, 2006, we have appointed a total of 17 manufacturer representatives covering a total of 28 States. We are currently negotiating for the appointment of additional representatives in other US States, as well as Canada and Mexico. We expect that we will complete the appointment of representatives in States across the United States by the end of 2007.

The Marketplace for Tankless Water Heaters.

According to the Appliance Manufacturers Association, 10 million tank water heaters were sold in the United States in 1997, at an average cost per unit of $210, for total gross sales of $3.15 billion. Annual tankless water heater sales in the United States exceed $100 million in gross sales, as of 2004. The worldwide market for tankless water heaters is more than $10 billion in gross annual sales.

SKYE believes that the U.S. market for tankless water heaters, that comprised less than 2% of total water heater sales in 2004, is poised for significant growth. According to a 2003 Frost & Sullivan report, tankless water heater sales were experiencing a significant growth rate exceeding 57% per year, as compared to only a 2% growth rate for traditional tank-based water heaters.

Extensive study of the tankless water heater market and strategies for penetrating that market show that:

- The water heater replacement market continues to grow and is over 10 million units annually.
- Government tax credits and sale incentives for energy efficiency are increasing.
- New home sales and home improvement spending are increasing.
- As incentives from energy companies beginning to enter the competitive market place, utility de-regulation offers an opportunity for manufacturers of energy saving appliances.
- The market for tankless water heaters is expected to grow in excess of 60% in 2006.

Historically, in the U.S., tankless water heaters have suffered from poor design and had problems such as water flow limits, overheating at low flow, shut downs, and burnout of elements at low flow rates. As a result, some plumbing contractors and specifying engineers believe tankless heaters do not perform well, and they discourage consumers from buying tankless systems. There is a common perception that tankless heaters are expensive, more complicated and more time consuming to install. In the past, tankless water heaters have not provided a viable option for heating water for a whole house. In addition, conventional tank water heaters today are somewhat more efficient and reliable than in the past.

The conventional water heater market is highly competitive, highly concentrated, and mature, and dominated by a small number of manufacturers. Conventional tank water heaters maintain approximately 97% market share of residential water heater sales. Steep discounts and rebates as high as 20% or more are standard. Some contractors are loyal to their favorite brands and are opposed to tankless systems. The five dominant U.S. manufacturers have substantial resources, well known brand names, established distribution networks, worldwide manufacturing capabilities, and sizeable engineering, research and development resources to protect and increase their market share and profitability. Further, price competition has increased in recent years, and major manufacturers have been increasing research and development activities. Contractors do not want to lose the “guaranteed” replacement business provided by the shorter life of tank heaters, and the plumbing industry is somewhat resistant to tankless heaters.

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ITEM 1. DESCRIPTION OF BUSINESS - continued

Studies show that most consumers are not aware of tankless systems or their benefits, and do not evaluate whether to change from tank water heaters. Studies report that sales growth in tankless water heaters will require extensive education to change opinions in the plumbing industry, better tankless products than in the past, and a major consumer education campaign to increase awareness and motivate them to change.

Until just a few years ago, there were only a few tankless water heater manufacturers with a presence in the United States. But that has changed. Now, all the major players from Japan, as well as many European manufacturers, are all in the United States, and they all are experiencing dramatic growth. The differences between Japanese and American products vary in the way they heat the water. Demand for space savings and efficiency has driven the Japanese market, while in America, the additional functionality of endless hot water, particularly driven by the custom home market, continues to increase demand for instant water heaters. Today, there are no electric water heaters manufactured in Japan. The Japanese have a 40-year history of using gas-based instant water heaters, primarily in the Ofuro tub market, and they are now leveraging that experience in the US marketplace. These Japanese manufactures include Takagi, Noritz, and Rinnai. The European competitors in the US marketplace in gas, and to a lesser extent, electric-based heaters, include Bosch and Steibel, both of which gained their market experience in Europe where point-of-use instant use water heaters are commonplace.

One of the significant barriers to the entry of an electric tankless unit has been the inability of an electrically powered unit to generate enough heated water flow for the average U.S. household. SKYE's *FORTIS*™ product addresses this problem by incorporating a "multi-pass" heating technology that keeps incoming water in contact with a large heating surface for a longer time period of time when compared to many other electric models. The greater contact with a larger heating surface results in the ability to produce greater volumes of heated water because of the added operating efficiency of the product. This new level of functionality afforded by SKYE's patented technology we believe will give SKYE a competitive advantage over many other electrically powered tankless water heaters, and for the first time provide what SKYE believes to be a truly viable alternative for the consumer that demands higher flows of heated water.

Product Overview

The Company has developed two series of what it believes will be the world's most advanced, efficient and reliable electric tankless water heaters - *FORTIS*™ and *Paradigm*™. The *FORTIS*™ series has substantially all metal construction and features a bright LCD display for ease of use. The units also offer up to six remote controls for home automation, programmable processor to allow easy installation of the latest software, a modular design for ease of expansion of heating capacity, easy replacement of immersion elements, and industry-standard non-proprietary components for cost-effective part replacement.

Safety features include mechanical power breakers (included within the heater eliminating the need for an external sub-panel), wet sensor-leak detection, a valve to flush any sediment that may have accumulated in the system, an optional self-cleaning mode, and mechanical over temp switch that will shut off the unit in the event other safety devices fail. The units also feature a function that allows the consumer to program time-of-day energy savings modes, and even limit how long a user can get hot water in the shower.

The *FORTIS*™ Series.

SKYE expects to offer five power models of the *FORTIS*™ unit, with different combinations of heating elements. The Company believes all models have the following characteristics:

- 304 series stainless steel housing

- paddle wheel flow sensor that can be cleaned if necessary
- solid aluminum heating chamber coated to prevent mineralization build-up
- Incoloy® sheathed immersion heating elements for longevity

ITEM 1. DESCRIPTION OF BUSINESS - continued

- Surgical grade stainless steel end-caps to move heated water within heating chamber
- Custom microprocessor controller with backlit color LCD interface
- Avionic grade solid state relays
- Breaker sub-panel included inside each appliance
- Redundant mechanical power breakers
- Wet sensor
- Optional automatic flush cleaning system

The *FORTIS*™ is a durable tank-replacement product that is capable of meeting the needs of most U.S. households. Endless hot water, energy savings, compact design and redundant safety systems make this tankless water heater a viable choice for most residential applications.

The *Paradigm*™ Series

The *Paradigm*™ series water heaters heat water using new technology never before used in heating water in a residential appliance. Essentially, instead of putting the heater in the water, the *Paradigm*™ series water heaters put the water through the heater. The *Paradigm*™ series is currently in the final engineering and design phase with expected engineering for manufacturing to follow.

The *Paradigm*™ technology will offer virtually instantaneous hot water, and is extremely efficient. The *Paradigm*™ series can heat water over 100° F in only seconds. The *Paradigm*™ technology is even more energy efficient than *FORTIS*™. Like FORTIS™, *Paradigm*™ requires no tank. In *Paradigm*™, there is no impediment in the water flow, whatsoever, so it does not need an external cleaning system. *Paradigm*™ technology provides virtually instantaneous heat response upon demand.

Included in the *Paradigm*™ series of heaters is a whole house, point-of-use and under-the-sink tankless water heater. Moreover, the Company believes that this smaller unit will find a market much larger than the whole-house unit and that the volume of smaller units will likely exceed the whole-house units.

Product Development and Production Status - March 30, 2007

***FORTIS*™.** SKYE is completing the final controller design of the *FORTIS*™ series of products at the present time and, when completed, anticipates the ability to deliver saleable volumes of *FORTIS*™ product in 2007. Jabil Circuit has agreed to manufacture the first run of product at its Tempe, Arizona facility. Once the design of the *FORTIS*™ has stabilized and larger production volumes are achieved, Jabil expects that manufacturing of product will be moved off-shore to lower cost centers.

***Paradigm*™.** SKYE is engaged in the design phase and engineering for manufacturing phase for a line of point-of-use and whole-house water heaters. Once this engineering phase is complete, SKYE intends to seek the approvals noted below and anticipates that initial production will likely commence in 2007 with market introduction likely in late 2007 or early 2008. SKYE is currently in negotiations with key suppliers-to establish strategic relationships with certain component vendors that may be able to assist in reducing the time to market.

Other. SKYE intends to conduct further research and development to design other value-added consumer products to incorporate the Paradigm™ thick-film resistive technology. Current efforts include an ultra-efficient space heater, as well as a new generation ceiling fan to cool in the summer and provide heat in the winter. Using the *FORTIS*™ and Paradigm™ technology, along with other proprietary technology, the Company seeks to develop additional products for recreational vehicles, marine applications and swimming pools and spas.

Governmental Approvals, Effect of Regulations. All of SKYE's products are currently being tested to ensure compliance with applicable code requirements. Additionally, SKYE is submitting its products for testing and/or approval by the following agencies:

• UL/CUL
• NSF
• IAPMO/UPC

Consumer safety, building, electric and plumbing codes are in a constant state of change and thus SKYE is always subject to the potentially negative impacts of any adverse legislation. SKYE is not currently aware of any pending legislation that will adversely affect the ability of SKYE to conduct its business.

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ITEM 1. DESCRIPTION OF BUSINESS - continued

Sales and Distribution

Because tankless water heaters are still relatively new in the U.S., SKYE has determined it will use wholesale distribution through appointed manufacturer's representatives to enter the market place. As consumer knowledge of tankless is still quite low, SKYE believes that a "push" style distribution through wholesale distribution is needed. Utilizing the resources of wholesalers to make sales calls and stock inventory locally will help to reduce initial capital needs and expedite a broader distribution network. To date, SKYE has appointed manufacturer's representatives in 28 states and expects that it will continue to appoint more representatives over the balance of 2007, including manufacturer's representatives in Canada and Mexico.

The wholesale distribution model is favored by SKYE because, among other reasons, according to the 2004 Frost & Sullivan report, over 60% of plumbing sales are made by wholesale distributors. Many of the wholesale distributors add value to SKYE's distribution because, in addition to providing the local sales and installation force, they also are able to inventory both units and parts. As awareness of tankless grows, a local presence is essential to convert home building, architects and other key decision makers to adopt tankless technology.

Over time SKYE believes that certain of its products, particularly the *Paradigm*™ point-of-use water heaters will likely be sold through traditional and "big-box" retailers. Although retailers typically drive somewhat higher margins for SKYE as compared to wholesale distribution, the infrastructure necessary to support this sales channel is significantly higher and SKYE is not currently staffed or capitalized to do this. We will continue to monitor our distribution and determine on a product-by-product basis, which method of distribution or sales channel best serves SKYE's interests.

Manufacturing

On February 15, 2006, SKYE entered into a Manufacturing Services Agreement with Jabil Circuit, Inc. ("Jabil") pursuant to which Jabil has agreed to manufacture certain components and to assemble SKYE's tankless water heater products as specified by SKYE from time to time. The agreement has an effective date of January 30, 2006. SKYE anticipates that Jabil will become SKYE's primary manufacturer and is currently completing the engineering for manufacturing. Additionally, SKYE is also actively negotiating with critical suppliers to quality them to supply *Paradigm*™ components, as well as potentially expedite the earlier market availability of products utilizing the new *Paradigm*™ technology.

Intellectual Property

In May 2002, Envirotech was granted a patent by the United States Patent Office for its Modular Electronic Tankless Water Heater (ETWH) (Patent No. US 6,389,226). The Founders of Envirotech and Steve Onder, and each of the contractors or consultants who have performed research and development services for and on behalf of Envirotech made written assignments to Envirotech of proprietary and intellectual property rights relating to the ETWH and that research and development, and have signed non-disclosure, non-competition agreements with Envirotech.

During the past two years, based on newly developed technology, ION has filed several applications for patents with the United States Patent and Trademark Office, and expects the products offered using this new technology to replace the products previously manufactured by Envirotech. All persons deemed inventors have executed written assignments to ION of proprietary and intellectual property rights relating to the inventions forming the basis of the various applications for patents and the attendant research and development. In November 2005, the Company received notice from the USPTO that the first such patent request has been allowed, which was issued on May 16, 2006 as US Patent No. 7,046,922. On August 8, 2006, the USPTO issued a method patent No, 7,088,915 to ION on the Company's modular tankless water heater technology. On January 16, 2007, the Company was advised that its

wholly owned subsidiary, ION Tankless, Inc., received US Patent No. 7,164,851 entitled "Modular Tankless Water Heater Control Circuitry and Method of Operation" as issued and published by the United States Patent and Trademark Office. Additionally, ION has further been notified that another patent has been allowed in connection with its thick film on steel heating technology developed in connection with the Paradigm research initiative. SKYE expects that such patent will be published in due course. While there can be no assurances that the other patents sought will be granted or that the technology will be considered proprietary to SKYE or ION, the Company believes that its applications are meritorious and will be granted at least in part.

ITEM 1. DESCRIPTION OF BUSINESS - continued

Materials and Principal Suppliers.

SKYE has retained Jabil Circuit, Inc. to manufacture its products, and, as such, is heavily dependent upon Jabil to perform satisfactorily so as to ensure the availability of product for sale. Jabil is required to buy components for SKYE's products from the market at large, as well as from an approved list of suppliers, including Siemens, AG (electrical components), Lake Monitors (flow sensors), Tru-Heat (heating elements), Hydro Aluminum (extruded heating chamber), and Arnold Bros. (stainless steel sheet metal and components). Although limited production experience has been obtained, SKYE is satisfied that Jabil has the necessary experience to avoid supplier delivery problems. In order to avoid losses associated with lack of production components, SKYE has worked closely with Jabil to identify suppliers that have traditionally performed well in addition to ensuring that multiple suppliers for most components are available. With the exception of certain proprietary components manufactured by Jabil, and the preferred vendors noted above, the balance of components are readily available from a variety of sources both domestically and internationally. SKYE is satisfied that it and Jabil have adequately planned to avoid production disruption resulting from a breakdown in its supply chain.

Research and Development

The Company conducts all of its research and development activities through ION. All employees, contractors and consultants engaged in the research and development process by ION were required to execute non-disclosure, non-competition agreements covering the subject, scope and work product of the program. The Company expended approximately $26,878 in 2006 and $450,000 in 2005 on research and development.

Employees

At December 31, 2006, Skye had two full-time employees. Additionally, the Company retained the services of consulting professionals to provide on-going management, legal, accounting and engineering research and development work. The Company anticipates adding several full time employees in the near future in management and for administrative and technical support. Additional employees are expected to be engaged as revenues from operations permit.

Dependence on Major Customer

Skye expects to commence the wholesale introduction of its products sometime during the second quarter 2007 or later. It has not developed a dependence upon any single customer or group of customers. By necessity, initial sales of Skye's products may be concentrated with certain distributors or retailers until a broader distribution network can be achieved. Skye will monitor its sales and distribution activities closely to avoid such reliances.

Costs of Environmental Compliance

Because Skye does not manufacture any of its products, it does not anticipate incurring material costs related to environmental compliance, which is the responsibility of the manufacturer.

Recent Developments

- On August 8, 2006, the USPTO issued a method patent No, 7,088,915 to ION on the modular tankless water heater.

- On January 5, 2007, the Company was advised that its securities had been cleared by the compliance unit of the National Association of Securities Dealers ("NASD") for quotation on the OTC Bulletin Board. Accordingly, the Company commenced trading on the OTCBB under the trading symbol SKYY effective on the opening on January

8, 2007.

ITEM 1. DESCRIPTION OF BUSINESS - continued

- On January 16, 2007, the Company was advised that its wholly owned subsidiary, ION, received US Patent No. 7,164,851 entitled "Modular Tankless Water Heater Control Circuitry and Method of Operation".

- ION also received notice of patent allowance for its thick film on steel heating technology developed during the Paradigm research initiative. SKYE expects that such patent will be published in due course.

- On January 19, 2007, legal counsel on behalf of the Company filed, in the United States District Court for the District of Arizona, the Registrant's Response and Counterclaims to that certain derivative lawsuit filed as case No.: 2:06-CV-1291. The Registrant's Response and Counterclaim was filed against JEFFREY M. STEBBINS, CORBIN T. JONES, DAN DE SADE, BRODY HANNSEN, LEON SLADE, and DWAIN MENDENHALL, as Counterclaim Defendants and TIMES SECURITIES, INC., a California corporation; JEFFREY M. STEBBINS and JULIANE A. STEBBINS, husband and wife; CORBIN T.JONES and CHELSEA JONES, husband and wife; STEPHANIE CHOOI, an individual; TARA LEWIS, an individual; MICHAEL STEBBINS, an individual; ERIC STEBBINS, an individual; DAN DE SADE, an individual; WILLIAM PAPAZIAN and MADELINE PAPAZIAN, husband and wife; SPINELLI CORPORATION, an Arizona corporation, as Additional Counterclaim Defendants. The Counterclaims by the Registrant against these other individuals and entities include claims for Fraud, Federal RICO Violations, Breach of Fiduciary Duty, Breach of Confidentiality Obligations, Misappropriation, Breach of Contract (Financing), Negligent Misrepresentation, Tortious Interference, Injurious Falsehood, Illegal Takeover of Skye, Defamation, State Racketeering Violations, Unauthorized Sale of Restricted Securities, Formation of Group, Breach of Contract (Non-Compete), Abuse of Process and Malicious Prosecution. The Counterclaim was amended on January 29, 2007.

- On January 19, 2007 the Company issued a President's letter to shareholders providing shareholders with an update of events in 2006 and an outlook for 2007.

- On January 30, 2007, the Board of Directors of the Registrant filled two vacancies on the Board with the election of Mr. Perry Logan and Mr. Ted Marek. Both Mr. Logan and Mr. Marek will serve as directors until the next Annual General Meeting of the Registrant's shareholders. Mr. Logan and Mr. Marek were also appointed to serve as independent Directors on the Company's Audit Committee and Corporate Governance Committee and will serve in such capacity until the next Annual General Meeting of shareholders.

- On February 5, 2007, the Board of Directors ratified and reaffirmed the consulting agreements previously entered into with Sundance Financial Corp., Digital Crossing and Gregg C. Johnson.

ITEM 2. DESCRIPTION OF PROPERTY

At December 31, 2006, the Company owned no real property.

Effective August 31, 2006, Skye acquired, and on the same day sold, its former offices located at 7150 W. Erie St., Chandler AZ 85226 to a third party for net proceeds to Skye of $75,000. Since September 1, 2006, until the date of this report, the Company has sub-leased office space, at a no-cost basis, located at 7650 E. Evans Road, Suite C, Scottsdale, AZ 85260 from Studio One Entertainment Inc.

Skye is actively seeking to lease new office and warehouse facilities for its growing business. Skye currently plans to locate its facilities in either Tempe or Scottsdale, AZ ,and it hopes to conclude lease arrangements and complete its move to a new facility sometime during the second quarter of 2007.

Investments

The Company uses available capital to fund its current operating expenses and product research and development. Accordingly, it does not have a long-term investment plan. Short-term investments are invested in bank deposits and other liquid secure investments.

ITEM 3. LEGAL PROCEEDINGS.

The Company is currently engaged in a significant amount of costly and burdensome litigation, including:

Distributor Suit. Prior to the acquisition of Envirotech, by the Company, Envirotech was the defendant in a lawsuit filed by a former distributor alleging a breach of a Distributor Agreement entered into with Envirotech in May, 1998. On August 13, 2003, Envirotech entered into a Settlement Agreement and Release pursuant to which Envirotech agreed to pay the distributor the sum of $520,500 in installments over a period of ten years. The obligations under this Settlement Agreement are secured by a Security Agreement covering all assets of Envirotech except its intellectual properties, as defined therein, subordinated, however, to a first lien on all assets of Envirotech, tangible and intangible, granted to the Senior Secured Creditor in 2001 and 2002 by Envirotech to secure two promissory notes given in satisfaction of legal fees. As part of the settlement, Envirotech granted the distributor a Stipulated Judgment which was not to be filed of record so long as no default existed. On May 3, 2004, the distributor claimed a breach and filed the Stipulated Judgment. Management believes no default existed to warrant the filing of the judgment. With the filing of the Bankruptcy Petition by Envirotech (see below), this action was stayed. However, with the dismissal of the Chapter 11 Proceedings on February 28, 2006, this judgment is once again a claim against the assets of Envirotech, subject, however, to the claims and rights of the Senior Secured Creditor.

Seitz Suit. In 2002, Envirotech was named as a Defendant in a law suit filed in the U.S. District Court for the Southern District of Texas, Houston, Texas (Civil Action No. H-02-4782, David Seitz and Microtherm, Inc., vs. Envirotech Systems Worldwide, Inc., and Envirotech of Texas, Inc., the “Seitz Suit”). The Company is not directly affiliated with Envirotech of Texas, Inc., which was a distributor of Envirotech’s products. The suit alleges that Envirotech infringed patent rights of others and seeks damages and an order to cease and desist. Management believes the suit is without merit. The suit was stayed pending the disposition of the Chapter 11 Bankruptcy Petition filed by Envirotech in August 2004. On September 30, 2005, however, the Bankruptcy Court allowed the plaintiff to re-open the Seitz Suit and he has done so. The suit is in the discovery stage and the Company is vigorously engaged in the discovery process. On December 5, 2005, the Houston Court issued an injunction against Envirotech and its affiliated entities, including SKYE, enjoining them from further marketing, advertising or offering for sale, or accepting any orders for (i) the Envirotech ESI 2000 heater, (ii) any other heater, regardless of its model, using parts of the Model ESI 2000 heater, and (iii) any other heater, regardless of model number, utilizing in whole any part any technology embodied in the Model ESI 2000 heater. At a hearing on May 18, 2006, the Court directed that discovery be expanded to include the technology and products of SKYE, including, specifically the *FORTIS*™ and *Paradigm*™ technologies. On July 26, 2006 Envirotech retained the Dallas, TX firm Hemingway, Hansen, LLP to continue the defense and prosecution of this litigation. At a subsequent hearing on February 28, 2007, the Court indicated that it would reconsider and modify the wording on the scope of the preliminary injunction. Additionally, the Court allowed Seitz to amend his complaint. Seitz filed his amended complaint attempting to expand the complaint to also cover Skye, Valeo and the FORTIS™ product. Skye and Valeo have filed motions to dismiss this amended complaint, and Envirotech has filed a ten count counterclaim against Seitz. Envirotech continues to aggressively defend the Seitz suit and will pursue this litigation to conclusion.

Unpaid Fees. Subsequent to December 31, 2003, Envirotech has been named in five separate lawsuits for unpaid legal and consulting fees totaling $280,000. These include the Myers and Jenkins Suit and the Sensor Technologies Suit discussed below. On May 3, 2004, Envirotech settled one of these suits claiming fees of $112,500. In connection with that settlement, Envirotech reimbursed the plaintiff for alleged out-of-pocket expenses and the Company issued 10,000 shares of common stock, restricted under SEC Rule 144, to the plaintiff on the basis of a loan from the Company to Envirotech. The settlement, and any settlements of the other suits, will be reflected as a charge in the year of the settlement. In two of the other three suits judgments have been granted in the aggregate amount of approximately $155,500, both of which were stayed by the bankruptcy filing discussed above. The fourth suit is on behalf of a law firm that served as a contract arbitrator in Envirotech’s dispute with the Distributor noted above. With

the dismissal of the Chapter 11 proceedings, the Company has received notice from the plaintiff that it intends to resume the suit, which seeks approximately $3,500 in fees.

Myers and Jenkins Suit. On May 24, 2006, Envirotech was served with a Motion for Entry of Default in connection with an action filed in Arizona Superior Court, case number CV-2006-003671 by Envirotech's prior legal counsel, Myers and Jenkins. The motion seeks judgment for the payment of the principal sum of $103,830, together with interest and costs. Envirotech has not defended the action.

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ITEM 3. LEGAL PROCEEDINGS - continued

Sensor Technologies Suit. On May 24, 2006, Envirotech was served with an Application for Entry of Default in connection with an action filed in the Arizona Superior Court, case number CV-2006-0060632, by Sensor Technologies & Systems, Inc., an engineering firm that provided engineering consulting services in connection with Envirotech's ESI-2000 product. The application seeks judgment for the payment of $72,391, together with interest and costs. Envirotech has not defended the action.

Bankruptcy Proceedings. On August 6, 2004, Envirotech filed a Voluntary Petition for protection under Chapter 11 of the United States Bankruptcy Code in Phoenix, Arizona. The filing of this Petition with the Bankruptcy Court stayed all existing litigation, judgments and efforts to collect on the judgments. Envirotech was acquired by the Company in November 2003 in a stock-for-stock transaction and has been held and operated by the Company as an operating subsidiary. With the exception of a guarantee to one critical supplier in the current amount of approximately $42,500, SKYE has not assumed any liability for the Obligations of Envirotech. As of the date of the filing of the Chapter 11 Bankruptcy Petition, Envirotech had liabilities of approximately $1.6 million. Several creditors, not related to the supply of parts or the assembly of products, have obtained judgments against Envirotech and an action was pending in the U.S. District Court, Southern District of Texas, alleging patent infringement (see above). All claims of creditors, including the above-mentioned judgments, and efforts to collect same, together with the litigation pending in the U.S. District Court in Houston, were stayed during the pendency of the Bankruptcy Proceedings. Envirotech filed a Disclosure Statement and Plan of Reorganization on November 7, 2004 and the Court approved its request to submit the plan to the creditors for approval. The Plan, however, did not receive approval of the Court and Envirotech subsequently filed a Motion to Dismiss the Chapter 11 proceedings which was granted, with prejudice, on February 28, 2006. As a result of this dismissal, all claims and judgments of creditors of Envirotech are likely to be renewed.

Shareholder Inspection Claim. In April 2006 a shareholder purporting to have obtained consent from at least 15% of the Company's shareholders filed a lawsuit in the United States District Court for the District of Nevada (Case No. 2:06-CV-0541-RLH-GWF) seeking inspection of the Company's books and records pursuant to Nevada corporate law. The Court denied plaintiff's initial request. The Company has asserted several counterclaims against the plaintiff for tortious conduct and for abuse of the legal process in connection with the lawsuit. The complaint was dismissed by the Court on May 22, 2006, but the plaintiffs were granted leave to re-file the complaint if certain technical deficiencies are corrected. The matter is currently pending.

Shareholder Derivative Action. In May 2006 a small group of dissident shareholders (including the plaintiff from the Shareholder Inspection Claim) filed a lawsuit in the United States District Court for the District of Arizona (Case No. CV06-1291-PHX-ROS) as a derivative action seeking injunctive and declaratory relief. The Company was named as a nominal defendant and there are no claims for monetary damages against the Company. The primary claims involve the prior issuance of the Company's common stock to former consultants to the Company, as well as prior issuances of stock to certain members of current management. Among other things the plaintiffs seek to prevent these individuals from using their stock and related voting rights to solicit proxies and notice shareholder meetings, and have demanded that they return the shares to the Company. The costs likely to be incurred by the Company in connection with such indemnities will be significant. The Company has filed extensive counter and cross-claims. The matter is currently pending and the Company is awaiting a decision of the Court after the TRO hearing on February 21 & 22, 2007.

Berry-Shino Claim. The Company has on several occasions during the past three years utilized the services of Berry-Shino Securities, Inc., Scottsdale, Arizona, in raising various forms of financing to further its business plan and operations. In the course of each of these engagements, the Company has paid Berry-Shino various fees and expenses and has issued a certain number of shares of its Common Stock to Berry-Shino. The Company has received correspondence from Berry-Shino stating that it believes it is entitled to be issued an additional 456,500 shares of Common Stock as additional consideration for its services. The Company is currently negotiating a settlement of this matter directly with Berry-Shino.

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ITEM 3. LEGAL PROCEEDINGS - continued

Pending Arbitrations. The Company is party to two separate arbitrations. The first matter involves Skye and Lawrence K. White in an action first filed in Arizona State Court and later removed to arbitration. Mr. White seeks payment to him of fees in the amount of approximately $7,000, and punitive and other damages in an amount totalling approximately $100,000 in a matter related to certain accounting consulting services rendered to Skye in 2006. The second matter involves Skye and its former independent auditors, Semple & Cooper, LLP relating to unpaid audit and accounting fees in the amount of approximately $39,000. The Company intends to vigorously defend both actions and may file counterclaims in either or both actions. Both matters are pending and arbitrations are expected to be held before the end of the third quarter 2007.

Claim by Director William Papazian for Legal Defense and Indemnity. The Company is a party to an action seeking to require Skye to both "defend" and "indemnify" Director William Papazian from and against costs and liabilities arising in connection with a counterclaim filed by Skye against Mr. Papazian in connection with the Shareholder Derivative Action described above. Though filed by Mr. Papazian in Arizona State Court, the lawsuit has been removed to the jurisdiction of the Federal District Court. The Company seeks an interjudicial transfer of the matter to Federal Judge Roslyn O. Silver, the Judge hearing the Shareholder Derivative Action. The Company's motion is being opposed by Mr. Papazian and the matter remains pending.

Quick & Confidential Claim. On January 23, 2007, Skye was served with a complaint filed in Arizona State Court by Quick & Confidential Inc. who seeks the payment of fees to it in the amount of approximately $13,000 in connection with legal copying services. The Company intends to seek a settlement of this matter.

Except as noted above, to the best knowledge of the officers and directors of the Company, neither the Company nor its subsidiaries, nor any of their respective officers or directors is a party to any material legal proceeding or litigation.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

In March 2006, the Company was served with a demand by Danial DeSade, acting on behalf of himself and certain other shareholders, purporting to represent shareholders of record holding in excess of 15% of the outstanding shares of the Company (collectively, the "Demand Shareholders"). The Demand Shareholders had signed authorizations giving Mr. DeSade the authority to demand that the Company permit an inspection of its books and records pursuant to relevant provisions of Nevada law. The Company's Board of Directors denied such demand and took the position that the actions of Mr. DeSade, specifically, the solicitation of proxies, were in contravention of Federal Securities laws, and further, that the demand itself could not be supported under applicable Nevada law. Subsequently, in April 2006, Mr. DeSade, representing the Demand Shareholders, filed a petition in the U.S. District Court for the District of Nevada, case number 2:06-cv-00541-RLH-GWE, seeking an inspection of the Company's financial and other records pursuant to Nevada law. The Company believes the request was not properly made and contested that request. The complaint was dismissed on May 22, 2006, but the plaintiffs were granted leave to re-file the complaint if certain technical deficiencies are corrected.

On April 20, 2006, the President of the Company, acting pursuant to Article II section 2 of the Company's By-laws, having received a demand of shareholders holding in excess of 15% of the issued and outstanding shares of the Registrant, called a Special Meeting of the common shareholders of the Company that was to be held on May 31, 2006. The purpose of the special meeting was to:

a. To elect directors of the Company to hold office until the succeeding Annual General Meeting of Shareholders.

b. To transact such other business as may properly come before the Meeting or any adjournment or adjournments thereof.

At its meeting on May 11, 2006, the Board of Directors postponed the Special Shareholders' Meeting until a future date that was to be established after the Company had brought its SEC filings current. The Board did not evaluate whether the Special Shareholders Meeting was duly called.

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ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS - continued

The Board has not, as of the date of this report, set a date to reconvene the postponed Special Shareholders Meeting, nor has the Company taken any other actions in the furtherance of such Special Shareholders' Meeting or any other meeting of shareholders for any purpose.

The Company expects that it will cancel the Special Shareholders Meeting in lieu of a combined Annual and Special Meeting of Shareholders at a future date to be determined by the Board of Directors once the Company has received the decision of the Court in the Shareholder Derivative Action, all as more fully described under "Item 3 - Legal Proceedings" above.

PART II

ITEM 5. MARKET FOR COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

Market Information.

Except as otherwise disclosed, Skye's common stock has been traded on the NASD Over the Counter Bulletin Board since 1998 under various symbols, including:

CRRZ - 1998 to December 12, 2002
ELUT - December 12, 2002 to July 25, 2003
TSYW - July 25, 2003 to November 11, 2005
SKYY - November 11, 2005 to May 19, 2006
SKYYE - May 19, 2006 to June 5, 2006
SKYY -June 5, 2006 to January 8, 2007 (as traded on the Pink Sheets)
SKYY - January 8, 2007 to present

The following table sets forth the range of high and low bid quotations for each fiscal quarter for the last two fiscal years. These quotations reflect inter-dealer prices without retail mark-up, markdown, or commissions and may not necessarily represent actual transactions.

Per Share Common Stock Bid Prices by Quarter

For the Fiscal Year Ending on December 31, 2006	High	Low
Quarter Ended December 31, 2006	$ 0.35	$ 0.16
Quarter Ended September 30, 2006	0.60	0.25
Quarter Ended June 30, 2006	0.96	0.40
Quarter Ended March 31, 2006	1.25	0.41

For the Fiscal Year Ending on December 31, 2005	High	Low
Quarter Ended December 31, 2005	$ 1.12	$ 0.62
Quarter Ended September 30, 2005	1.40	0.66
Quarter Ended June 30, 2005	1.05	0.57
Quarter Ended March 31, 2005	1.40	0.75

For the Fiscal Year Ending on December 31, 2004		High		Low
Quarter Ended December 31, 2004	$	0.91	$	0.88
Quarter Ended September 30, 2004		0.73		0.73
Quarter Ended June 30, 2004		0.80		0.65
Quarter Ended March 31, 2004		1.05		1.20

ITEM 5. MARKET FOR COMMON EQUITY AND RELATED STOCKHOLDER MATTERS - continued

Holders of Common Equity

As of December 31, 2006, there were approximately 415 shareholders of record of the Registrant's Common Stock and there were approximately 21,622,243 shares of Common Stock issued and outstanding.

Dividends

Skye has not declared or paid a cash dividend to stockholders since it became a "C" corporation. The Board of Directors presently intends to retain any earnings to finance the Company's operations and does not expect to authorize cash dividends in the foreseeable future. Any payment of cash dividends in the future will depend upon the Company's earnings, capital requirements and other factors.

Equity Compensation Plans

As of December 31, 2006 our equity compensation plans were as follows:

Plan category	**Number of securities to be issued upon exercise of outstanding options, warrants and rights**	**Weighted average exercise price of outstanding options, warrants and rights**		**Number of securities remaining available for future issuance(1)**
Equity compensation plans approved by security holders	None		N/A	None
Equity compensation plans not approved by security holders	900,000	$	0.53	N/A
Total	900,000	$	0.53	N/A

(1) Excluding securities reflected in column (a)

The Company has granted options to (1) Sundance Financial Corp., and Digital Crossing, LLC, to purchase 300,000 shares each of common stock at an exercise price of $0.50 per share. The option may be exercised, in whole or in part, at any time within a ten-year period beginning February 11, 2004 and ending February 11, 2014. The options are fully exercisable as of the grant date, February 11, 2004, and require that the exercise price be paid in cash. The number of shares purchasable upon exercise of the option are subject to certain adjustments, and in certain circumstances the price per share may also be adjusted. The grantees have unlimited piggy-back registration rights to have shares purchased pursuant to the option included in any registration statement filed by the Company. Copies of the Option Agreements with Sundance and Digital Crossing, and amendments thereto, are attached as Exhibits 99.3 and 99.4, respectively, of the Company's Form 10-KSB filed for the period ended December 31, 2005. The Company has also granted options to each Director and Ronald O. Abernathy, to each purchase 50,000 shares of common stock at an exercise price of $0.50 per share, and to its Chairman to purchase 150,000 shares at an exercise price of $0.50 per share. The options may be exercised, in whole or in part, at any time within a five-year period beginning September 8, 2006 and ending September 7, 2012. The options are fully exercisable as of the grant date, and require that the exercise price be paid in cash. The grantees have unlimited piggy-back registration rights to have shares purchased pursuant to the option included in any registration statement filed by the Company.

Changes in Control

The Company is not aware of any arrangements which may result in a change in control of the Company. The stipulated agreement among the parties noted in “Item 3. Legal Proceedings, Shareholder Derivative Action” above prevents the Company from implementing the terms of the shareholder consent referred to in “Item 4 - Submission Of Matters to a Vote Of Security Holders” above.

ITEM 5. MARKET FOR COMMON EQUITY AND RELATED STOCKHOLDER MATTERS - continued

Sale of Unregistered Securities

Information on the sales of unregistered securities is noted in “Item 1. Description of Business, Financing” above.

ITEM 6. MANAGEMENT’S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION

The following discussion should be read in conjunction with the financial statements and accompanying notes included in this Form 10-KSB.

Plan of Operation.

The Company is in the business of designing, developing, manufacturing and marketing consumer lifestyle products, including, initially, several models of electronic, tankless water heaters. Previously the Company produced, marketed and sold its electronic tankless water heater products directly through the internet. The Fortis™ and Paradigm™ units, and future products, however, will be sold primarily through manufacturer’s representatives in the wholesale market.

Liquidity and Capital Resources.

As of December 31, 2006, the Company’s only prior source of established revenue was from the sales of the ESI-2000 product through its subsidiary, Envirotech. However, the ESI-2000 product line was discontinued in 2005 and thus the Company has no establish source of revenue as at December 31, 2006 or the date of this Report. Future revenues are expected to derive from the sale of the *FORTIS*™ and *Paradigm*™ series of water heating products, and later, from additional consumer lifestyle products the Company expects to manufacture and sell. The consolidated financial statements for the Company disclosed that the Company has working capital deficiency of $3,185,116, and has accumulated losses of $12,527,800. The Company will require additional funding for continued operations, and will therefore be dependent upon its ability to raise additional funds through bank borrowings, equity or debt financing, or asset sales. We expect to access the public and private equity or debt markets periodically to obtain the funds we need to support our operations and continued growth. There is no assurance that the Company will be able to obtain additional funding when needed, or that such funding, if available, can be obtained on terms acceptable to the Company. If we require, but are unable to obtain, additional financing in the future on acceptable terms, or at all, we will not be able to continue our business strategy, respond to changing business or economic conditions, withstand adverse operating results or compete effectively. If the Company cannot obtain needed funds, the Company may be forced to curtail or cease its activities. If additional shares are issued to obtain financing, current shareholders will suffer a dilutive effect on their percentage of stock ownership in the Company and this dilutive effect may be substantial. The Company has no commitments or plans for any additional funding at the present time. Insufficient financial resources may require the Company to delay or eliminate all or some of its development, marketing and sales plans, which will have a material adverse effect on the Company's business, financial condition and results of operations. There is no certainty that the expenditures to be made by the Company will result in a profitable business.

Executive Summary

The Company’s business is the design production, marketing and sale of value-added consumer appliances. Skye’s premier consumer product is the *FORTIS* ™, a new series of electric instantaneous water heater. Skye will market the *FORTIS* ™ tankless water heater which it believes: (i) maintains a pre-determined water temperature (ii) conserves water (by installing the electronic tankless water heater close to the use point or by heating water at the tap, rather than drawing cold water before the hot water travels from a tank to the tap) (iii) conserves energy (by heating water only

when it is needed) (iv) has a greater life span than most other water heaters (v) to be competitive with the purchase price of other water heaters, (vi) saves space, and (vii) is powerful and versatile (for example, making the heater able to heat water for an entire house in most any climate). On the heels of *FORTIS*™ will be a new technology that Skye refers to as *Paradigm*™. This technology ushers in an entirely new method of heating water that is both fast and extremely efficient. The primary application for the Paradigm™ technology will be for the point-of-use instantaneous heating market. Skye is currently working to commercialize this technology into a suite of products that can be used in homes across North America.

ITEM 6. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION - continued

Once *FORTIS*™ (and later *Paradigm*™) is ready for commercial production and distribution, likely during the second quarter of 2007, the Company's success will be dependent upon its ability to attract high quality distributors and manufacturer's representatives to market its products. To date, the Company has been able to attract distributors and manufacturer's representative groups with a solid track record selling tankless water heating devices to home builders and the wholesale plumbing trade. The Company is unable to provide forecasts as to the amount of product it anticipates selling. As of March 30, 2007, the Company has contracts with twelve (15) U.S. manufacturers' representative groups with operations in 28 States. The major terms of the contracts are: (a) distributors receive a graduated discount based on volume with the greatest discount being 35%, and 10% commissions to manufacturer's representatives; (b) non-exclusive territories; (c) termination upon 30 day notice and; (d) no maximum purchase requirements and sales goals to be mutually agreed, or in default, $1,000,000 per territory. The Company is currently training all its U.S. distributors and manufacturers representatives in the use of its products.

Going Forward

The Company has expended considerable efforts in working with its contract manufacturer, Jabil Circuit, Inc., in order to begin the production of the *FORTIS*™ line of products. As of March 30, 2007, much of the prepatory work to commence production has been completed and Jabil has completed the manufacturing work cell to commence production. The Company expects that the first *FORTIS*™ units will be produced during the second quarter of 2007 with sales and delivery to also commence during such period. Despite commencing production, the Company expects that it may take up to one year for the production design and processes to stabilize. Once the production and processes have stabilized the Company anticipates that it will seek to move production of the *FORTIS*™ to a lower cost center in Mexico or China in order to gain additional margin.

The Company has also continued to focus development efforts on the commercialization of its new *Paradigm*™ technology. Although we have been very excited about the functionality that the *Paradigm*™ technology offers, we have not been successful in developing a cost effective means to commercialize the technology into a consumer product line. We are currently in final negotiations with a critical supplier to (i) jointly complete the engineering and commercialization process, and then (ii) engage in an engineering for manufacturing phase. In the event we are successful in concluding a strategic relationship in this regard, the Company expects that it will have first delivery of product utilizing the *Paradigm*™ technology by the end of 2007. As we have not yet completed our negotiations there can be no assurance that we will finalize any such agreement, or if we do finalize the agreement, that we will be successful in developing a commercialized product for distribution within a reasonable period of time.

Access to capital remains one of the most pressing considerations for the Company. Although we were successful in concluding a $600,000 non-brokered private placement in April 2006, and a further $100,000 as of September 30, 2006, such funds were not sufficient to provide adequate working capital to meet the needs of the Company beyond the beginning of the third quarter 2006. As such, the Company expects to be working diligently to access additional funding likely by way of further private placements of equity. We have commenced negotiations with several parties with a view to completing further private placements to fund our business strategy, but to date we have not yet concluded any such arrangement. Our business strategy will require us to raise in excess of $2 million over the next 12 month period in order to fully execute our current business plan. There can be no assurance that we will be able to raise such additional funding by way of either new debt or equity, and in the event we are unable to raise the funds necessary to fund our business plan it will be necessary to curtail such plans and this could have a detrimental impact on our business. Management believes that, in order to properly exploit the introduction of both the *FORTIS*™ and *Paradigm*™ technologies, it will be necessary that we be positioned not only as a quality supplier of products, but that we also be able to supply a sufficient volume of product to meet wholesale demand. We believe that, relative to the wholesale market, there is a very high expectation that product be available in a timely fashion when ordered. In order to meet this expectation we must be capable of not only producing our products in sufficient volume, but

holding quantities of product in inventory as well. These things all require capital and we must be successful in our efforts to obtain this funding if we are to be successful in the wholesale sales and distribution channel.

ITEM 6. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION - continued

Over the balance of the year we will continue to focus our efforts on initiating production of the *FORTIS*™ product line and in getting it into the market to be sold. We will continue to develop our markets and train installers and field service personnel in cooperation with our appointed manufacturer's representatives. This is no small task and it will require a significant effort on the part of our existing staff, as well as new staff that must be hired in order to provide sales and customer service to the field. We will also focus our efforts on completing the *Paradigm*™ technology and we are challenged by the opportunity to introduce this powerful technology to the US marketplace. While *Paradigm*™ will require a significant investment of time and capital in order to yield a line of marketable products, we are confident that products based on this technology will be amongst the most efficient and technologically advanced in the market. Many challenges remain and Skye's Board, Management and Staff are committed to the challenge.

Results of Operations

The following discussion and analysis of the financial condition and results of our operations should be read in conjunction with the financial statements and the notes to those statements included elsewhere in this document. This discussion contains forward-looking statements that are based on our current expectations and involve risks and uncertainties. Skye's actual results could differ materially from those discussed below. Factors that could cause or contribute to such differences include, but are not limited to, those identified below, and those discussed in the section titled "Risk Factors" included elsewhere in this Annual Report on Form 10-KSB.

Comparison of the Years Ended December 31, 2006 and 2005

Revenues.

Revenue decreased by $33,467 or 3% to $167,984 for 2006 compared to $172,424 for 2005. The decrease was attributable to a suspension of product sales due to the unavailability of product arising from both the lack of working capital, as well as the preliminary injunction granted in December 2005 prohibiting the further sales of the Envirotech ESI-2000 product line. Income in 2006 is attributable to the purchase by the parent company of debt of a subsidiary at substantial discount and the sale of its position with respect to the facilities the Company occupied in Chandler, Arizona.

Cost of Goods Sold and Gross Margin.

With the discontinuance of sales of the ESI-2000, Cost of Goods Sold decreased from $172,651 for 2005 to $28,357 in 2006.

General and Administrative Expenses.

Legal and Professional costs, which includes fees paid to outside consultants for management services, decreased significantly in 2006 to $1,772,479 as compared to $2,032,825 in 2005. The decrease is mostly attributable to the valuation accounting relative to shares paid to certain consultants for services rendered during 2006, and reduced expenses incurred in patent fees, but offset to some extent by on-going litigation costs. Advertising/Marketing Expenses increased to $131,323 in 2005 as compared to $44,147 in 2005. General and Administrative (G&A) expenses decreased by $666,410, 53%, to $586,619 in 2006 as compared to $1,253,029 for 2005 due to a reduction in staff and the Company's move from its Chandler, Arizona facility. The Company incurred non-cash charges in the amount of $684,127 for the value of stock grants to employees, key consultants and for the value of stock granted to a new consultant which became fully vested in 2006.

Research and Development Expenses.

Research and Development (R&D) expenses decreased in 2006 to $26,,878 from $447,657 for 2005 and $285,544 for 2004. The Company's decrease in R&D expenses is attributable to the completion of most of the engineering associated with the *FORTIS*™.

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ITEM 6. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION - continued

Net Loss.

Net loss decreased $1,588,583 to $(2,463,287) or $(0.12) per common share for 2006 compared to a net loss of $(4,051,870) or $(0.27) per common share for 2005. This decreased loss was due primarily to the contraction of the Company's staff and the elimination of rent and overhead by moving from the Chandler, Arizona facility, and the non-cash expense in connection with shares issued to consultants as prepaid services during 2006.

Liquidity and Capital Resources

Based on the Company's current plans and market conditions, management does not believe that the Company's existing cash and current operations will be sufficient to satisfy its anticipated cash requirements for the next twelve months. In addition, the Company is unable to provide assurance that its planned levels of revenue, costs and expenses will be achieved. If the Company's operating results fail to meet its expectations or if the Company fails to manage its inventory, accounts receivable or other assets, it will have a negative impact on the Company's liquidity and the Company will be required to seek additional funding through public or private financings or other arrangements. In addition, due to the planned expansion of its product offerings, marketing efforts, channels and geographic presence, the Company may require additional working capital. If this were to occur, it is possible that adequate funds may not be available when needed or may not be available on favorable or commercially acceptable terms, which could have a negative effect on the Company's business and results of operations.

At December 31, 2006 the Company had total current assets of $271,112, including a cash balance of $8,672, $163,062 in raw materials inventory, and $99,379 in prepaid expenses. These funds are not sufficient to meet the Company's operational and liquidity needs for the next twelve months and thus additional debt or equity financing will be required. The Company's working capital at December 31, 2006 was a negative $3,185,116. This represents a decrease in working capital of approximately $849,774 from a negative working capital of $2,335,342 at December 31, 2005.

The Company reported negative operating cash flows from operations of $2,463,287 for the twelve months ended December 31, 2006. The net loss of $2,284,500 was offset by non-cash charges of $684,127 which represented the value of stock issuances and stock options exchanged for services rendered and $9,870 in depreciation and amortization expenses. At December 31, 2006, the Company had no inventory purchase commitments.

The long-term continuation of the Company's business plans is dependent upon generation of sufficient revenues from its products to offset expenses. Until the Company has achieved a sales level sufficient to break even, it will not be self-sustaining or be competitive in the areas in which it intends to operate. The Company will require additional funding for continued operations, and will therefore be dependent upon its ability to raise additional funds through bank borrowings, equity or debt financing, or asset sales. We expect to need to access the public and private equity or debt markets periodically to obtain the funds we need to support our operations and continued growth. There is no assurance that the Company will be able to obtain additional funding when needed, or that such funding, if available, can be obtained on terms acceptable to the Company. If we require, but are unable to obtain, additional financing in the future on acceptable terms, or at all, we will not be able to continue our business strategy, respond to changing business or economic conditions, withstand adverse operating results or compete effectively. If the Company cannot obtain needed funds, the Company may be forced to curtail or cease its activities. If additional shares are issued to obtain financing, current shareholders may suffer a dilutive effect on their percentage of stock ownership in the Company and this dilutive effect may be substantial. The Company has no commitments or plans for any additional funding at the present time. Insufficient financial resources may require the Company to delay or eliminate all or some of its development, marketing and sales plans, which could have a material adverse effect on the Company's business, financial condition and results of operations. There is no certainty that the expenditures to be made by the Company

will result in a profitable business.

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ITEM 6. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION - continued

Intangible Assets

The Company's intangible assets consist of two pending patents and four patents for tankless water heater technology. Generally a patent has a life of 17 to 20 years.

The Company performed an impairment test in accordance with the guidance provided in SFAS 142, "Goodwill and Other Intangible Assets", and has determined that, as of December 31, 2006 no impairment exists on any of the Company's assets based on the present value of future cash flows generated from Company assets. The Company recognized an impairment of $39,778 related to the Envirotech Patent in 2004.

The Envirotech Patent is subject to a lien registered against it by the Law Firm of Jennings, Strouss & Salmon ("JSS") relating to an outstanding claim against Envirotech for unpaid legal services. In 2001, JSS obtained security from Envirotech in the form of a U.C.C 1 registration over all the tangible and intangible assets and receivables of Envirotech. In 2002 the security was amended to include a specific lien against the Envirotech Patent that was subsequently registered by JSS with the U.S. Patent & Trademark Office (collectively, the JSS Security"). After the filing for Chapter 11 bankruptcy protection by Envirotech on August 6, 2004, Envirotech commenced negotiations with JSS, as Envirotech's sole secured creditor, to acquire the JSS security. Envirotech was unable to reach an agreement with JSS. Subsequently the JSS Security was purchased by Sundance Financial Corp. ("Sundance"). Envirotech was successful in reaching a verbal agreement to acquire the JSS Security by way of the payment of Sundance's actual costs to acquire the JSS Security, together with an amount of $2,000, an amount reflective of Sundance's legal fees and expenses in connection with acquiring the JSS Security. Between July and October 2005, the Company made a series of payments to Sundance totaling $83,000 in order to acquire the JSS Security. By way of an agreement dated and effective as of June 1, 2006, between Sundance and Ion Tankless, Inc., we acquired the JSS Security (the "JSS Security Purchase"). By way of the conclusion of this agreement, Sundance acknowledged the prior repayment to it of $83,000 by the Company, and with the payment of the sum of $2,000 reflective of Sundance's legal expenses and fees, all payment obligations under and in connection with the JSS Security Purchase have been fulfilled.

Critical Accounting Policies

We have identified the following policies as critical to our business operations and the understanding of our results of operations. The preparation of these financial statements require us to make estimates and assumptions that effect the reported amount of assets and liabilities, disclosure of contingent assets and liabilities at the date of our financial statements, and the reported amounts of revenue and expenses during the reporting period. There can be no assurance that actual results will not differ from those estimates. The effect of these policies on our business operations is discussed below where such policies affect our reported and expected financial results.

Revenue Recognition. Our revenue recognition policy is significant because our revenue is a key component of our results of operations. We recognize revenue when delivery of the product has occurred or services have been rendered, title has been transferred, the price is fixed and collectability is reasonably assured. Sales of goods are final with no right of return.

Warranty Costs. We warrant our products against manufacturing defects for a period of five years on electrical components and 10 years on other components. As of December 31, 2005, we have had no significant warranty claims on ESI-2000 products sold. Once sales of our new products commence, we expect to make an accrual for warranty claims based on our sales.

Intangible Assets. We have intangible assets in the form of patents issued and pending. Our estimate of the remaining useful life of these assets and the amortization of these assets will affect our gain from operations. Since we do not have a method of quantifying the estimated number of units that may be sold we have elected to amortize these intangibles over a seven year period beginning in the first quarter of 2006.

Purchase Accounting. Our purchase accounting policy is to record any acquisitions in accordance with current accounting pronouncements and allocate the purchase price to the net assets. The Company evaluates the fair market values of tangible and intangible assets based on current market conditions, and financial and economic factors. Intangible assets are valued using several cash flow projection models and financial models to establish a baseline for their respective valuations. The Company's policy is to expense in-process research and development costs at acquisition.

ITEM 6. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION - continued

Stock Options. We have a stock option plan under which options to purchase shares of our common stock may be granted to employees, consultants and directors at a price no less than the fair market value on the date of grant. We account for grants to employees in accordance with the provisions of APB No. 25, *Accounting for Stock Issued to Employees* ("APB No. 25"). Under APB No. 25, compensation expense is based on the difference, if any, on the date of the grant between the fair value of our stock and the exercise price of the option and is recognized ratably over the vesting period of the option. Because our options must be granted with an exercise price equal to the quoted market value of our common stock at the date of grant, we recognize no stock compensation expense at the time of the grant in accordance with APB No. 25. On January 1, 2006 we adopted the fair value based method set forth in Statement of Financial Accounting Standards ("SFAS") No. 123, *Accounting for Stock-Based Compensation* ("SFAS No. 123"), we would recognize compensation expense based upon the fair value at the grant date for awards under the plans. The amount of compensation expense recognized using the fair value method requires us to exercise judgment and make assumptions relating to the factors that determine the fair value of our stock option grants. We account for equity instruments issued to non-employees in accordance with SFAS No. 123 and Emerging Issues Task Force Issue No. 96-18, *Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling Goods or Services*.

FACTORS THAT MAY AFFECT OUR RESULTS OF OPERATIONS

Risks Relating To Our Business and Our Marketplace

History of Operations and Dependence on Future Development.

SKYE International, Inc. ("SKYE") was organized November 23, 1993 and existed as a development stage company until its acquisition of Envirotech Systems Worldwide, Inc. ("Envirotech"), on November 7, 2003. Envirotech was organized December 9, 1998. Envirotech has a limited history of operations. The first sales of its products occurred in calendar year 2000. The Company, on an operating and consolidated basis, has continued to incur substantial losses from operations since the date of acquisition. The Company did not generate significant revenue from sales of its discontinued ESI-2000 product line and has not generated any revenues yet from the sale of other products, including FORTIS™, developed in conjunction with the Company's research and development initiatives.

Prior to the development of new technology, the Company was dependent upon the operations of Envirotech for its revenue. The Company expects that additional operating losses will occur until new product commences sales in the market and the resulting revenue is sufficient to offset the level of costs incurred for ongoing marketing, sales and product development. The Company is subject to all of the risks inherent in establishing a new business enterprise. Since the Company has a very limited record of operations, there can be no assurance that its business plan will be successful. The potential for success of the Company must be considered in light of the significant problems, expenses, difficulties, complications and delays experienced by the Company to date; and as are frequently encountered with the start-up of new businesses. A prospective investor should be aware that if the Company is not successful in achieving its goals and achieving profitability, any money invested in the Company will be lost. The Company's management team believes that its success depends on the Company's ability to complete product development and obtain regulatory approval, then in manufacturing, marketing and selling its products and, over the longer term, in developing new products for which larger markets are possible.

The Company has not had sufficient funds to date with which to even partially implement its business plans. We cannot be certain that our business strategy will be successful because these strategies are unproven. There can be no assurance that the Company will generate sufficient revenues to the extent necessary to render it profitable. There can be no assurance that management has accurately forecast the Company's performance or that planned operations will

lead to profits in the future. In addition, outside of product know-how, intellectual property and contractual relationships, the Company has only very limited hard assets, the value of which is far less than the accrued payables of the Company as of the date of this Offering. If the Company is unable to develop marketable products, obtain customers and/or generate sufficient revenues so that it can profitably operate, the Company's business will not succeed. We will be particularly susceptible to the significant risks and uncertainties as described in these risk factors, and we will be more likely to incur the expenses associated with addressing such risks. Our business and prospects must be considered in light of the risks, expenses and difficulties frequently encountered by companies in the early stages of development. These risks are particularly severe among companies in new and rapidly evolving markets such as those that we expect will serve as our target markets. Accordingly, purchasers of Units must be in a financial position to bear the risk of loss of their entire investment in the Company.

ITEM 6. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION - continued

Awaiting SEC Response to Amended Financial Filings for the Year Ended December 31, 2004

On September 15, 2005 the Company received a letter from the U.S. Securities and Exchange Commission ("SEC") relating to information provided by the Company in its financial filings for the year ended December 31, 2004 (the "2004 10KSB"), as well as the interim quarterly filings preceding such date. The SEC has requested, among other things, that we clarify and restate certain disclosures in the 2004 10KSB and possibly some related quarterly disclosures on form 10QSB during such year. On June 14, 2006 the Company filed an amended and restated 10KSB for the year ended December 31, 2004, and, to date, we have not received any comments thereon from the SEC. Other than filing an amended and restated financial as discussed above we have not formally responded in writing to the SEC, and thus we have not yet concluded such matters with the SEC and the Company may be required to undertake further actions or financial restatements as a result of further enquiries or actions by the SEC and the Company's Board of Directors.

Limited Capital and Need for Additional Financing.

The Company does not have sufficient capital to execute its existing business plan and until the Company has achieved a sales and net margin level sufficient to break even, it will not be self-sustaining or be competitive in the areas in which it intends to operate. The Company will require additional funding for continued operations, and will therefore be dependent upon its ability to raise additional funds through bank borrowings, equity or debt financing, or asset sales. We expect to access the public and private equity or debt markets periodically to obtain the funds we need to support our operations and continued growth. There is no assurance that the Company will be able to obtain additional funding when needed, or that such funding, if available, can be obtained on terms acceptable to the Company. If we require, but are unable to obtain, additional financing in the future on acceptable terms, or at all, we will not be able to continue our business strategy, respond to changing business or economic conditions, withstand adverse operating results or compete effectively. If the Company cannot obtain needed funds, the Company may be forced to curtail or cease its activities. If additional shares are issued to obtain financing, current shareholders will suffer a dilutive effect on their percentage of stock ownership in the Company and this dilutive effect may be substantial. The Company has no commitments or plans for any additional funding at the present time. Insufficient financial resources may require the Company to delay or eliminate all or some of its development, marketing and sales plans, which will have a material adverse effect on the Company's business, financial condition and results of operations. There is no certainty that the expenditures to be made by the Company will result in a profitable business.

Lack of Diversification.

The size of the Company makes it unlikely that the Company will be able to commit its funds to diversify the business until it has a proven track record of profitable operations, and the Company may not be able to achieve the same level of diversification as larger entities engaged in this type of business.

Competition.

The water heater market is mature, highly concentrated and highly competitive, and steep discounts and rebates as high as 20% or more are standard. Some contractors are loyal to favorite brands and on occasion resistant to tankless systems, and the plumbing industry is on occasion also resistant to tankless systems, particularly electric powered tankless units. Pricing competition has increased in recent years, and major manufacturers are increasing their expenditures on research and development. Conventional water heaters (tank heaters) are slightly more efficient and reliable than conventional tank water heaters in previous years. There are several companies around the world who manufacture water heaters, conventional and tankless. It is reasonable to expect to encounter intense competition in all aspects of our business and that such competition would increase. Substantial competition could emerge at any time.

Many of our competitors and potential competitors have longer operating histories and significantly greater experience, resources, and managerial, financial, technical, and marketing capabilities than us. In addition, many of these competitors offer a wider range of products and services than we contemplate offering.

ITEM 6. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION - continued

Many current and potential competitors also have greater name recognition, industry contacts and more extensive customer bases that could be leveraged to accelerate their competitive activity. Moreover, current and potential competitors have established and may establish future cooperative relationships among themselves and also with third parties to enhance their products and services in this space. Consequently, new competitors or alliances may emerge and rapidly acquire significant market share. We cannot assure you that we will be able to compete effectively with current or future competitors or that the competitive pressures faced by us will not harm our business. This intense competition, and the impact it has on the valuation of companies of this nature, could limit our opportunities and have a materially adverse effect on the Company's profitability or viability.

The Company believes that its primary competition will be the manufacturers of conventional tank water heaters, who are firmly established with the plumbing industry. There are a large number of manufacturers of tank water heaters, both domestic and foreign. The dominant manufacturers are five large, multinational, established companies with significantly more resources than the Company (Bradford-White, Rheem, A. O. Smith, State Industries and American Standard). Manufacturers of tank water heaters dominate the U.S. market, maintaining over 96% market share of residential water heater sales. The Company cannot predict the likelihood that it will take market share away from those manufacturers, or whether or how long it will take the Company to build up sales of its tankless product line. In addition, there can be no assurance that larger, more established companies with significantly more financial, technical, research, engineering, development and marketing resources; with established distribution networks and worldwide manufacturing capabilities; and with greater revenues and greater name recognition than the Company; will not develop competing systems and products which will surpass the Company's business.

Performance; Market Acceptance.

The quality of the Company's products, manufacturing capability, and marketing and sales ability, and the quality and abilities of its personnel, are among the operational keys to the Company's success. A primary management challenge will be to penetrate the market for water heaters, a mature, highly competitive and concentrated market. Also, distributors and users of water heaters may resist or be slow to accept an electric tankless water heater. Other important factors to the success of the Company will be the ability to complete the development process for new products in a timely manner and the ability to attract an adequate number of buyers, distributors and investors. There can be no assurance that the Company can complete development of new technology so that other companies possessing greater resources will not surpass it. There can be no assurance that the Company can achieve its planned levels of performance, or can be successful in establishing relationships with the number and quality of distributors it needs to be successful, in a timely way. If the Company is unsuccessful in these areas, it could have a material adverse effect on the Company's business, results of operations, financial condition and forecasted financial results.

Dependence on Intellectual Property - Design and Proprietary Rights.

Our success and ability to compete depend to a significant degree on our intellectual property. We will rely on patent, copyright and trademark law, as well as confidentiality arrangements, to protect our intellectual property. Even if legal actions are initiated by the Company to enforce our intellectual property rights however there can be no guarantee that such actions will be successful in protecting our intellectual property adequately.

Envirotech was granted a patent by the United States Patent and Trademark Office for its Modular Electronic Water Heater (ETWH) (Patent No. US 6,389,226 B1). Proprietary rights to the design of the ETWH were Envirotech's principal assets. The existing patent and intellectual property of Envirotech were assigned as collateral for debts owed by Envirotech for legal services arising prior to the acquisition of Envirotech by SKYE. Envirotech, in 2005, discontinued production of all models of the ESI-2000 tankless water heater previously manufactured by it. On December 5, 2005 by order of Judge Lee Rosenthal of the US District Court for the Southern District of Texas in

Houston a preliminary injunction against the Company was issued in connection with the civil action H-02-4782 between David Seitz and Microtherm (as Plaintiff) and Envirotech (as Defendant and Plaintiff by counterclaim) enjoining the Company and others from manufacturing, assembling, selling or offering for sale, any Product (as defined in the order) including the Envirotech ESI-2000 heater, any other heater regardless of its model number utilizing parts from the ESI-2000 or any other heater, regardless of its model number, utilizing in whole any part any technology embodied in the ESI-2000 heater (sic). The Court has indicated that it is considering the current wording of the preliminary injunction.

ITEM 6. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION - continued

The new line of tankless water heaters designed by the Company do not, in the opinion of the Company, utilize the technology embodied in the Envirotech patent or technology related to the ESI-2000 product, and are constructed using parts and operational methodologies distinct from the Envirotech ESI-2000 heater. The Company does not intend to produce any further ESI-2000 heaters and believes all future water heaters will embody designs and technologies related to newly developed intellectual property of the Company's research and design subsidiary Ion Tankless, Inc. There can, however, be no assurance that a third party may claim or continue to claim that the Company's products infringe any of such third party's patents or intellectual property. During the past year, based on newly developed technology, SKYE has filed several applications for patents with the United States Patent and Trademark Office, and expects that a range of products using this new technology will replace the products previously manufactured by Envirotech. In November 2005, the Company received notice from the USPTO that the first such patent request had been allowed, which was issued on May 16, 2006 as US Patent No. 7,046,922. On August 8, 2006, the USPTO issued a method patent (No, 7,088,915) to ION on the modular tankless water heater technology. On January 16, 2007, the Company was advised that its wholly owned subsidiary, ION Tankless, Inc., received US Patent No. 7,164,851 entitled "Modular Tankless Water Heater Control Circuitry and Method of Operation" as issued and published by the United States Patent and Trademark Office. Additionally, ION has further been notified that another patent has been allowed in connection with its thick film on steel heating technology developed in connection with the Paradigm research initiative. SKYE expects that such patent will be published in due course. While there can be no assurances that the other patents sought will be granted or that the technology will be considered proprietary to SKYE or ION, the Company believes that its applications are meritorious and will be granted at least in part. It is expected that further research and development undertaken by the Company through its subsidiary, ION Tankless, Inc., will result in the issuance of more patents. However, there is no guarantee that the concepts and technologies we use in the future will be patentable.

Effective Protection may not be available for our Trademarks.

Although we have applied to register our trade marks in the United States, we cannot assure you that we will be able to secure significant protection for these marks. Our competitors or others may adopt product or service names similar to "SKYE", thereby impeding our ability to build brand identity and possibly leading to client confusion. Our inability to adequately protect the name "SKYE" could seriously harm our business.

Policing Efforts to Protect Intellectual Property may not be successful.

Policing unauthorized use of our intellectual property is made especially difficult by the global nature of the high technology industry and difficulty in controlling hardware and software. The laws of other countries may afford us little or no effective protection for our intellectual property. We intend to make all reasonable and practical efforts to enforce our rights but we cannot assure you that the steps we take will prevent misappropriation of our intellectual property or that agreements entered into for that purpose will be enforceable. In addition, litigation may be necessary in the future to: enforce our intellectual property rights; determine the validity and scope of the proprietary rights of others; or defend against claims of infringement or invalidity. Such litigation, whether successful or unsuccessful, could result in substantial costs and diversions of resources, either of which could seriously harm our business. There can be no assurance that competitors of the Company, some of which have substantially greater resources, will not obtain patents or other intellectual property protection that will restrict the Company's ability to make, use and sell its products. If the Company were unsuccessful in protection of proprietary and intellectual property rights, it could have a material adverse effect on the Company's business, results of operations, financial condition and value, and forecasted financial results.

Some of our markets are cyclical, and a decline in any of these markets could have a material adverse effect on our operating performance.

Our business is cyclical and dependent on consumer spending and is therefore impacted by the strength of the economy generally, interest rates, and other factors, including national, regional and local slowdowns in economic activity and job markets, which can result in a general decrease in product demand from professional contractors and specialty distributors. For example, a slowdown in economic activity that results in less home renovations can have an adverse effect on the demand for some of our products. In addition, unforeseen events, such as terrorist attacks or armed hostilities, could negatively affect our industry or the industries in which our customers operate, resulting in a material adverse effect on our business, results of operations and financial condition.

ITEM 6. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION - continued

Disaster.

A disaster that disables the Company's operations will negatively impact the Company's ability to perform for a period of time. The Company's disaster recovery plan includes future multiple-site storage of inventory and the possibility of multiple manufacturing facilities.

We increasingly manufacture and/or source critical components for our products outside the United States, which may present additional risks to our business.

A significant portion of our future production will likely be manufactured outside of the United States, principally in China and/or Mexico, and expanding international manufacturing capacity in China and Mexico is part of our strategy to reduce costs. International operations generally are subject to various risks, including political, religious and economic instability, local labor market conditions, the imposition of foreign tariffs and other trade restrictions, the impact of foreign government regulations, and the effects of income and withholding tax, governmental expropriation, and differences in business practices. We may incur increased costs and experience delays or disruptions in product deliveries and payments in connection with international manufacturing and sales that could cause loss of revenue. Unfavorable changes in the political, regulatory, and business climate could have a material adverse effect on our financial condition, results of operations, and cash flows.

Our operations will suffer if we are unable to complete our internal cost reduction programs.

We are proposing a cost reduction program in our business, which includes a transfer of portions of our manufacturing and assembly work from of existing United States operations to proposed operations in China or Mexico. In implementing this program, we may not be able to successfully consolidate management, operations, product lines, distribution networks, and manufacturing facilities, and we could experience a disruption in our inventory and product supply or in administrative services. In addition, we may not be able to complete this program without unexpected costs or delays, or the need for increased management time and effort. If we do not successfully implement this program on a timely basis, we will not achieve the planned operational efficiencies and cost savings, and there could be an adverse impact on ongoing relationships with our customers, all of which would impact our profitability.

Our results of operations may be negatively impacted by product liability lawsuits.

Our business exposes us to potential product liability risks that are inherent in the design, manufacture, and sale of our products. While we intend to obtain what we believe to be suitable product liability insurance, we cannot assure you that we will be able to obtain or maintain this insurance on acceptable terms or that this insurance will provide adequate protection against potential liabilities. In addition, we currently self-insure a portion of product liability claims. A series of successful claims against us could materially and adversely affect our reputation and our financial condition, results of operations, and cash flows.

Loss of key suppliers, lack of product availability or loss of delivery sources could decrease sales and earnings.

Our ability to manufacture a variety of products is dependent upon our ability to obtain adequate product supply from manufacturers or other suppliers. While in many instances we have agreements, including supply agreements, with our suppliers, these agreements are generally terminable by either party on limited notice. The loss of, or a substantial decrease in the availability of, products from certain of our suppliers, or the loss of key supplier agreements, could have a material adverse effect on our business, results of operations and financial condition. In addition, supply interruptions could arise from shortages of raw materials, labor disputes or weather conditions affecting products or

shipments, transportation disruptions or other factors beyond our control. Furthermore, since we acquire a portion of our supply from foreign manufacturers, our ability to obtain supply is subject to the risks inherent in dealing with foreign suppliers, such as potential adverse changes in laws and regulatory practices, including trade barriers and tariffs, and the general economic and political conditions in these foreign markets.

ITEM 6. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION - continued

Our ability to both maintain our existing customer base and to attract new customers is dependent in many cases upon our ability to deliver products and fulfill orders in a timely and cost-effective manner.

To ensure timely delivery of our products to our customers, we frequently rely on third parties, including couriers such as UPS, DHL and other national shippers as well as various local and regional trucking contractors. Outsourcing this activity generates a number of risks, including decreased control over the delivery process and service timeliness and quality. Any sustained inability of these third parties to deliver our products to our customers could result in the loss of customers or require us to seek alternative delivery sources, if they are available, which may result in significantly increased costs and delivery delays. Furthermore, the need to identify and qualify substitute service providers or increase our internal capacity could result in unforeseen operations problems and additional costs. Moreover, if customer demands for our products increases, we may be unable to secure sufficient additional capacity from our current service providers, or others, on commercially reasonable terms, if at all.

In some cases we are dependent on long supply chains, which may subject us to interruptions in the supply of many of the products that we distribute.

An increasing portion of the products that we manufacture and distribute are imported from foreign countries, including China and Mexico. We are thus dependent on long supply chains for the successful delivery of many of our products. The length and complexity of these supply chains make them vulnerable to numerous risks, many of which are beyond our control, which could cause significant interruptions or delays in delivery of our products. Factors such as labor disputes, changes in tariff or import policies, severe weather or terrorist attacks or armed hostilities may disrupt these supply chains. We expect more of our name brand and private label products will be imported in the future, which will further increase these risks. A significant interruption in our supply chains caused by any of the above factors could result in increased costs or delivery delays and have a material adverse effect on our business, results of operations and financial condition.

Our results of operations could be adversely affected by fluctuations in the cost of raw materials.

As a manufacturer we are subject to world commodity pricing for many of the raw materials used in the manufacture of our products. Such raw materials are often subject to price fluctuations, frequently due to factors beyond our control, including changes in supply and demand, general U.S. and international economic conditions, labor costs, competition, and government regulation. Inflationary and other increases in the costs of raw materials have occurred in the past and may recur in the future. Any significant increase in the cost of raw materials could reduce our profitability and have a material adverse effect on our business, results of operations and financial condition.

Dilution and Board Action To Ratify Prior Share Issuances.

As at December 31, 2006 the Company had 21,622,243 shares issued and outstanding. If the Company issues additional shares either outright or through any future options or warrant programs, or if it requires additional financing, further dilution in value and in the percentage ownership will occur and the dilutive effect could be significant. On February 5, 2007, the Board of Directors passed a resolution to reaffirm and ratify the issuance of a total of 2,250,000 common shares (the "Disputed Shares") to certain officers and consultants to the Company. Such Disputed Shares had previously been recorded as issued and outstanding and so the Board action will not increase the total issued shares as at the date of the Offering. The Disputed Shares are the subject of the Shareholder Derivative Action (as disclosed in "Item 3 - Legal Proceedings") above. The Court's determination of the validity of the Disputed Shares has, as of the date hereof, not been rendered. In the event the Disputed Shares are deemed to have been validly issued, such Disputed Shares will immediately vest to the current holders thereof.

Restrictions on Transfer - No Public Market.

The shares of common stock of the Company are currently traded on the NASD Bulletin Board under the ticker symbol "SKYY". However, the Shares included in the Units are restricted pursuant to SEC Rule 144 of the Securities Act of 1933 (the "Act") and there is presently no public or private market for such restricted Shares. The Shares issuable pursuant to this Private Placement may only be offered or sold pursuant to registration under or an exemption from the Act. The Units offered by this Private Placement are subject to an exemption from registration.

ITEM 6. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION - continued

The Units have not been registered under the Act, as amended, or any State securities laws and are being issued under Section 4(2) of the Act and Rule 506 of Regulation D promulgated under the Act. The Shares sold in this Private Placement may not be sold or transferred except pursuant to an exemption from registration under the Act or State securities laws, or unless registered. There is no assurance that the Company will be able to affect any such registration or qualification for registration exemption and the Company makes no representations that it will file any such application for registration. No assurances can be made that the Shareholder will be able to find a willing buyer at a price that will enable the Shareholder to recover his investment. Moreover, because of the restrictions on transfer, a regular trading market will not develop for the Shares until such restrictions shall have expired as provided in SEC Rule 144. As a result, any investment in the Company's Units will be highly illiquid. Prospective investors should be fully aware of the long-term nature of their investment in the Company. Accordingly, purchasers of the Units will need to bear the economic risk of their investment for an indefinite period of time. For the foregoing reasons, among others, a public market will not develop for the purchase and sale of the Units, and the Units may not be readily acceptable as collateral for loans. Consequently, if as a result of changed circumstances arising from an event not now contemplated, an Investor wishes to transfer the Units owned by him, he may find only a limited or no ability to transfer or sell the Units or the underlying shares issuable upon conversion.

Expect to Incur Losses for the Foreseeable Future.

We expect to incur losses for the foreseeable future and we may never become profitable. Although our current revenue model contemplates revenues from sale of products sufficient to break-even within 12 to 24 months from the date of this Private Placement Memorandum, there is no assurance that these revenues will occur. Because technology companies, even if successful, typically generate significant losses while they grow, we do not expect to generate profits for the foreseeable future, and we may never generate profits. In addition, we expect our expenses to increase significantly as we develop the infrastructure necessary to implement our business strategy. Our expenses will continue to increase as we: hire additional employees; pursue research and development; expand our information technology systems; and lease and purchase more space to accommodate our operations.

Possible Claims That the Company Has Violated Intellectual Property Rights of Others.

In 2002, Envirotech was named as a Defendant in a law suit filed in the U.S. District Court for the Southern District of Texas, Houston, Texas (Civil Action No. H-02-4782, David Seitz and Microtherm, Inc., vs. Envirotech Systems Worldwide, Inc., and Envirotech of Texas, Inc., the "Seitz Suit"). The Company is not directly affiliated with Envirotech of Texas, Inc., which was a distributor of Envirotech's products. The suit alleges that Envirotech infringed patent rights of others and seeks damages and an order to cease and desist. Management believes the suit is without merit. The suit was stayed pending the disposition of the Chapter 11 Bankruptcy Petition filed by Envirotech in August 2004. On September 30, 2005, however, the Bankruptcy Court allowed the plaintiff to re-open the Seitz Suit and he has done so. The suit is in the discovery stage and the Company is vigorously engaged in the discovery process. On December 5, 2005, the Houston Court issued an injunction against Envirotech and its affiliated entities, including SKYE, enjoining them from further marketing, advertising or offering for sale, or accepting any orders for (i) the Envirotech ESI 2000 heater, (ii) any other heater, regardless of its model, using parts of the Model ESI 2000 heater, and (iii) any other heater, regardless of model number, utilizing in whole any part any technology embodied in the Model ESI 2000 heater. At a hearing on May 18, 2006, the Court directed that discovery be expanded to include the technology and products of SKYE, including, specifically the *FORTIS*™ and *Paradigm*™ technologies. On July 26, 2006 Envirotech retained the Dallas, TX firm Hemingway, Hansen, LLP to continue the defense and prosecution of this litigation. At a subsequent hearing on February 28, 2007, the Court indicated that it would reconsider and modify the wording on the scope of the preliminary injunction. Additionally, the Court allowed Seitz to amend his complaint. Seitz filed his amended complaint attempting to expand the complaint to also cover Skye, Valeo and the FORTIS™ product. Skye and Valeo have filed motions to dismiss this amended complaint, and Envirotech has filed a ten count counterclaim

against Seitz. Envirotech continues to aggressively defend the Seitz suit and will pursue this litigation to conclusion.

Except as described above, neither SKYE nor Envirotech is the subject of any other dispute, claim or lawsuit or threatened law suit alleging the violation of intellectual property rights of a third party. To the extent that the Company is alleged, or may in the future be alleged to have violated a patent or other intellectual property right of a third party, it may be prevented from operating its business as planned, and it may be required to pay damages, to obtain a license, if available, to use the patent or other right or to use a non-infringing method, if possible, to accomplish its objectives. Any of these claims, with or without merit, could subject the Company to costly litigation and the diversion of the Company's technical and management personnel. If the Company incurs costly litigation and its personnel are not effectively deployed, the resulting expenses and management time losses will likely result in a significant impairment of the Company's ability to achieve its business plan or achieve profitability from operations.

ITEM 6. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION - continued

Business Plans and Operational Structure May Change.

We continually analyze our business plans and internal operations in light of market developments. As a result of this ongoing analysis, we may decide to make substantial changes in our business plan and organization. In the future, as we continue our internal analysis and as market conditions and our available capital changes, we may decide to make organizational changes and/or alter some or entirely all of our overall business plans.

Reliance on Management.

The Company believes that it currently lacks certain key management in order to fully execute its business plan. It has undertaken to recruit additional persons to key Board of Directors and management positions, including engineering and finance. Should the Company be unsuccessful in recruiting persons to fill the key management positions, or in the event any of the existing key management should cease to be affiliated with the Company for any reason before qualified replacements could be found, there could be material adverse effects on the Company's business and prospects. Each of the officers and other key personnel, has an agreement with the Company, that contains provisions dealing with confidentiality of trade secrets, ownership of patents, copyrights and other work product, and non-competition. Nonetheless, there can be no assurance that these personnel will remain employed for the entire duration of the respective terms of such agreements or that any employee or consultant will not breach covenants and obligations owed to the Company.

In addition, all decisions with respect to the management of the Company will be made exclusively by the officers and directors of the Company. Investors will only have rights associated with minority ownership interest rights to make decision that affect the Company. The success of the Company, to a large extent, will depend on the quality of the directors and officers of the Company. Accordingly, no person should invest in the Units unless he is willing to entrust all aspects of the management of the Company to the officers and directors.

Inability to Attract and Retain Qualified Personnel.

The future success of the Company depends in significant part on its ability to attract and retain key management, technical and marketing personnel. As we grow, we will also need to continue to hire additional technical, marketing, financial and other key personnel. Competition for highly qualified professional, technical, business development, and management and marketing personnel is intense. We may experience difficulty in attracting new personnel, may not be able to hire the necessary personnel to implement our business strategy, or we may need to pay higher compensation for employees than we currently expect. A shortage in the availability of required personnel could limit the ability of the Company to grow, sell its existing products and services and launch new products and services. We cannot assure you that we will succeed in attracting and retaining the personnel we need to grow.

Inability to Manage Rapid Growth.

The Company expects to grow very rapidly. Rapid growth often places considerable operational, managerial and financial strain on a business. To successfully manage rapid growth, the Company must accurately project its rate of growth and:

- rapidly improve, upgrade and expand its business infrastructures;
- deliver products and services on a timely basis;
- maintain levels of service expected by clients and customers;
- maintain appropriate levels of staffing;
- maintain adequate levels of liquidity; and

- expand and upgrade its technology, transaction processing systems and network hardware or software or find third parties to provide these services.

Our business will suffer and may ultimately fail if the Company is unable to successfully manage its growth.
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ITEM 6. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION - continued

Regulatory Factors.

The Federal Government, a State Government or any Local Government could at any time enact, repeal or change law in such a way as to eliminate, reduce or postpone certain advantages available to the water heater industry. In addition, possible future consumer legislation, regulations and actions could cause additional expense, capital expenditures, restrictions and delays in the activities undertaken in connection with the business, the extent of which cannot be predicted. The exact affect of such legislation cannot be predicted until it is proposed. Additionally, much of the Company's business is regulated by National, State and Municipal codes that affect the manner in which the Company's products are installed and used. Although the Company believes it is aware of existing practices around the United States, there can be no assurance that one or more governing jurisdictions could make changes to such codes, the effect of which could be detrimental to the Company and its business in such jurisdictions.

Effects of Amortization Charges.

Our losses will be increased, or our earnings, if we have them in the future, will be reduced, by charges associated with our issuances of options. The options and restricted stock granted under this plan, as amended, may have exercise prices lower than the fair value of our common stock at the dates of grant. The total unearned stock-based compensation will be amortized as stock-based compensation expense in our consolidated financial statements over the vesting period of the applicable options or shares, generally five years in the case of options granted to employees and one year in the case of options granted to non-employee directors and restricted stock issued to employees. These types of charges may increase in the future. Future unearned stock-based compensation charges may also include potential additional charges associated with options granted to consultants. The future value of these potential charges cannot be estimated at this time because the charges will be based on the future value of our stock.

Dividend Policy.

There can be no assurance that the proposed operations of the Company will result in significant revenues or any level of profitability. We do not anticipate paying cash dividends on our capital stock in the foreseeable future. We plan to retain all future earnings, if any, to finance our operations and the acquisitions of interests in other companies and for general corporate purposes. Any future determination as to the payment of dividends will be at our Board of Directors' discretion and will depend on our financial condition, operating results, current and anticipated cash needs, plans for expansion and other factors that our Board of Directors considers relevant. No dividends have been declared or paid by the Company, and the Company does not contemplate paying dividends in the foreseeable future.

Conflicts of Interest.

Existing and future officers and directors may have other interests to which they devote time, either individually or through partnerships and corporations in which they have an interest, hold an office, or serve on Boards of Directors, and each may continue to do so. As a result, certain conflicts of interest may exist between the Company and its officers and/or directors that may not be susceptible to resolution. All potential conflicts of interest will be resolved only through exercise by the directors of such judgment as is consistent with their fiduciary duties to the Company and it is the intention of management to minimize any potential conflicts of interest.

Tax Risks.

There may be tax considerations, risks and uncertainties associated with an investment in the Company's Shares. Prospective investors should consult their own tax advisors with respect to the tax considerations of making an

investment in the Company.

ITEM 6. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION - continued

Terms of subsequent financings will adversely impact your investment.

We will engage in common equity, debt, or preferred stock financings in the future. Your rights and the value of your investment in the common stock will be reduced. Interest on debt securities could increase costs and negatively impacts operating results. Shares of our preferred stock are likely to be issued in series from time to time with such designations, rights, preferences, and limitations as needed to raise capital. The terms of preferred stock are likely to be more advantageous to those investors than to the holders of common stock. In addition, if we need to raise more equity capital from sale of common stock, institutional or other investors may negotiate terms at least as, and likely more, favorable than the terms of your investment. Shares of common stock which we sell will, at some point, be sold into the market and such market sales will likely adversely affect market price.

The industry in which we operate is characterized by rapid technological change that requires us to develop new technologies and products.

Our future will depend upon our ability to successfully develop and market innovative products in a rapidly changing technological environment. We will likely require significant capital to develop new technologies and products to meet changing customer demands that, in turn, may result in shortened product lifecycles. Moreover, expenditures for technology and product development are generally made before the commercial viability for such developments can be assured. As a result, we cannot assure you that we will successfully develop and market these new products that the products we do develop and market will be well received by customers, or that we will realize a return on the capital expended to develop such products.

Our future operating results may fluctuate and cause the price of our common stock to decline, which could result in substantial losses for investors.

Our limited operating history, the lack of established products and the substantial litigation in which the company and certain of its officers and consultants is involved make it difficult to predict accurately our future operations. We expect that our operating results will fluctuate significantly from quarter to quarter, due to a variety of factors, many of which are beyond our control. If our operating results fall below the expectations of investors or securities analysts, the price of our common stock will decline significantly. The factors that will cause our operating results to fluctuate include, but are not limited to:

- ability to commercialize new products from ongoing research and development activities;
- developments in tankless water heating technology;
- price and availability of alternative solutions for water heating systems;
- availability and cost of technology and marketing personnel;
- our ability to establish and maintain key relationships with industry partners;
- the amount and timing of operating costs and capital expenditures relating to maintaining our business, operations, and infrastructure;
- general economic conditions and economic conditions specific to the cost of electricity and water; and
- the ability to maintain a product margin on sales, given the early stage of our market for our products.

These and other external factors have caused and may continue to cause the market price and demand for our common stock to fluctuate substantially, which may limit or prevent investors from readily selling their shares of common stock and may otherwise negatively affect the liquidity of our common stock. In the past, securities class action litigation or shareholder derivative litigation has often been brought against companies following periods of volatility in the market price of their securities, as happened in the case of the Company. If additional derivative litigation or securities class action litigation were to be brought against us it could result in substantial costs and a diversion of our

management's attention and resources. Such adverse events, will hurt our business and may result in the inability to continue operations, and in such a case, investors will face the risk of an entire loss of their investment.

ITEM 6. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION - continued

Our common stock is subject to penny stock regulation that may affect the liquidity for our common stock.

Our common stock is subject to regulations of the Securities and Exchange Commission relating to the market for penny stocks. These regulations generally require that a disclosure schedule explaining the penny stock market and the risks associated therewith be delivered to purchasers of penny stocks and impose various sales practice requirements on broker-dealers who sell penny stocks to persons other than established customers and accredited investors. The regulations applicable to penny stocks may severely affect the market liquidity for our common stock and could limit your ability to sell your securities in the secondary market.

Future equity transactions, including exercise of options or warrants, could result in dilution.

From time to time, we sell restricted stock, warrants, and convertible debt to investors in other private placements. Because the stock is restricted, the stock is sold at a greater discount to market prices compared to a public stock offering, and the exercise price of the warrants sometimes is at or even lower than market prices. These transactions cause dilution to existing stockholders. Also, from time to time, options are issued to officers, directors, or employees, with exercise prices equal to market. Exercise of in-the-money options and warrants will result in dilution to existing stockholders. The amount of dilution will depend on the spread between the market and the exercise price, and the number of shares, options or warrants involved. Such dilution is very likely to be significant.

We have incurred losses and may continue to incur losses in the future.

At December 31, 2006, our accumulated deficit was in excess of $12 million. We have not been able to generate enough sales to cover our expenses and have survived only by raising funds through the sale of debt and equity securities. We must continue to raise funds in the near future to continue operations. While management has been successful in the past in raising these funds, there is no assurance that management will be successful in raising sufficient funds to continue operations and thus the Company may fail.

Our future existence remains uncertain and the report of our auditors on our December 31, 2004; 2005 and 2006 financial statements contain a "going concern" qualification.

The report of the independent auditors on our financial statements for the years ended December 31, 2004 and 2005, includes an explanatory paragraph relating to our ability to continue as a going concern. We have suffered substantial losses from operations, require additional financing, are subject to significant and costly litigation and need to continue the development and marketing of our products. Ultimately we need to generate additional revenues and attain profitable operations. These factors raise substantial doubt about our ability to continue as a going concern. There can be no assurance that we will ever be able to develop commercially viable products or an effective marketing system. Even if we are able to develop commercially viable products, there is no assurance that we will ever be able to attain profitable operations. Management anticipates that financial statements for the year ended December 31, 2006 will also contain a "going concern" qualification.

ITEM 7. FINANCIAL STATEMENTS

Financial statements as of and for the year ended December 31, 2006, and for the year ended December 31, 2005 are presented in a separate section of this report following Part IV.

ITEM 8. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

On February 24, 2006, Shelley International, CPA ("Shelley") withdrew as the Company's independent registered public accounting firm. The reason for the withdrawal was the retirement of the firm's principal. Shelley had audited the registrant's financial statements for the fiscal years ended December 31, 2004 and 2003.

ITEM 8. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE - continued

On February 24, 2006, the registrant engaged Semple & Cooper, LLP to serve as the Company's independent registered public accountants for the fiscal year ending December 31, 2005. The Company's Board of Directors approved the engagement of Semple & Cooper.

On June 2, 2006, Semple and Cooper resigned as auditors for the Company and on the same date the Board of Directors approved the engagement of Moore & Associates, Chartered of Las Vegas, Nevada to be its independent registered public accountants for the fiscal year ending December 31, 2005. During the short time that Semple and Cooper were the Company's auditors, there were disagreements on certain matters. Semple and Cooper furnished the Company with a letter addressed to the Commission setting forth its understanding of such matters. A copy of that letter was filed as an exhibit to the report on Form 8-K/A dated June 15, 2006. The Company disputes the factual basis for the disagreements identified by our former auditors.

The resignation of Semple & Cooper was accepted, but was not encouraged or recommended, by Skye's Board of Directors and Audit Committee. As noted above, the engagement of Moore and Associates has been approved by both the Skye Board and Audit Committee.

On June 13, 2006, Semple & Cooper provided the Company with a letter to the SEC dated June 9, 2006. That letter noted certain issues that it believed, if further investigated, might materially impact the fairness or reliability of the financial statements of the Company for 2004 and 2005. In particular, the auditors noted the receipt of a letter from an attorney representing certain shareholders that contained allegations of financial and accounting improprieties and accusations of possible bankruptcy and securities fraud. The Board of Directors had not concluded its investigation of those allegations at the time Semple & Cooper resigned. The matters noted in that letter are the subject of the Shareholder Derivative Action discussed in "Item 3 - Legal Proceedings" above.

Semple & Cooper also noted that it had questions regarding the propriety of certain arrangements relating to a patent owned by a subsidiary of the Company that were not addressed to the auditor's satisfaction before it resigned. Documentation of those arrangements was completed after the firm's resignation. The Board has concluded its investigation of the propriety of the transactions and the related disclosures and has determined that there were no improprieties in such transactions, and further, that related disclosures were fully and timely made.

The audit reports of Shelley on the financial statements for each of the past two years as of December 31, 2004 and December 31, 2003 contained a separate paragraph stating: "The accompanying financial statements have been prepared assuming that the company will continue as a going concern. The Company has experienced losses since inception. This raises substantial doubt about the Company's ability to continue as a going concern. The financial statements do not include any adjustments that might result from this uncertainty." There were no other adverse opinions, disclaimers of opinions, or qualifications or modifications as to uncertainty, audit scope, or accounting principles.

During the two most recent fiscal years and the subsequent interim period through February 24, 2006, there were no disagreements with Shelley on any matter of accounting principles or practices, financial statement disclosure, or auditing scope or procedure which, if not resolved to the satisfaction of Shelley, would have caused it to make reference to the subject matter of the disagreement in connection with its report. The registrant requested Shelley to furnish it a letter addressed to the Commission stating whether it agrees with the above statements. A copy of that letter was filed as an exhibit to the report on Form 8-K dated February 24, 2006.

During the registrant's two most recent fiscal years and through February 24, 2006, the date prior to the engagement of Semple & Cooper, LLP, neither the registrant nor anyone on its behalf consulted Semple & Cooper, LLP regarding

the application of accounting principles to a specified transaction, either completed or proposed, or the type of audit opinion that might be rendered on the registrant's consolidated financial statements.

Moore and Associates, Chartered, audited the restatement of the 2004 financial statements-filed in connection with the Amended Annual Report on SEC Form 10-KSB/A which was filed by the Company on June 14, 2006 (as amended, the "2004 10-KSB/A"). In connection with that restatement, Moore filed a consent with the 2004 10-KSB/A.

ITEM 8. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE - continued

During the registrant's two most recent fiscal years and through June 2, 2006, the date prior to the engagement of Moore and Associates, neither the Company nor anyone on its behalf consulted Moore and Associates regarding the application of accounting principles to a specified transaction, either completed or proposed, or the type of audit opinion that might be rendered on the registrant's consolidated financial statements.

There were no other "reportable events" as that term is described in Item 304(a)(1)(iv) of Regulation S-B occurring within the registrant's two most recent fiscal years and the subsequent interim period ending June 6, 2006.

ITEM 8A. CONTROLS AND PROCEDURES

Evaluation of disclosure controls and procedures

Management, with the participation of our Chief Executive Officer and the Chief Financial Officer, carried out an evaluation of the effectiveness of our "disclosure controls and procedures" (as defined in the Exchange Act, Rules 13a-15(e) and 15-d-15(e)) as of the end of each of the periods covered by this report (the "Evaluation Date"). Based upon that evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that, as of December 31, 2004, our disclosure controls and procedures were ineffective to ensure that the information we were required to disclose in reports that we file or submit under the Securities and Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms. More specifically, the company identified a material weakness due to a lack of sufficient personnel with appropriate knowledge in U.S. GAAP and lack of sufficient analysis and documentation of the application of U.S. GAAP to transactions, including but not limited to equity transactions. During either of the years ended December 31, 2005 and December 31, 2006, there was no change in our internal control over financial reporting identified in connection with the evaluation that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Internal Control over Financial Reporting

Management is responsible for establishing and maintaining adequate internal control over financial reporting for the Company. Management used the framework of conducting an extensive review of existing documentation and transactions to make that evaluation. As of December 31, 2004, the Company had a deficiency in internal controls over the application of current US GAAP principles. Specifically, an effective review of the Balance Sheet was not performed. As a result of the ineffective review, errors in the year-end 2004 were not detected prior to the issuance of the annual 2004 consolidated financial statements. This control deficiency resulted in the restatement of our annual 2004 consolidated financial statements as set forth in Form 10-KSB/A filed June 14, 2006. Management has concluded that this control deficiency constituted a material weakness that continued throughout 2005. There were changes in our internal controls implemented during the first quarter of 2006, including, specifically, a process to review the balance sheet of the company by persons with significant experience with US GAAP principles. Additionally, internal controls were adopted to separate accounting tasks within the company so as to ensure the separation of duties between those persons who approve and issue payment from those persons who are responsible to record and reconcile such transactions within the Company's accounting system. Such internal controls were implemented during the first quarter period ending March 31, 2006, and ,accordingly, as of the end of the first quarter 2006, management found the internal control over financial reporting to be effective, with no material weaknesses. There were no changes in our internal control over financial reporting that occurred during our most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, internal control over financial reporting.

The Company’s management is reviewing the Company’s internal controls over financial reporting to determine the most suitable recognized control framework. The Company will give great weight and deference to the product of the discussions of the SEC’s Advisory Committee on Smaller Public Companies (the “Advisory Committee”) and the Committee of Sponsoring Organizations’ task force entitled Implementing the COSO Control Framework in Smaller Businesses (the “Task Force”). Both the Advisory Committee and the Task Force are expected to provide practical, needed guidance regarding the applicability of Section 404 of the Sarbanes-Oxley Act to small business issuers. The Company’s management intends to perform the evaluation required by Section 404 of the Sarbanes-Oxley Act at such time as the Company adopts a framework. For the same reason, the Company’s independent registered public accounting firm has not issued an “attestation report” on the Company management’s assessment of internal controls.

ITEM 8B. OTHER INFORMATION

None.

PART III

ITEM 9. DIRECTORS, EXECUTIVE OFFICERS, PROMOTERS AND CONTROL PERSONS; COMPLIANCE WITH SECTION 16(a) OF THE EXCHANGE ACT

Executive Officers and Directors

As of the date of this filing, the Skye Board of Directors consists of the following members:

Mark D. Chester, Chairman.
Barry M. Goldwater, Jr., Director
Perry D. Logan, Director
Thadeus (Ted) F. Marek, Director
William S. Papazian, Director
Wesley G. Sprunk, Director

Mr. Ronald O. Abernathy serves as Skye's Chief Executive Officer, Treasurer and Chief Financial Officer. He has held his respective positions since November 17, 2006 when he succeeded Thomas Kreitzer who previously held these positions since 2001. Mark Chester became a director on September 19, 2005. William Papazian became a Director on February 13, 2006. Wesley Sprunk became a Director on May 11, 2006. Barry M. Goldwater, Jr. was appointed as a Director on July 12, 2006. Perry Logan and Ted Marek became Directors on January 30, 2007. The Board of Directors is currently fixed at seven members; however, as of the date of this report, only six persons comprise the current Board of Directors.

Directors are elected to serve for a one-year term. Officers hold their positions at the will of the Board of Directors. There are no arrangements, agreements or understandings between non-management shareholders and management under which non-management shareholders may directly or indirectly participate in or influence the management of the Company's affairs.

The names, ages, and respective positions of the directors and executive officers of the Company as of January 31, 2007 are set forth below:

Ronald O. Abernathy	62	Chief Executive Officer, President, Treasurer, and Chief Accounting Officer of SKYE
Mark D. Chester, Esq.	45	Chairman and Director of SKYE
Gregg C. Johnson	42	Director of Valeo, ION and Envirotech; President, Chief Executive Officer and Secretary of Envirotech, Valeo and ION; and Executive VP and Secretary of SKYE
Wesley G. Sprunk	70	Director of SKYE
Barry M. Goldwater, Jr.	68	Director of SKYE
Thadeus (Ted) F. Marek	65	Director of SKYE
Perry D. Logan	78	Director of SKYE

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ITEM 9. DIRECTORS, EXECUTIVE OFFICERS, PROMOTERS AND CONTROL PERSONS; COMPLIANCE WITH SECTION 16(a) OF THE EXCHANGE ACT - continued

Mark D. Chester, Chairman, Director - Member of Corporate Governance Committee

Mark Chester, age 45, is a licensed attorney in the State of Arizona and former Chairman of the State Bar's Securities Regulation Section and its Executive Council. He practices in Scottsdale at the law firm of Chester & Shein, P.C., which focuses on business and real estate transactions and litigation. Mr. Chester was formerly a shareholder at the Phoenix law firm of Gallagher and Kennedy where he represented local businesses, broker-dealers and homebuilders in arbitration, state and federal court, and administrative agency cases. He was a member of the Board of Arbitrators for the National Association of Securities Dealers and has served on numerous arbitration panels in a variety of securities industry disputes. Mr. Chester has had has matters before the SEC, NASD, the Arizona Securities Division and the NYSE. Mr. Chester received his B.S. in commerce at the University of Virginia and his J.D. with honors from the Arizona State University, Sandra Day O'Connor College of Law.

Wesley G. Sprunk, Director

Wes Sprunk resides in Scottsdale, Arizona and is President of Tire Service Equipment Mfg., Inc. and Saf-Tee Siping & Grooving, Inc. The main office for these companies is in Phoenix, Arizona with manufacturing plants in Alamogordo, New Mexico and Monticello, Minnesota. Tire Service Equipment Mfg., Inc./Saf-Tee Siping & Grooving, Inc. manufactures automotive wheel service equipment and recycling equipment. It markets these products in the U.S. and foreign countries and presently has 300+ distributors. Wes Sprunk is also a Board member with Amerityre Corporation, a NASDAQ public company (Nasdaq: AMTY) located in Boulder City, Nevada. Amerityre specializes in urethane polycomposites and the company's mission is to replace rubber in most applications, including tires. Wes Sprunk is married to Jody Ann Zadra, and has three children.

Perry D. Logan, Director and Member of Audit and Corporate Governance Committee

Perry Logan, of Las Vegas, Nevada, is one of the original investors in Skye and is, at present, one of the Company's largest individual investors. His business career centered predominantly in the automotive industry as an owner of several major dealerships in the greater Phoenix area, as well as interests in dealerships in other regions. Mr. Logan is a substantial investor in several high technology ventures, in addition to Skye, and is well informed about the research and development programs of Skye and the new FORTIS product line it hopes to market this year. His vast business experience is considered a tremendous addition to Skye's already experienced Board of Directors.

Thadeus (Ted) F. Marek, Director and Member of Audit and Corporate Governance Committee

Ted Marek, is the Principal and Designated Broker of Ted Marek Real Estate Co., Inc. He is an active investor in Skye and other emerging companies. Ted has been active in the Phoenix market for over 30 years, all along building his reputation as a very knowledgeable and successful commercial real estate broker. He maintained this same stellar reputation in Chicago for over 10 years prior to moving to the Valley. To date most of the company's client base has been grown and generated from referrals. In addition to his vast experience and knowledge of land area sales, he is recognized nationally by many professionals in the automotive real estate industry as someone who really understands this unique market. He has been very instrumental in the movement and placement of automotive dealerships, site selection, sales and acquisition in the Phoenix Metro area. In 1975 Ted was employed by Del Webb Realty & Management Corp in Phoenix as a real estate broker and in 1983 he resigned from the position of Vice President and Designated Broker. Prior to his affiliation with Del Webb, Ted was active in the automotive industry in both the Phoenix and Chicago markets.

Barry M. Goldwater, Jr., Director - Member of Corporate Governance Committee

The Goldwaters are legendary in Arizona. Barry's great-grandfather, Mike Goldwater, emigrated from Poland to the United States in the 1840s, landing in San Francisco. In 1850 he began a mercantile business traveling by wagon throughout mining camps in California, Nevada, and Arizona. He settled that year in Prescott, Arizona, where he opened his first dry goods store, which through the efforts of his sons Baron and Morris and grandsons, Bob and Barry, would expand into a tremendously successful clothing business. Like his father before him, Barry, Jr. worked in the family business, planning to accede to management. However, about the time he graduated from Arizona State University with a bachelor of science in marketing and management, the stores were sold, leaving Barry with a decision to make about his future.

ITEM 9. DIRECTORS, EXECUTIVE OFFICERS, PROMOTERS AND CONTROL PERSONS; COMPLIANCE WITH SECTION 16(a) OF THE EXCHANGE ACT - continued

Barry moved to Los Angeles and became a stockbroker, and eventually a partner, in the Los Angeles securities firm of Noble Cook, Inc. (now Wedbush Securities), where he developed an institutional customer base and traded securities on all stock exchanges. It was here he developed his selling skills and eventually landing some of the country's largest financial banks and insurance companies as clients. He also became knowledgeable in financial planning, securities law, and underwriting.

The year 1964 found Barry, Jr. crisscrossing the country campaigning for his father, Senator Barry Goldwater, to become President of the United States. The outcome of that effort is well known, but its impact on Barry is not. It set the pattern of public service that he would soon undertake.

Already involved in local civic activities such as the Boys Club, Big Brothers, the Boy Scouts of America, and the president of a local Lions Club, Barry at the age of 30 ran for Congress and won. He not only won that election but seven more, serving 14 years in Washington, D.C., representing half a million constituents of northern Los Angeles County. He and his father were unique, representing one of the few instances in U.S. history when both father and son were serving in Congress at the same time.

Barry's 14 years in Washington (1969-1984) left an imprint on him and on the nation. He served on a number of committees, including Committee on Science and Technology, Committee on Public Works and Transportation, and the Joint Committee on Energy. His areas of expertise included energy, the space program, aviation and defense, and government procurement. He was on the committee that reviewed the disaster involving the space shuttle "Challenger”. Barry authored and saw the Privacy Act of 1974 signed into law. He served on the privacy Commission that looked into privacy issues affecting the private and corporate sectors. This issue remains a matter of his concern as we move into a global electronic network and information systems. He was very instrumental in all facets of energy policy and research and development including authoring the Solar Photovoltaic Act. He has also been involved with organizations as diverse as the National Aeronautic Association, the National Wildlife Federation, and the Veterans of Foreign Wars of the United States. He is a Life Member of the American Numismatic Association. He is also looked upon as an expert concerning transportation matters.

Congressman Barry Goldwater, Jr. retired from politics in 1983 and in1984 entered business in Beverly Hills, Los Angeles, New York and Phoenix where he currently lives with his wife Sylvia Goldwater and near his son Barry M. Goldwater III. For the past 23 years Barry has held responsible positions involving finance and management, including eight years as a member of the New York Stock Exchange. He has used his government experience and knowledge like a knife to pry open and get to the heart of a problem effecting business impacted by regulation or law. His love of business is only surpassed by his humanitarian interests which have landed him awards such as the Leadership Award from the President's Commission on Employment of the Handicapped and an Achievement Award from the National Academy of Television Arts and Sciences. His business career has not diminished his compassion for the people and his commitment to making this a better and safer world in which we live.

William S. Papazian, Director and Member of Audit Committee

William Papazian has been practicing law since 1986, specifically in the areas of corporate securities, regulatory and transactional work. In addition, since 2001, he has been the President, Chief Executive Officer and General Counsel of Spinelli Corporation, a privately-held litigation support and investigative firm located in Scottsdale, Arizona. Prior to that, he spent seven years as a Board Director, Executive Vice President and General Counsel of a public company that developed and managed projects in the hospitality and gaming sectors. Mr. Papazian received his Juris Doctor degree from McGeorge School of Law, University of Pacific in 1986 and his Bachelor of Arts degree from New York University in 1983. He has been backgrounded and licensed by several federal and state regulatory agencies.

Ronald O. Abernathy, President & CEO, Treasurer and Chief Accounting Officer

Mr. Abernathy is a seasoned entrepreneur and businessman who gained a wealth of business experience from his international transactional practice over the past 30 years. From his beginnings as a pointman in the 173rd airborne brigade where he received a Gold Star for military merit, to a position with the United Nations in New York, Mr. Abernathy later began his international business career as a free-lance entrepreneur completing a series of brokered transactions in Switzerland, and around the globe. In 1993 Mr. Abernathy became the President and CEO of Scottsdale, Arizona based U.S. Machinery, and in a joint venture with McDonald-Douglas, completed various international off-set trade programs valued in excess of $1 billion.

ITEM 9. DIRECTORS, EXECUTIVE OFFICERS, PROMOTERS AND CONTROL PERSONS; COMPLIANCE WITH SECTION 16(a) OF THE EXCHANGE ACT - continued

Mr. Abernathy is currently the President and CEO of Abernathy, Warburg & Hall, a Business Consulting and Marketing Strategies firm, a position he has held for over 10 years. Amongst his other business ventures, Mr. Abernathy is currently working with G.E. Capital to acquire a Major League Baseball™ team, a project that has been on-going for more than one year. In 2001 Mr. Abernathy was the first American ever elected as President of the International Nigerian Chamber of Commerce, a position he held until 2003.

Outside of his business ventures, Mr. Abernathy is engaged in philanthropic pursuits through his appointment to the Board of Directors of the World Children's Fund, a charitable foundation formed by Arizona based law firm of Lodmell & Lodmell. Mr. Abernathy has had many years of political involvement, and he was recently nominated as Republican of the Year for the State of Arizona by the Bush Administration. Mr. Abernathy is also a member of the Republican Governors Association's Team 1000 - a group of Republican business leaders committed to creating business and economic opportunities in the United States.

Gregg C. Johnson, Executive Vice President, Secretary and Interim General Counsel

Gregg Johnson is a lawyer (not admitted in AZ) with extensive experience in management of entrepreneurial companies. He received his law degree in 1988 from Osgoode Hall Law School in Toronto, Canada and was admitted as a lawyer in Alberta in 1989. His extensive legal career has included private practice in Tokyo, Japan with Aoki, Christensen & Nomoto (now Baker & McKenzie), where his practice focused on Japanese securities regulation and international debt instruments, and in Jeddah, Saudi Arabia, with the Law Offices of Dr. Mujahid M. Al-Sawwaf, where he acted as Outside Middle East Counsel to many fortune 500 companies. His career has included experience in corporate finance and venture capital for emerging growth companies across Canada and the United States. He was instrumental in building and growing many successful companies and he has been an officer and director of numerous Canadian and U.S. public companies over his career. Additionally Mr. Johnson was elected as a Councilor and later as Reeve (Mayor) of Red Deer County, AB from October 1998 to October 2004. In October 2004 Mr. Johnson was appointed as an Appeals Commissioner (Administrative Law Judge) with the Alberta Appeals Comission. His appointment as an Appeals Commissioner expires April 30, 2007.

Compliance with Section 16(a) of the Exchange Act.

Section 16(a) of the Securities Exchange Act of 1934 requires executive officers and directors, and persons who beneficially own more than 10% of any class of the Registrant's equity securities to file initial reports of ownership and reports of changes in ownership with the Securities and Exchange Commission ("SEC"). Executive officers, directors and beneficial owners of more than 10% of any class of the Registrant's equity securities are required by SEC regulations to furnish the Registrant with copies of all Section 16(a) forms they file.

Based solely on a review of the copies of such forms furnished to the Registrant during or with respect to fiscal 2006, and certain written representations from executive officers and directors, the Registrant is aware that Messrs Chester and Papazian inadvertently failed to file a Form 3 at the time of their election to the Board. They are in the process of preparing those forms and obtaining the required EDGAR ID's.

Code of Ethics

The Company maintains a Code of Ethics that was filed with its Annual Report on Form 10-KSB for 2003 filed on April 22, 2004. That code applies to the chief executive, financial and accounting officers, controller and persons performing similar functions. If the Company amends the code or grants a waive from the code with respect to the foregoing persons, it will post that amendment or waiver on its website, www.skye-betterliving.com.

Audit Committee

The Company's Audit Committee consists of Directors: Logan (Chairman), Papazian and Marek. Mr. Papazian has been designated by the Board or the Audit Committee as an "audit committee financial expert."

ITEM 10. EXECUTIVE COMPENSATION

The following table sets forth information about the remuneration of the Company's officers.

SUMMARY COMPENSATION TABLE

	Annual Compensation				Long Term Compensation			
					Awards		Payouts	
Name and Principal Position	**Fiscal Year**	**Salary ($)**	**Bonus ($)**	**Other Annual Compensation ($)**	**Restricted Stock Award(s) ($)**	**Securities Under-lying Options/ SARs (#)**	**LTIP Payouts ($)**	**All Other Compensa-tion($)**
Thomas Kreitzer, Chief Executive Officer, Treasurer and Chief Financial Officer	2005 2006	-0- -0-	-0- -0-	-0- -0-	$17,500 $-0-	-0- -0-	-0- -0-	$6,000 $10,800
David Kreitzer, President	2005 2006	-0- -0-	-0- -0-	-0- -0-	$7,000 -0-	-0- -0-	-0- -0-	$6,000 -0-
Gregg Johnson, Exec VP & Secretary	2005 2006	-0- -0-	-0- -0-	-0- -0-	$80,000 $15,000	-0- -0-	-0- -0-	$48,150 $88,496 (2)
Kenneth Pinckard, Vice President, Valeo (1)	2005 2006	-0- -0-	-0- -0-	-0- -0-	$109,900 (1) $100,500 (1)	-0- -0-	-0- -0-	$72,000 (1) $-0- (1)
Ronald Abernathy, President	2005 2006	-0- -0-	-0- -0-	-0- -0-	-0- -0-	-0- -0-	-0- -0-	-0- -0-

(1) Kenneth Pinckard became a vice president of Valeo in February 2005 and served in such capacity until February 2006. He was not compensated directly as an executive. All payments reflected in this table were made to Digital Crossing, LLC, pursuant to a consulting agreement. Kenneth Pinckard is an employee or consultant of Digital Crossing. The Company has no information concerning how much compensation Mr. Pinckard received from Digital Crossing relating to the services rendered by him to the Company. Excludes amounts owing to Digital Crossing but unpaid at Decemebr 31, 2006.

(2) Excludes $16, 504 in accrued but unpaid compensation at December 31, 2006.

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ITEM 10. EXECUTIVE COMPENSATION - continued

Employment and Consulting Agreements

The Company has entered into consulting agreements with Sundance Financial Corp., Digital Crossing, LLC, and Gregg C. Johnson. Copies of those agreements, together with any amendments thereto, are attached as Exhibits 10.5, 10.6 and 10.9, respectively, to the Company's Form 10-KSB filed for the FYE December 31, 2005.

The consulting agreements with Sundance and Digital Crossing commenced February 1, 2004 and will terminate on January 31, 2008. As amended, each provides for payments in the amount of $10,000 per month, with the Company having the option to pay any fee in excess of $5,000 per month, in the form of common stock of the Company. In addition, each of the agreements provides for the issuance of shares of common stock as additional compensation, including 750,000 shares issued pursuant to amendments dated September 6, 2005, and grants options to purchase 300,000 shares of common stock at any time prior to February 11, 2014 at a price of $0.55 (See Exhibits 10.7 and 10.8 attached to the Company's Form 10-KSB for the FYE December 31, 2005). At December 31, 2006, the Company was delinquent with respect to payments owing under these agreements and has accrued the following amounts: Sundance, $208,900; Digital Crossing, $169,336.

The consulting agreement with Gregg C. Johnson, who is secretary and Executive Vice President for the Company, provides for the payment of a monthly fee in the amount of $10,000. As additional compensation, Mr. Johnson has been issued 750,000 shares of common stock of the Company. The agreement with Mr. Johnson commenced August 2004 and continues until July 31, 2007 (See Exhibit 10.9 to the Company's Form 10-KSB filed for theFYE Decemebr 31, 2005). As of December 31, 2006 the Company was delinquent in the payment of $16,504 in salary and fees to Mr. Johnson. Effective March 15, 2007, the Company has entered into a short-term Memorandum of Understanding with Mr. Johnson that specifies an annual Salary of $120,000 pending commencement of production and sales of the FORTIS™ product line (See Exhibit 10.13 attached to this Report). Upon the commencement of FORTIS™ product sales the Company expects it will enter into a longer term employment agreement to retain Mr. Johnson.

The plaintiffs in the Shareholder Derivative Action (see Item 3, Legal Proceedings above) contest, among other things, the validity of the consulting agreements discussed above.

Compensation of Directors and Officers

Each Director is entitled to receive 10,000 restricted common shares for each quarter year of service to the Company. Additionally, the Company grants options on an annual basis to directors. Directors are currently entitled to receive 50,000 options for each year of service to the Company. Options issued in 2006 are valid for a period of 5 years and entitle the holder to purchase common shares at $0.50. The Board of Directors has not yet determined the pricing of options to be issued in 2007. From time to time the Board of Directors also grant options to officers and consultants that provide services to the Company. Typically such options are valid for a period of three to five years and are priced at or above the market.

From time to time the Company may grant stock, options or stock appreciation rights (SARs) to certain persons in connection with services provided to or for the benefit of the Company. In most cases such equity grants are dilutive to the interests of shareholders and such dilution may be substantial. The Board of Directors of the Company has absolute discretion in the issuance of such equity grants and therefore your interests as a shareholder are subject to the business judgment of the Board of Directors of the Company in making such discretionary grants.

ITEM 11. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The following table sets forth certain information, as of March 30, 2007, concerning shares of the Company's common stock, the only class of securities that are issued and outstanding, held by (1) each stockholder known to own beneficially more than five percent of the common stock, (2) each of the directors, (3) each of the executive officers, and (4) all of the directors and executive officers as a group:

Name and Address of Beneficial Owner (1)	Amount and Nature of Beneficial Ownership	Percent of Class (2)
Sundance Financial Corp. 13470 N. 85th Place Scottsdale, AZ 85260	1,350,000 (3) direct	6.24%
Digital Crossing, LLC 13835 N. Tatum Blvd., Ste. 9-170 Phoenix, AZ 85032	1,347,000 (4) direct	6.23%
Mark D. Chester 8777 N. Gainey Center Dr., Suite 191 Scottsdale, AZ 85258	540,000 (5,6) direct	2.50%
Ronald O. Abernathy 7650 E, Evans Rd. Suite C Scottsdale, AZ 85260	50,000 (6) direct	0.23%
Barry M. Goldwater, Jr. 3104 E. Camelback, #274 Phoenix, AZ 85016	70,000 (6) direct	0.32%
Gregg C. Johnson 6081 West Park Ave. Chandler, AZ 85226	878,857 direct	4.06%
William S. Papazian 4901 E. Calle Del Medio Phoenix, AZ 85018	90,000 (6) direct	0.42%
Perry D. Logan PO Box 35080. Las Vegas, NV 89144	1,322,666 (6) direct	6.12%
Ted F. Marek 2425 E. Camelback Rd., Suite 1060. Phoenix, AZ 85016	370,000 (6) direct	1.71%

Wesley G. Sprunk 3451 S. 40th St. Phoenix, AZ 85040	222,855 (5)(6) direct	1.03%
Officers and Directors as a group (8 persons)	**3,544,378**	**16.39%**

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ITEM 11. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS - continued

(1) To the Company's knowledge, except as set forth in the footnotes to this table and subject to applicable community property laws, each person named in the table has sole voting and investment power with respect to the shares set forth opposite the person's name.

(2) This table is based on 21,622,243 shares of Common Stock outstanding as of December 31, 2006. If a person listed on this table has the right to obtain additional shares of Common Stock within ninety (90) days from December 31, 2006, the additional shares are deemed to be outstanding for the purpose of computing the percentage of class owned by that person, but are not deemed to be outstanding for the purpose of computing the percentage of any other person.

(3) Sundance Financial Corp., and affiliated persons own 1,080,000 shares of Common Stock of the Company. Lawrence G. Ryckman is a director of Sundance Financial Corp. Sundance has the right to acquire up to 300,000 shares of common stock pursuant to Options granted February 2004 at any time prior to February 11, 2009, at an exercise price of $0.55 per share.

(4) Digital Crossing LLC, a Delaware limited liability company, owns 1,047,000 shares of Common Stock of the Company. Digital Crossing has the right to acquire up to 300,000 shares of common stock pursuant to Options granted February 2004 at any time prior to February 11, 2009, at an exercise price of $0.55 per share.

(5) Including 140,000 common shares and 200,000 options to purchase common shares at $0.50 per share that have been approved by the Board but unissued as at the date of this Report.

(6) Includes 50,000 options to purchase common shares at $0.50 per share and 10,000 restricted common shares granted for each quarter of service as a Director; includes option to Ronald Abernathy to purchase 50,000 shares at $0.50 per share.

Section 16(A) beneficial ownership reporting compliance

Section 16(a) of the Securities Exchange Act of 1934 requires the company's directors, executive officers and persons who own beneficially more than ten percent of our common stock, to file reports of ownership and changes of ownership with the SEC. Based solely on the reports received by the company and on written representations from certain reporting persons, we believe that the directors, executive officers and greater than ten percent beneficial owners have complied with all applicable filing requirements.

Information on Equity Compensation Plans is noted in "Item 5. Equity Compensation Plans" above.

ITEM 12. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

Other than as disclosed below, none of the Company's present directors, officers or principal shareholders, nor any family member of the foregoing, nor, to the best of the Company's information and belief, any of its former directors, senior officers or principal shareholders, nor any family member of such former directors, officers or principal shareholders, has or had any material interest, direct or indirect, in any transaction, or in any proposed transaction which has materially affected or will materially affect the Company.

Accrued Salaries and other Expenses to Officers and Directors

During the year ended December 31, 2006 and 2005, the Company had incurred the following charges with directors and officers of the Company or companies with common directors:

	2005	2004
General and Administrative	$	$
Accounting		
	255,800	260,950
Consulting	(1)	(1)
Rent		
Salaries		
	$ 255,800	$ 260,950

(1) Includes payments made or owing to Digital Crossing, LLC, pursuant to consulting agreement. Kenneth Pinckard is an employee or consultant of Digital Crossing. The Company has no information concerning how much compensation Mr. Pinckard received from Digital Crossing relating to the services rendered by him to the Company.

These charges were measured by the exchange amount, which is the amount agreed upon by the transacting parties and include amounts paid to persons who were officers or directors of the Company or any of its affiliates at any time during the respective fiscal years, even amounts paid prior to the time when they may have taken office.

Future Transactions

All future affiliated transactions are expected to be made or entered into on terms that are no less favorable to the Company than those that can be obtained from any unaffiliated third party. A majority of the independent, disinterested members of the Company's Board of Directors are asked to approve future affiliated transactions. The Company believes that of the transactions described above have been on terms as favorable to it as could have been obtained from unaffiliated third parties as a result of arm's length negotiations.

Conflicts of Interest

In accordance with the laws applicable to the Company, its directors are required to act honestly and in good faith with a view to the Company's best interests. In the event that a conflict of interest arises at a meeting of the Board of Directors, a director who has such a conflict is expected to disclose the nature and extent of his interest to those present at the meeting and to abstain from voting for or against the approval of the matter in which he has a conflict.

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ITEM 13. EXHIBITS.

Regulation S-B Number	Exhibit
2.1	Agreement of Share Exchange and Plan of Reorganization dated November 4, 2003 (1)
3.1	Articles of Incorporation of Amexan, Inc (2)
3.2	Articles of Amendment of Articles of Incorporation of Amexan, Inc. (2)
3.3	Articles of Amendment of Articles of Incorporation of Nostalgia Motors, Inc. (3)
3.4	Articles of Amendment of Articles of Incorporation of Elution Technologies, Inc. (4)
3.5	Articles of Amendment of Articles of Incorporation of Tankless Systems Worldwide, Inc.
3.6	Bylaws, as Amended (5)
4.1	Form of Notes issued in 2004 and 2005 Private Placement Offerings
10.1	2003 Stock Incentive Plan (6)
10.2	2003 Stock Incentive Plan #2 (7)
10.3	2005 Stock Incentive Plan (8)
10.4	Manufacturing Services Agreement between Jabil Circuit, Inc., and Skye International, Inc. (9)
10.5	Consulting Agreement between Skye International, Inc., and Sundance Financial Corp, including amendments
10.6	Consulting Agreement between Skye International, Inc., and Digital Crossing, LLC, including amendments
10.7	Stock Option Agreement between Skye International, Inc., and Sundance Financial Corp., including amendments
10.8	Stock Option Agreement between Skye International, Inc., and Digital Crossing, LLC, including amendments
10.9	Personal Services Consulting Agreement between Skye International, Inc., and Gregg C. Johnson #
10.10	Employment Agreement between Eric Stebbins and Skye International, Inc.
10.11	Separation Agreement between Michael Stebbins and Skye International, Inc.
10.12	Patent Issued May 16, 2006, by the United States Patent and Trademark Office relating to a design of a "Modular Tankless Water Heater" as Patent No. 7,046,922. (10)
10.13	Memorandum of Understanding between Skye and Gregg C. Johnson*#
10.14	Patent Issued August 8, 2006, by the United States Patent and Trademark Office relating to a method for a "Modular Tankless Water Heater" as Patent No. 7,088,915. (11)
10.15	Patent Issued January 16, 2007, by the United States Patent and Trademark Office entitled "Modular Tankless Water Heater Control Circuitry and Method of Operation" as Patent No. 7,164,851 (12)
10.16	
10.17	
14.1	Code of Ethics (13)
16.1	Letter from Shelley International, CPA (14)
16.2	Letter from Semple & Cooper, CPA (15)
21.1	Subsidiaries of Skye International, Inc.
23.1	Consents of Moore and Associates, Chartered *
31.1	Rule 13a-14(a) Certification of Chief Executive Officer and Chief Financial Officer *
32.1	Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 of Chief Executive Officer and Chief Financial Officer *

* Filed with this Annual Report
# Relates to executive compensation

ITEM 13. EXHIBITS. - continued

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(1) Incorporated by reference to the exhibits to the registrant's current report on Form 8-K, filed November 7, 2003.
(2) Incorporated by reference to the exhibits to the registrant's registration statement on Form 10-QSB, filed October 5, 1999.
(3) Incorporated by reference to the exhibits to the registrant's annual report on Form 10-KSB for the fiscal year ended December 31, 2002, filed May 15, 2003
(4) Incorporated by reference to the exhibits to the registrant's quarterly report on Form 10-QSB for the fiscal quarter ended June 30, 2003, filed August 21, 2003.
(5) Incorporated by reference to the exhibits to the registrant's annual report on Form 10-KSB for the fiscal year ended December 31, 2002.
(5) Incorporated by reference to the exhibits to the registrant's current report on Form 8-K, filed February 24, 2006.
(6) Incorporated by reference to the exhibits to the registrant's registration statement on Form S-8, file number 333-108728, filed September 12, 2003.
(7) Incorporated by reference to the exhibits to the registrant's registration statement on Form S-8, file number 333-111348, filed December 19, 2003.
(8) Incorporated by reference to the exhibits to the registrant's registration statement on Form S-8, file number 333-123663, filed March 30, 2005.
(9) Incorporated by reference to the exhibits to the registrant's current report on Form 8-K, filed February 23, 2006
(10) Incorporated by reference to the exhibits to the registrant's current report on Form 8-K, filed May 30, 2006
(11) Incorporated by reference to the exhibits to the registrant's current report on Form 8-K, filed August 10, 2006
(12) Incorporated by reference to the exhibits to the registrant's current report on Form 8-K, filed January 17, 2007
(13) Incorporated by reference to the exhibits to the registrant's annual report on Form 10-KSB for the fiscal year ended December 31, 2003, filed April 22, 2004.
(14) Incorporated by reference to the exhibits to the registrant's current report on Form 8-K/A, filed March 7, 2006.
(15) Incorporated by reference to the exhibits to the registrant's current report on Form 8-K, filed July 23, 2006.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES.

On February 24, 2006, Shelley International, CPA ("Shelley") withdrew as the registrant's independent registered public accounting firm, since the firm's principal retired. Shelley had audited the Company's financial statements for the fiscal years ended December 31, 2004 and 2003. On February 24, 2006, Semple & Cooper, LLP was engaged to serve as the Company's independent public accountants for the fiscal year ending December 31, 2005. On June 2, 2006, Semple and Cooper, LLP, withdrew as auditor for the Company and Moore and Associates, Chartered was engaged to serve as the Company's independent public accountants for the fiscal year ended December 31, 2005 and with respect to the restatement of financial statements for the fiscal year ended December 31, 2004.

Audit Fees

Moore and Associates, Chartered, is expected to bill $7,500 for the audit of the 2006 annual financial statement. For the fiscal year ended December 31, 2005, Moore and Associates, Chartered billed $7,500 for the 2005 annual audit and $7,500 for the review of the 1st, 2nd and 3rd quarter financial statements. Shelley international billed $10,000 for the audit of the annual financial statements for the fiscal year ended December 31, 2004 and $18,000 for the review of Form 10-QSB filings during the 2004 period; and $5,200 in connection with the restatement of the financial statements for the fiscal year ended December 31, 2004.

Audit-Related Fees

There were no fees billed for services reasonably related to the performance of the audit or review of our financial statements outside of those fees disclosed above under “Audit Fees” for fiscal years 2005 and 2004.

Tax Fees

There were no fees billed for tax compliance, tax advice, and tax planning services for the fiscal years ended December 31, 2006 and 2005.

All Other Fees

There were no fees billed for other services for the fiscal years ended December 31, 2006 and 2005.

Pre-Approval Policies and Procedures

Prior to engaging the accountants or auditors to perform a particular service, the Company’s Board of Directors obtains an estimate for the service to be performed. The Board in accordance with Company procedures approved all of the services described above.

SIGNATURES

In accordance with Section 13 or 15(d) of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

SKYE INTERNATIONAL, INC.

Date: April 2, 2007

By: /s/ Ronald O. Abernathy

Ronald O. Abernathy
Title Chief Executive Officer

In accordance with the Exchange Act, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Signature	**Title**	**Date**
/s/ Ronald O. Abernathy Ronald O. Abernathy	Chief Executive Officer, Treasurer and Chief Financial Officer	April 2, 2007
/s/ Mark D. Chester Mark D. Chester	Director and Chairman	April 2, 2007
/s/ Perry D. Logan Perry D. Logan	Director	April 2, 2007
/s/ Thadeus (Ted) F. Marek Thadeus (Ted) F. Marek	Director	April 2, 2007
/s/ Wesley G. Sprunk Wesley G. Sprunk	Director	April 2, 2007
/s/ Barry M. Goldwater, Jr. Barry M. Goldwater, Jr.	Director	April 2, 2007

ANNEX A

SKYE INTERNATIONAL, INC., AND SUBSIDIARIES

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

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MOORE & ASSOCIATES, CHARTERED
ACCOUNTANTS AND ADVISORS
PCAOB REGISTERED

CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

We consent to the use, in the statement on Form 10KSB of Skye International Inc and Subsidiaries, of our report dated April 6, 2007 on our audit of the financial statements of Skye International Inc and Subsidiaries as of December 31, 2006 and 2005, and the related statements of operations, stockholders' equity and cash flows for the years then ended, and the reference to us under the caption "Experts."

/s/ Moore & Associates, Chartered
Moore & Associates Chartered
Las Vegas, Nevada
April 6, 2007

2675 S. Jones Blvd. Suite 109, Las Vegas, NV 89146 (702)253-7511 Fax (702)253-7501

MOORE & ASSOCIATES, CHARTERED
ACCOUNTANTS AND ADVISORS
PCAOB REGISTERED

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors
Skye International Inc
Las Vegas, Nevada

We have audited the accompanying balance sheets of Skye International Inc as of December 31, 2006, and the related statements of operations, stockholders' equity and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Skye International Inc as of December 31, 2006 and the results of its operations and its cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note 7 to the financial statements, the Company's net losses and accumulated deficit of $12,527,800 as of December 31, 2006 and working capital deficit of $3,185,115 as of December 31, 2006 raises substantial doubt about its ability to continue as a going concern. Management's plans concerning these matters are also described in Note 7. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

/s/ Moore & Associates Chartered

Moore & Associates Chartered
Las Vegas, Nevada
April 6, 2007

2675 S. Jones Blvd. Suite 109, Las Vegas, NV 89146 (702) 253-7511 Fax (702) 253-7501

Skye International, Inc. and Subsidiaries
CONSOLIDATED BALANCE SHEETS

		December 31, 2006		December 31 2005
ASSETS				
CURRENT ASSETS				
Cash	$	8,672	$	2,711
Accounts Receivable, net		-		2,773
Inventory		163,062		25,069
Prepaid Expenses		99,379		757
Total Current Assets		271,113		31,310
EQUIPMENT, NET		43,921		56,626
OTHER ASSETS				
Deposits		-		20,000
Total Other Assets		-		20,000
Total Assets	$	315,034	$	107,936
LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIT)				
LIABILITIES				
Accounts Payable	$	2,160,624	$	234,557
Accrued Expenses		31,132		870,914
Notes Payable		1,053,615		1,118,241
Accrued Interest Payable		72,917		81,626
Warranty Accrual		34,570		34,570
Customer Deposits		103,371		103,371
		3,456,228		2,443,279
Total Liabilities		3,456,228		2,443,279
STOCKHOLDERS' EQUITY				
Common Stock: 100,000,000 shares authorized at $0.001par value;				
Issued and outstanding 21,622,243 and 17,838,231 shares, respectively		21,622		17,838
Common Stock Subscribed		108,675		275,000
Paid in Capital		9,256,308		7,436,333
Accumulated Deficit		(12,527,800)		(10,064,513)

Total Stockholders' Equity (Deficit)		(3,141,194)		(2,335,342)
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY (DEFICIT)	$	315,034	$	107,937

The accompanying notes are an integral part of these statements.

Skye International, Inc. and Subsidiaries

CONSOLIDATED STATEMENTS OF OPERATIONS

	Years Ended December 31, 2006	2005				
REVENUES						
Product Sales	$ 2,071	$ 172,169				
Other Income	194,269	255				
Total Revenues	196,341	172,424				
	(5)	712	(7)	1,394	(12)	
Total temporarily impaired	$ 9,252	$ (16)	$16,074	$(282)	$25,326	$(298)
June 30, 2014						
Description of Securities						
Mortgage-backed securities	$ —	$ —	$16,404	$(376)	$16,404	$(376)
Collateralized mortgage obligations (residential)	12,636	(14)	1,598	(9)	14,234	(23)
Total temporarily impaired	$ 12,636	$ (14)	$18,002	$(385)	$30,638	$(399)

The Company evaluates securities for other-than-temporary impairment at least on a quarterly basis, and more frequently when economic or market concerns warrant such evaluation. Consideration is given to the length of time and the extent to which the fair value has been less than cost, the financial condition and near-term prospects of the issuer, and the Company does not have the intent to sell these securities and it is not more likely than not that it will be required to sell the securities before their anticipated recovery. In analyzing an issuer's financial condition, the Company may consider whether the securities are issued by the federal government or its agencies, whether downgrades by bond rating agencies have occurred, and the results of reviews of the issuer's financial condition.

At December 31, 2014, eight debt securities had an aggregate unrealized loss of 1.4% of the Company's amortized cost basis. At June 30, 2014, ten debt securities had an unrealized loss of 1.3% of the Company's amortized cost basis. We do not own any non-agency mortgage-backed securities ("MBSs") or collateralized mortgage obligations ("CMOs"). All MBSs and CMOs were issued

by a wholly-owned government corporation, Ginnie Mae, or U.S. government-sponsored enterprises and agencies, including Fannie Mae and Freddie Mac, institutions which the government has affirmed its commitment to support. The unrealized losses relate principally to the general change in interest rates and liquidity, and not credit quality, that has occurred since the securities' purchase dates, and such unrecognized losses or gains will continue to vary with general interest rate level fluctuations in the future. As management has the intent and ability to hold debt securities until recovery, which may be maturity, and it is not more likely than not that it will be required to sell the securities before their anticipated recovery, no declines in fair value are deemed to be other-than-temporary as of December 31, 2014 and June 30, 2014.

At December 31, 2014 and June 30, 2014, there were no investments in any one issuer, other than the U.S. Government and its agencies, in an amount greater than 10% of stockholders' equity.

Note 5 – Loans

The composition of loans consists of the following:

	December 31, 2014	June 30, 2014
	(Dollars in thousands)	
Real Estate:		
One-to-four family residential	$278,501	$288,960
Multi-family residential	313,270	335,040
Commercial real estate	31,477	38,062
	623,248	662,062
Consumer:		
Automobile	48,351	45,686
Home equity	607	625
Other consumer loans, primarily unsecured	12,323	11,481
	61,281	57,792
Total loans	684,529	719,854
Deferred net loan origination costs	44	213
Net premium on purchased loans	220	263
Allowance for loan losses	(3,914)	(4,580)
Loans receivable, net	$680,879	$715,750

Loans held for sale totaled $2.0 million as of December 31, 2014 as compared to $3.7 million as of June 30, 2014. Loans held for sale are recorded at the lower of cost or fair value. Fair value, if lower than cost, is determined by outstanding commitments from the investor. Proceeds from sales of loans held for sale were $19.3 million and $17.0 million during the six months ended December 31, 2014 and 2013, resulting in net gain on sales of $311,000 and $330,000, respectively.

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The following is an analysis of the changes in the allowance for loan losses:

	Allowance for loan losses for the Three months ended December 31, 2014						
	One-to-four family	Multi-family residential	Commercial real estate	Automobile	Home equity	Other	Total
	(Dollars in thousands)						
Balance, beginning of period	$2,151	$ 722	$ 1,103	$253	$2	$99	$4,330
Provision for loan losses	(217)	(145)	(153)	50	—	65	(400)
Recoveries	—	—	—	15	—	5	20
Loans charged-off	—	—	—	(21)	—	(15)	(36)
Balance, end of period	$1,934	$ 577	$950	$297	$2	$154	$3,914

	Allowance for loan losses for the Three months ended December 31, 2013						
	One-to-four family	Multi-family residential	Commercial real estate	Automobile	Home equity	Other	Total
	(Dollars in thousands)						
Balance, beginning of period	$2,628	$ 1,287	$ 1,408	$112	$4	$48	$5,487
Provision for loan losses	(247)	(94)	(222)	27	(1)	237	(300)
Recoveries	6	—	—	20	—	2	28
Loans charged-off	—	(131)	—	(36)	—	(9)	(176)
Balance, end of period	$2,387	$ 1,062	$ 1,186	$123	$3	$278	$5,039

	Allowance for loan losses for the Six Months Ended December 31, 2014						
	One-to-four family	Multi-family residential	Commercial real estate	Automobile	Home equity	Other	Total
	(Dollars in thousands)						
Balance, beginning of period	$2,300	$ 993	$ 1,051	$136	$2	$98	$4,580
Provision for loan losses	(366)	(416)	(354)	282	—	104	(750)
Recoveries	—	—	253	17	—	8	278
Loans charged-off	—	—	—	(138)	—	(56)	(194)
Balance, end of period	$1,934	$ 577	$950	$297	$2	$154	$3,914

	Allowance for loan losses for the Six Months Ended December 31, 2013						
	One-to-four family	Multi-family residential	Commercial real estate	Automobile	Home equity	Other	Total
	(Dollars in thousands)						
Balance, beginning of period	$3,009	$ 839	$ 1,654	$83	$4	$54	$5,643
Provision for loan losses	(599)	454	(469)	74	(1)	241	(300)

Recoveries	10	—	1	28	—	3	42
Loans charged-off	(33)	(231)	—	(62)	—	(20)	(346)
Balance, end of period	$2,387	$ 1,062	$1,186	$123	$3	$278	$5,039

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The following tables present the balance in the allowance for loan losses and the recorded investment in loans by portfolio segment and based on impairment method as of December 31, 2014 and June 30, 2014:

December 31, 2014	One-to-four family (Dollars in thousands)	Multi-family residential	Commercial real estate	Automobile	Home equity	Other	Total
Allowance for loan losses:							
Ending allowance balance attributed to loans:							
Individually evaluated for impairment	$673	$—	$40	$—	$—	$6	$719
Collectively evaluated for impairment	1,261	577	910	297	2	148	3,195
Total ending allowance balance	$1,934	$577	$950	$297	$2	$154	$3,914

	One-to-four family	Multi-family residential	Commercial real estate	Automobile	Home equity	Other	Total
Loans:							
Individually evaluated for impairment	$11,693	$1,214	$2,501	$—	$—	$6	$15,414
Collectively evaluated for impairment	266,808	312,056	28,976	48,351	607	12,317	669,115
Total ending loan balance	$278,501	$313,270	$31,477	$48,351	$607	$12,323	$684,529

June 30, 2014	One-to-four family (Dollars in thousands)	Multi-family residential	Commercial real estate	Automobile	Home equity	Other	Total
Allowance for loan losses:							
Ending allowance balance attributed to loans:							
Individually evaluated for impairment	$910	$—	$52	$2	$—	$15	$979
Collectively evaluated for impairment	1,390	993	999	134	2	83	3,601
Total ending allowance balance	$2,300	$993	$1,051	$136	$2	$98	$4,580

	One-to-four family	Multi-family residential	Commercial real estate	Automobile	Home equity	Other	Total
Loans:							
Individually evaluated for impairment	$12,431	$1,263	$3,506	$2	$—	$15	$17,217
Collectively evaluated for impairment	276,529	333,777	34,556	45,684	625	11,466	702,637
Total ending loan balance	$288,960	$335,040	$38,062	$45,686	$625	$11,481	$719,854

A loan is impaired when it is probable, based on current information and events, the Company will be unable to collect all contractual principal and interest payments due in accordance with the terms of the loan agreement. When it is determined that a loss is probable, a valuation allowance is established and included in the allowance for loan losses. The amount of impairment is determined by the difference between the recorded investment in the loan and the present value of expected cash flows, or estimated net realizable value of the underlying collateral on collateral dependent loans.

The difference between the recorded investment and unpaid principal balance of loans relates to net deferred origination costs, net premiums on purchased loans, charge-offs and interest payments received on impaired loans that are recorded as a reduction of principal. There were no collateral dependent loans measured at fair value with a valuation allowance recorded and $6.9 million impaired loans evaluated based on the loans' present value of expected cash flows with a valuation allowance of $713,000 at December 31, 2014. This compares to no collateral dependent loans measured at fair value with a valuation allowance recorded and $8.6 million impaired loans evaluated based on the loans' present value of expected cash flows with a valuation allowance of $962,000 at June 30, 2014.

The following tables present loans individually evaluated for impairment by class of loans as of December 31, 2014 and June 30, 2014:

December 31, 2014	Unpaid Principal Balance	Recorded Investment	Allowance for Loan Losses Allocated
	(Dollars in thousands)		
With no related allowance recorded:			
Real estate loans:			
One-to-four family	$6,980	$5,910	$ —
Multi-family residential	1,638	1,214	—
Commercial real estate	1,876	1,344	—
	10,494	8,468	—
With an allowance recorded:			
Real estate loans:			
One-to-four family	6,054	5,783	673
Commercial real estate	1,157	1,157	40
Other loans:			
Other	6	6	6
	7,217	6,946	719
Total	$17,711	$15,414	$ 719

June 30, 2014	Unpaid Principal Balance	Recorded Investment	Allowance for Loan Losses Allocated
	(Dollars in thousands)		
With no related allowance recorded:			
Real estate loans:			
One-to-four family	$6,175	$5,035	$ —
Multi-family residential	1,656	1,263	—
Commercial real estate	3,084	2,336	—
	10,915	8,634	—
With an allowance recorded:			
Real estate loans:			
One-to-four family	7,705	7,396	910
Commercial real estate	1,170	1,170	52
Other loans:			
Automobile	2	2	2
Other	15	15	15
	8,892	8,583	979
Total	$19,807	$17,217	$ 979

The following table presents monthly average of individually impaired loans by class for the three and six months ended December 31, 2014 and 2013:

	Three months ended December 31,		Six months ended December 31,	
	2014	2013	2014	2013
	(Dollars in thousands)			
Real estate loan:				
One-to-four family	$11,636	$13,561	$11,901	$13,971
Multi-family residential	1,227	1,921	1,239	1,796
Commercial real estate	2,527	5,744	2,854	5,875
Total	$15,390	$21,226	$15,994	$21,642

Payments received on non-accrual loans are recorded as a reduction of principal. Interest payments collected on non-accrual loans are characterized as payments of principal rather than payments of the outstanding accrued interest on the loans until the remaining principal on the non-accrual loans is considered to be fully collectible. If the loan returns to accrual status, interest income would be recognized based on the effective yield to maturity on the loan and the amount of interest applied to principal will be accreted over the remaining term of the loan.

Foregone interest income, which would have been recorded had the non-accrual loans been current in accordance with their original terms, amounted to $148,000 and $228,000 for the three months ended December 31, 2014 and 2013, respectively, and was not included in the results of operations, of which $116,000 and $155,000, respectively, was collected and applied to the net loan balances. Foregone interest income amounted to $307,000 and $444,000 for the six months ended December 31, 2014 and 2013, respectively, and was not included in the results of operations, of which $261,000 and $306,000, respectively, was collected and applied to the net loan balances.

The following table presents interest payments recorded as reduction of principal on impaired loans by class:

	Three months ended December 31,		Six months ended December 31,	
	2014	2013	2014	2013
	(Dollars in thousands)			
Real estate loan:				
One-to-four family	$69	$102	$151	$195
Multi-family residential	16	28	32	58
Commercial real estate	31	25	78	53
Total	$116	$155	$261	$306

At December 31, 2014 and June 30, 2014, there were no loans past due more than 90 days and still accruing interest.

The following table presents non-accrual loans by class of loans:

Non-accrual loans:	December 31, 2014	June 30, 2014
	(Dollars in thousands)	
Real estate loans:		
One-to-four family	$5,711	$5,390
Multi-family residential	738	781
Commercial	1,344	1,460
Other loans:		
Automobile	—	2
Other	6	15
Total non-accrual loans	$7,799	$7,648

There were nine one-to-four family residential loans totaling $3.2 million, two multi-family loans totaling $737,000, and two commercial real estate loans totaling $1.3 million on non-accrual status that were performing in accordance with their contractual terms at December 31, 2014. There were seven one-to-four family residential loans totaling $2.1 million and two multi-family loans totaling $781,000 on non-accrual status that were performing in accordance with their contractual terms at June 30, 2014.

The following tables present the aging of past due loans by class of loans:

December 31, 2014	30-59 Days Delinquent	60-89 Days Delinquent	90 Days or More Delinquent	Total Delinquent Loans	Total Current Loans	Total Loans
	(Dollars in thousands)					
Real estate loans:						
One-to-four family	$1,374	$160	$967	$2,501	$276,000	$278,501
Multi-family	—	—	—	—	313,270	313,270
Commercial	—	—	—	—	31,477	31,477
Other loans:						
Automobile	261	49	—	310	48,041	48,351
Home Equity	—	—	—	—	607	607
Other	58	20	2	80	12,243	12,323
Total loans	$1,693	$229	$969	$2,891	$681,638	$684,529

June 30, 2014	30-59 Days Delinquent	60-89 Days Delinquent	90 Days or More Delinquent	Total Delinquent Loans	Total Current Loans	Total Loans
	(Dollars in thousands)					
Real estate loans:						
One-to-four family	$2,123	$409	$301	$2,833	$286,127	$288,960
Multi-family	—	—	—	—	335,040	335,040
Commercial	1,061	—	399	1,460	36,602	38,062
Other loans:						
Automobile	113	15	2	130	45,556	45,686
Home Equity	—	—	—	—	625	625
Other	31	4	15	50	11,431	11,481
Total loans	$3,328	$428	$717	$4,473	$715,381	$719,854

Troubled Debt Restructurings:
Troubled debt restructurings totaled $10.2 million and $12.5 million at December 31, 2014 and June 30, 2014, respectively. Troubled debt restructurings of $2.6 million and $2.9 million are included in the non-accrual loans at December 31, 2014 and June 30, 2014. The Bank has allocated $61,000 and $79,000 of valuation allowance to customers whose loan terms have been modified in troubled debt restructurings and were on non-accrual status as of December 31, 2014 and June 30, 2014, respectively. Troubled debt restructured loans are included in non-accrual loans until there is a sustained period of payment performance (usually six months or longer and determined on a case by case basis) and there is a reasonable assurance that the timely payment will continue. During the six months ended December 31, 2014, one troubled debt restructuring with an aggregate outstanding balance of $203,000 was returned to accrual status as a result of the borrower paying the modified terms as agreed for a sustained period of more than six months and the Bank believes there is reasonable assurance that timely payment will continue. This compares to eight troubled debt restructurings returning with an aggregate outstanding balance of $2.8 million that were returned to accrual status during the same period last year. There were no further commitments to customers whose loans were troubled debt restructurings at December 31, 2014 and June 30, 2014.
During the six months ended December 31, 2014 and 2013, there were no new loans that were modified as troubled debt restructurings.
At December 31, 2014 and 2013, there were no loans modified as troubled debt restructurings within the previous 12 months for which there was a payment default. A loan is considered to be in payment default once it is 30 days contractually past due under the modified terms.
The terms of certain other loans were modified during the three and six months ended December 31, 2014 and 2013 that did not meet the definition of a troubled debt restructuring. During the three and six months ended December 31, 2014, seven loans in the amount of $2.7 million and seventeen loans in the amount of $5.8 million were modified and not accounted for as troubled debt restructurings. During the three and six months ended December 31, 2013, ten loans in the amount of $3.1 million and sixteen loans in the amount of $5.4 million were modified and not accounted for as troubled debt restructurings.The modifications were made to refinance the credits to maintain the borrowing relationships and generally consisted of term or rate modifications. The borrowers were not experiencing financial difficulty or delay in loan payments and the modifications were made at market terms.
In order to determine whether a borrower is experiencing financial difficulty, an evaluation is performed of the probability that the borrower will be in payment default on any of its debt in the foreseeable future without the modification. This evaluation is performed under the Company’s internal underwriting policy.
Credit Quality Indicators
The Company categorizes loans into risk categories based on relevant information about the ability of the borrowers to service their debt such as: current financial information, historical payment experience, credit documentation and current economic trends among other factors. This analysis is performed monthly. The Company uses the following definitions for risk ratings:
Special Mention. Loans are classified as special mention when it is determined a loan relationship should be monitored more closely. Loans that are 60 days to 89 days past due are generally classified as special mention. In addition, loans are classified as special mention for a variety of reasons including changes in recent borrower financial conditions, changes in borrower operations, changes in value of available collateral, concerns regarding changes in economic conditions in a borrower’s industry, and other matters. A loan classified as special mention in many instances may be performing in accordance with the loan terms.

Substandard. Loans that are 90 days or more past due are generally classified as substandard. A loan is also considered substandard if it is inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Substandard assets include those characterized by the distinct possibility that the insured institution will sustain some loss if the deficiencies are not corrected.
Doubtful. Assets classified as doubtful have all of the weaknesses inherent in those classified substandard with the added characteristic that the weaknesses present make collection or liquidation in full highly questionable and

improbable.

Loss. Assets classified as loss are considered uncollectible and of such little value that continuance as an asset, without establishment of a valuation allowance individually evaluated or charge-off, is not warranted.

Loans not meeting the criteria as part of the above described process are considered to be Pass rated loans. Pass rated loans are generally well protected by the current net worth and paying capacity of the obligor or by the value of the underlying collateral. Pass rated assets are not more than 59 days past due and are generally performing in accordance with the loan terms.

As of December 31, 2014 and June 30, 2014, and based on the most recent analysis performed, the risk category of loans by class of loans is as follows:

December 31, 2014	Pass	Special Mention	Substandard	Doubtful	Loss
	(Dollars in thousands)				
Real estate loans:					
One-to-four family	$263,379	$8,477	$6,645	$—	$—
Multi-family	309,791	2,300	1,179	—	—
Commercial	19,272	2,959	9,246	—	—
Other loans:					
Automobile	47,909	235	162	45	—
Home equity	607	—	—	—	—
Other	12,240	18	12	47	6
Total loans	$653,198	$13,989	$17,244	$92	$6

June 30, 2014	Pass	Special Mention	Substandard	Doubtful	Loss
	(Dollars in thousands)				
Real estate loans:					
One-to-four family	$272,261	$10,257	$6,442	$—	$—
Multi-family	327,999	3,174	3,867	—	—
Commercial	24,708	7,556	5,798	—	—
Other loans:					
Automobile	45,542	87	55	—	2
Home equity	625	—	—	—	—
Other	11,455	8	2	1	15
Total loans	$682,590	$21,082	$16,164	$1	$17

Note 6 - Real Estate Owned

Changes in real estate owned are summarized as follows:

	Six months ended December 31, 2014	December 31, 2013
	(Dollars in thousands)	
Beginning of period	$284	$—
Transfers in	306	539
Capitalized expenditures	—	70
Sales	(590)	(325)
End of period	$—	$284

Net income (expenses) related to foreclosed assets are as follows and are included in net operating expense:

	Six months ended December 31, 2014	December 31, 2013
	(Dollars in thousands)	
Net gain on sales	$181	$4
Net operating expense	(13)	(19)
Total	$168	$(15)

The company has no valuation allowance or activity in the valuation allowance account during the six months ended December 31, 2014 and 2013.

Note 7 – Federal Home Loan Bank Advances

FHLB advances were $65.0 million and $85.0 million at December 31, 2014 and June 30, 2014, respectively. At December 31, 2014, the stated interest rates on the Bank's advances from the FHLB ranged from 0.82% to 2.43% with a weighted average stated rate of 1.80%. At June 30, 2014, the stated interest rates on the Bank's advances from the FHLB ranged from 0.82% to 2.43% with a weighted average stated rate of 1.57%.

The contractual maturities by fiscal year of the Bank's FHLB advances over the next five years and thereafter are as follows:

Fiscal Year of Maturity	December 31, 2014	June 30, 2014
	(Dollars in thousands)	
2015	$—	$20,000
2016	—	—
2017	25,000	25,000
2018	10,000	10,000
2019	30,000	30,000
Total	$65,000	$85,000

Note 8 – Change in Accumulated Other Comprehensive Loss

Accumulated other comprehensive income includes unrealized gains and losses on securities available-for-sale and actuarial gains and losses, net periodic benefit costs and benefits paid for postretirement medical benefit. Changes in accumulated other comprehensive income are presented net of tax effect as a component of equity. Reclassifications out of accumulated other comprehensive income are recorded on the consolidated statement of income either as a noninterest income or expense.

The following tables present a summary of the accumulated other comprehensive income balances, net of tax, fro the three and six months ended December 31, 2014 and 2013.

	Three Months Ended December 31, 2014		
	Unrealized gains and losses on securities available-for-sale	Postretirement medical benefits costs items	Total
	(Dollars in thousands)		
Balance at beginning of period	$(172)	$(85)	$(257)
Other comprehensive income (loss) before reclassifications	202	(8)	194
Amounts reclassified from accumulated other comprehensive income	—	8	8
Tax effect of current period changes	(83)	—	(83)
Net current period other comprehensive income	119	—	119
Balance at end of period	$(53)	$(85)	$(138)

	Three Months Ended December 31, 2013		
	Unrealized gains and losses on securities available-for-sale	Postretirement medical benefits costs items	Total
	(Dollars in thousands)		
Balance at beginning of period	$(307)	$(129)	$(436)
Other comprehensive loss before reclassifications	(330)	(17)	(347)
Amounts reclassified from accumulated other comprehensive income	—	17	17
Tax effect of current period changes	135	—	135
Net current period other comprehensive loss	(195)	—	(195)
Balance at end of period	$(502)	$(129)	$(631)

	Six Months Ended December 31, 2014		
	Unrealized gains and losses on securities available-for-sale	Postretirement medical benefits costs items	Total
	(Dollars in thousands)		
Balance at beginning of period	$(139)	$(85)	$(224)
Other comprehensive income (loss) before reclassifications	147	(21)	126
Amounts reclassified from accumulated other comprehensive income	—	21	21
Tax effect of current period changes	(61)	—	(61)
Net current period other comprehensive income	86	—	86
Balance at end of period	$(53)	$(85)	$(138)

	Six Months Ended December 31, 2013		
	Unrealized gains and losses on securities	Postretirement medical benefits costs items	Total

	available-for-sale (Dollars in thousands)		
Balance at beginning of period	$(362)	$(129)	$(491)
Other comprehensive loss before reclassifications	(237)	(35)	(272)
Amounts reclassified from accumulated other comprehensive income	—	35	35
Tax effect of current period changes	97	—	97
Net current period other comprehensive loss	(140)	—	(140)
Balance at end of period	$(502)	$(129)	$(631)

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Note 9 – Repurchase of Common Stock

On February 27, 2014 the Company announced that its Board of Directors authorized the sixth stock repurchase program pursuant to which the Company intends to repurchase up to 5% of its issued and outstanding shares, or up to approximately 374,393 shares. Since November 2011, the Company has repurchased 2,312,765 shares under stock repurchase programs. The shares were repurchased at prices ranging from $12.00 to $17.90 per share with a weighted average cost of $15.02 per share. At December 31, 2014, there were 240,079 shares remaining to be repurchased under the sixth authorized stock repurchase program. For the six months ended December 31, 2014, the Company did not repurchase any shares.

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Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Forward-Looking Statements

This Quarterly Report on Form 10-Q contains certain forward-looking statements and information relating to the Company and the Bank that are based on the beliefs of management as well as assumptions made by and information currently available to management. Forward-looking statements can be identified by the fact that they do not relate strictly to historical or current facts. They often include words like "believe," "expect," "anticipate," "estimate," and "intend" o future or conditional verbs such as "will," "should," "could," or "may" and similar expressions or the negative thereof. Certain factors that could cause actual results to differ materially from expected results include, changes in the interest rate environment, changes in general economic conditions, legislative and regulatory changes that adversely affect the business of Simplicity Bancorp, Inc. and Simplicity Bank, and changes in the securities markets. Should one or more of these risks or uncertainties materialize or should underlying assumptions prove incorrect, actual results may vary materially from those described herein. We caution readers not to place undue reliance on forward-looking statements. The Company disclaims any obligation to revise or update any forward-looking statements contained in this Form 10-Q to reflect future events or developments.

Market Area

Our success depends primarily on the general economic conditions in the California counties of Los Angeles, Orange, San Diego, San Bernardino, Riverside, Santa Clara and Alameda, as nearly all of our loans are to customers in this market area. There have been positive developments in current economic conditions in our market area since the end of the recession. Improving financial conditions, increasing credit availability, accommodative monetary policy, and healthier labor and housing markets all support the economic growth in our market area. According to the Beige Book published by the Federal Reserve in January 2015, economic activity in the U.S. continued to expand at a modest to moderate pace from mid-November 2014 to late-December 2014. In the Twelfth Federal Reserve District (San Francisco), activity in real estate markets advanced, mainly in the commercial construction sector. The pace of new single-family home construction increased modestly with relatively more activity in urban areas than in rural areas. Multifamily residential real estate construction activity was strong; retail, office, industrial, or infrastructure projects also were widespread. Lending activity was mixed and the increase in loan demand was mostly in the construction segment. Overall loan demand remained somewhat weak. Stiff competition for high-quality borrowers exerted downward pressure on loan interest rates, and declines in net interest margins were widespread in our market area. Compressed margins contributed to increased acquisitions as smaller banks combined in order to reduce operating costs. Future growth opportunities will be influenced by the stability of the nation and the regional economy and other trends within California, including unemployment rates and housing market conditions.

Sustained employment gains have helped to lower the unemployment rate. This has brought unemployment closer to the estimate of full employment levels, although the labor force still exhibits considerable slack. In particular, California continues to experience elevated unemployment rates as compared to the national average. Unemployment rates in California decreased from 7.4% in June 2014 to 7.0% in December 2014. This compares to the national unemployment rate which trended down from 6.1% in June 2014 to 5.6% in September 2014.

Comparison of Financial Condition at December 31, 2014 and June 30, 2014.

Assets. Total assets declined 1.8% to $863.2 million at December 31, 2014 from $879.2 million at June 30, 2014 due primarily to a decrease in gross loans receivable and securities available-for-sale, partially offset by an increase in cash and cash equivalents.

Cash and cash equivalents increased by $25.4 million, or 36.7%, to $94.7 million at December 31, 2014 from $69.3 million at June 30, 2014. The increase was primarily due to principal repayments of loans and securities and an increase in deposits.

Securities available-for-sale decreased by $5.3 million, or 9.3%, to $51.6 million at December 31, 2014 from $56.9 million at June 30, 2014 due to principal repayments of existing securities.

Gross loans receivable decreased by $35.3 million, or 4.9%, to $684.5 million at December 31, 2014 from $719.9 million at June 30, 2014. The decrease was primarily attributable to loan principal repayments and payoffs, offset in

part by organic growth in consumer loans. Multi-family loans decreased $21.8 million, or 6.5%, to $313.3 million at December 31, 2014 from $335.0 million at June 30, 2014 due to principal repayments and payoffs outpacing new loan originations during the six months ended December 31, 2014. Commercial real estate loans decreased $6.6 million, or 17.3%, to $31.5 million at December 31, 2014 from $38.1 million at June 30, 2014 due to principal repayments and payoffs as there have been no new commercial real estate loan originations during the six months ended December 31, 2014. One-to-four family residential real estate loans decreased $10.5 million, or 3.6%, to $278.5 million at December 31, 2014 from $289.0 million at June 30, 2014 due primarily to principal repayments and payoffs and sales of newly originated conforming fixed rate loans held for sale in the secondary market. Consumer loans

which were comprised primarily of automobile loans totaling $48.4 million and unsecured loans totaling $8.7 million increased $3.5 million, or 6.0%, to $61.3 million at December 31, 2014 from $57.8 million at June 30, 2014 due to $12.8 million and $6.2 million in automobile and unsecured loan originations, respectively, during the six months ended December 31, 2014.

The allowance for loan losses decreased by $666,000, or 14.5%, to $3.9 million at December 31, 2014 from $4.6 million at June 30, 2014 due primarily to a lower level of classified and criticized loans and a decline in net charge-offs and historical loss factors on loans collectively evaluated for impairment. Non-performing assets decreased to $7.8 million, or 0.90% of total assets at December 31, 2014 as compared to $7.9 million, or 0.90% of total assets at June 30, 2014.

Deposits. Total deposits increased $3.4 million, or 0.5%, to $656.3 million at December 31, 2014 from $652.8 million at June 30, 2014. The increase was comprised of a $5.6 million increase in interest-bearing deposits and a $2.2 million decrease in non-interest bearing demand deposits.

The increase in interest bearing deposits was primarily attributable to a $37.0 million, or 45.2%, increase in interest-bearing checking from $81.8 million at June 30, 2014 to $118.7 million at December 31, 2014. The increase was partially offset by a $15.5 million, or 11.21%, decrease in money market accounts from $138.2 million at June 30, 2014 to $122.7 million at December 31, 2014, a $10.3 million, or 8.2%, decrease in savings accounts from $125.8 million at June 30, 2014 to $115.5 million at December 31, 2014, and a $5.5 million, or 2.2%, decrease in certificates of deposit from $246.5 million at June 30, 2014 to $241.0 million at December 31, 2014. The growth in interest-bearing checking balances was due primarily to the Company's marketing strategy to promote interest-bearing checking deposits with enhanced features to deepen customer relationships. The decrease in certificates of deposit was attributable to non-relationship customers seeking higher yields at other financial institutions as accounts repriced to lower offering rates. The decline in money market balances was attributable to the promotion of interest-bearing checking accounts. Savings accounts decreased primarily due to the seasonality of Holiday Club accounts and the discontinuation of certain savings products which traditionally had higher intrerest rates. The change in deposit mix was consistent with the Company's strategic decision to promote interest-bearing checking deposits to attract relationship customers in our target markets while reducing our reliance on time deposits by competing less aggressively on time deposit interest rates.

Borrowings. FHLB advances decreased to $65.0 million at December 31, 2014 as compared to $85.0 million at June 30, 2014 due to the payoff of a $20.0 million scheduled maturity in a lower costing FHLB advance. The weighted average cost of FHLB advances was 1.80% at December 31, 2014 as compared to 1.57% at June 30, 2014.

Stockholders’ Equity. Total stockholders’ equity, represented 16.0% of total assets and increased to $138.2 million at December 31, 2014 from $136.9 million at June 30, 2014. The increase in stockholders’ equity was primarily attributable to an increase of $2.0 million in net income, partially offset by cash dividends paid of $1.3 million in the six months ended December 31, 2014.

Average Balances, Net Interest Income, Yields Earned and Rates Paid
The following table sets forth certain information for the three months ended December 31, 2014 and 2013, respectively.

	For the three months ended December 31,							
	2014 [1]				2013 [1]			
	Average Balance	Interest	Average Yield/ Cost		Average Balance	Interest	Average Yield/ Cost	
	(Dollars in thousands)							
INTEREST-EARNING ASSETS								
Loans receivable[2]	$687,751	$7,236	4.21	%	$718,515	$8,016	4.46	%
Securities[3]	53,257	190	1.43		47,202	179	1.52	
Federal funds sold	83,678	49	0.23		36,946	22	0.24	
Federal Home Loan Bank stock	5,579	103	7.38		5,962	84	5.64	
Total interest-earning assets	830,265	7,578	3.65		808,625	8,301	4.11	
Noninterest earning assets	39,697				38,272			
Total assets	$869,962				$846,897			
INTEREST-BEARING LIABILITIES								
Interest-bearing checking	$111,580	$217	0.78	%	$14,454	$4	0.11	%
Money market	126,742	70	0.22		163,133	95	0.23	
Savings deposits	120,317	43	0.14		129,108	28	0.09	
Certificates of deposit	243,567	1,020	1.68		259,449	1,153	1.78	
Borrowings	65,000	293	1.80		72,500	287	1.58	
Total interest-bearing liabilities	667,206	1,643	0.99		638,644	1,567	0.98	
Noninterest bearing liabilities	64,865				65,902			
Total liabilities	732,071				704,546			
Stockholders' equity	137,891				142,351			
Total liabilities and stockholders' equity	$869,962				$846,897			
Net interest/spread		$5,935	2.67	%		$6,734	3.12	%
Margin[4]			2.86	%			3.33	%
Ratio of interest-earning assets to interest bearing liabilities	124.44 %				126.62 %			

(1) Yields earned and rates paid have been annualized.
(2) Calculated net of deferred fees, loss reserves and includes non-accrual loans.
(3) Calculated based on amortized cost of held-to-maturity securities and fair value of available-for-sale securities.
(4) Net interest income divided by interest-earning assets.

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The following table sets forth certain information for the six months ended December 31, 2014 and 2013, respectively.

	For the six months ended December 31,					
	2014 [1]			2013 [1]		
	Average Balance	Interest	Average Yield/ Cost	Average Balance	Interest	Average Yield/ Cost
	(Dollars in thousands)					
INTEREST-EARNING ASSETS						
Loans receivable[2]	$699,154	$14,953	4.28 %	$711,907	$16,034	4.50 %
Securities[3]	54,543	394	1.44	48,861	346	1.42
Federal funds sold	76,012	88	0.23	45,476	51	0.22
Federal Home Loan Bank stock	5,579	207	7.42	5,962	164	5.50
Total interest-earning assets	835,288	15,642	3.75	812,206	16,595	4.09
Noninterest earning assets	38,598			37,994		
Total assets	$873,886			$850,200		
INTEREST-BEARING LIABILITIES						
Interest-bearing checking	$104,442	$437	0.84 %	$14,414	$6	0.08 %
Money market	130,472	146	0.22	161,968	187	0.23
Savings deposits	122,115	70	0.11	131,162	60	0.09
Certificates of deposit	244,501	2,055	1.68	265,166	2,418	1.82
Borrowings	70,714	605	1.71	67,143	536	1.60
Total interest-bearing liabilities	672,244	3,313	0.99	639,853	3,207	1.00
Noninterest bearing liabilities	64,095			66,885		
Total liabilities	736,339			706,738		
Stockholders' equity	137,547			143,462		
Total liabilities and stockholders' equity	$873,886			$850,200		
Net interest/spread		$12,329	2.76 %		$13,388	3.09 %
Margin[4]			2.95 %			3.30 %
Ratio of interest-earning assets to interest bearing liabilities	124.25 %			126.94 %		

(1) Yields earned and rates paid have been annualized.
(2) Calculated net of deferred fees, loss reserves and includes non-accrual loans.
(3) Calculated based on amortized cost of held-to-maturity securities and fair value of available-for-sale securities.
(4) Net interest income divided by interest-earning assets.

Comparison of Results of Operations for the Three Months Ended December 31, 2014 and December 31, 2013.
General. Net income for the three months ended December 31, 2014 was $940,000, a decrease of $400,000, or 29.9%, as compared to net income of $1.3 million for the three months ended December 31, 2013. Earnings per basic and diluted common share were $0.13 for the three months ended December 31, 2014, compared to $0.18 for the three months ended December 31, 2013. The decrease in net income was due primarily to decreases in net interest income and noninterest income, partially offset by decreases in noninterest expense and higher reversals in provision for loan losses. Excluding merger related expenses of $251,000, our net income would have been $1.3 million for the three months ended December 31, 2014.
Interest Income. Interest income decreased $723,000, or 8.7%, to $7.6 million for the three months ended December 31, 2014 from $8.3 million for the three months ended December 31, 2013. The decline in interest income was primarily due to decreases in interest and fees on loans.
Interest and fees on loans decreased $780,000, or 9.7%, to $7.2 million for the three months ended December 31, 2014 from $8.0 million for the three months ended December 31, 2013. The primary reason for the decrease was a decline of 25 basis points in the average yield on loans from 4.46% for the three months ended December 31, 2013 to 4.21% for the three months ended December 31, 2014 and a decrease of $30.8 million in the average balance of loans receivable to $687.8 million for the three months ended December 31, 2014 from $718.5 million for the three months ended December 31, 2013. The decrease in the average yield on loans was primarily caused by lower average yields earned on new loan originations and payoffs of higher yielding seasoned loans during the period as a result of the current relatively low interest rate environment. The decrease in the average loan receivable balance was attributable to loan principal repayments, sales and payoffs exceeding new loan originations.
Interest Expense. Interest expense of $1.6 million for the three months ended December 31, 2014 increased slightly by $76,000, or 4.9%, as compared to the same period last year. The increase was primarily a result of a higher average balance of deposits during the three months ended December 31, 2014.
Interest expense on deposits increased $70,000, or 5.5%, to $1.4 million during the three months ended December 31, 2014 as compared to $1.3 million for the same period last year. The primary reason for the increase was an increase of $36.1 million in the average balance of deposits to $602.2 million for the three months ended December 31, 2014 from $566.1 million for the three months ended December 31, 2013 as a result of continued growth from the promotion of the relationship checking product.
Provision for Loan Losses. Provision for loan losses reversal of $400,000 was recorded for the three months ended December 31, 2014 as compared to a $300,000 provision for loan losses reversal for the same period last year. The improvement in the provision during the current period was primarily a result of a lower level of classified and criticized loans and a decline in net charge-offs and loss factors on loans collectively evaluated for impairment. Annualized net charge-offs decreased to 0.01% of average outstanding loans for the three months ended December 31, 2014 as compared to 0.08% of average outstanding loans for the same period last year. Non-performing assets decreased to $7.8 million, or 0.90% of total assets at December 31, 2014 as compared to $7.9 million, or 0.90% of total assets at June 30, 2014. Delinquent loans 60 days or more past due were $1.2 million or 0.18% of total loans at December 31, 2014 as compared to $1.1 million or 0.16% of total loans at June 30, 2014. Loans 30 to 59 days delinquent totaled $1.7 million, or 0.25% of total loans at December 31, 2014, as compared to $3.3 million, or 0.47% of total loans at June 30, 2014. Loans 30 to 59 days delinquent were either criticized or classified assets. Some loans 30 to 59 days delinquent were individually evaluated for impairment and others were collectively evaluated for impairment with additional qualitative adjustments factored in due to loan classification.
The reversal of provision for loan losses for the three months ended December 31, 2014 was comprised of a $217,000 reduction in provision on one-to-four family loans, a $145,000 reduction in provision on multi-family loans, a $153,000 reduction in provision on commercial real estate loans, a $50,000 provision on automobile loans, and a $65,000 provision on other loans. The decrease in provision on one-to-four family residential loans was primarily due to a decline in the overall historical loss factors on one-to-four family loans collectively evaluated for impairment and a decrease in the one-to-four family residential loan balance collectively evaluated for impairment. The decrease in provision on multi-family loans was primarily due to a lower level of criticized and classified multi-family loans as

well as a decline in the overall historical loss factors and balance of multi-family loans collectively evaluated for impairment. The reduction in provision on commercial real estate loans was primarily due to a lower level of criticized and classified commercial real estate loans, a decline in the overall historical loss factors and a reduction in the balance of commercial real estate loans collectively evaluated for impairment.

The increase in provision on automobile loans and other loans was primarily caused by an increase in loss factors and higher balance of unsecured loans collectively evaluated for impairment. The provision reflects management's continuing assessment of the credit quality of the Company's loan portfolio, which is affected by various trends, including current economic conditions.

Noninterest Income. Our noninterest income decreased $98,000, or 7.0%, to $1.3 million for the three months ended December 31, 2014 as compared to $1.4 million for the three months ended December 31, 2013 due primarily to a $42,000 decline in ATM fees and charges resulting from a reduced number of ATMs in service, a $33,000 decline in gains on one-to-four family residential mortgage loans sold reflecting the impact of a lower average loan sale margin and a $14,000 decrease in the fair values of mortgage banking derivative assets.
Noninterest Expense. Our noninterest expense decreased $427,000, or 6.8%, to $5.9 million for the three months ended December 31, 2014 as compared to $6.3 million for the three months ended December 31, 2013 primarily due to decreases in advertising and promotional expenses, professional services expense, and salaries and benefits expense, partially offset by increases in legal fees related to the merger.
Advertising and promotional expenses decreased $275,000, or 81.6%, to $62,000 for the three months ended December 31, 2014 as compared to $337,000 for the same period last year. The decrease was primarily due to the overall reduction in branding and marketing campaign expenses.
Professional services expense decreased $184,000, or 32.7%, to $379,000 for the three months ended December 31, 2014 as compared to $563,000 for the same period last year due to lower expenses in e-Commerce initiatives, management consulting and outsourced risk management services.
Salaries and benefits expense decreased $118,000, or 3.8%, to $3.0 million for the three months ended December 31, 2014 as compared to $3.1 million for the same period last year. The decrease in salaries and benefits expense was due primarily to a decrease in the number of full-time equivalent employees.
Legal fees increased $185,000, or 474.4%, to $224,000 for the three months ended December 31, 2014 as compared to $39,000 for the same period last year. The increases were primarily due to $210,000 in legal fees related to the merger.
Income Tax Expense. Income tax expense increased $30,000, or 3.7%, to $835,000 for the three months ended December 31, 2014 as compared to $805,000 for the three months ended December 31, 2013. The effective tax rates were 47.0% and 37.5% for the three months ended December 31, 2014 and 2013, respectively. This higher effective tax rate for the three months ended December 31, 2014 as compared to the same period last year was primarily the result of non-deductible professional services and legal fees associated with the merger transaction, the termination of the California enterprise zone tax deduction as well as the expiration of California affordable housing tax credits effective January 2014.
Comparison of Results of Operations for the Six Months Ended December 31, 2014 and December 31, 2013.
General. Net income for the six months ended December 31, 2014 was $2.0 million, a decrease of $472,000, or 19.0% as compared to the six months ended December 31, 2013. Earnings per basic and diluted common share were $0.29 for the six months ended December 31, 2014, compared to $0.33 for the six months ended December 31, 2013. The decrease in net income was due primarily to decreases in net interest income and noninterest income, partially offset by decreases in noninterest expense and higher reversals in provision for loan losses. Excluding merger related expenses of $666,000, our net income would have been $2.6 million for the six months ended December 31, 2014.
Interest Income. Interest income decreased $1.0 million, or 5.7%, to $15.6 million for the six months ended December 31, 2014 from $16.6 million for the six months ended December 31, 2013. The decline in interest income was primarily due to decreases in interest and fees on loans.
Interest and fees on loans decreased $1.1 million, or 6.7%, to $15.0 million for the six months ended December 31, 2014 from $16.0 million for the six months ended December 31, 2013. The primary reason for the decrease was a decline of 22 basis points in the average yield on loans from 4.50% for the six months ended December 31, 2013 to 4.28% for the six months ended December 31, 2014 and a decrease of $12.8 million in the average balance of loans receivable to $699.2 million for the six months ended December 31, 2014 from $711.9 million for the six months ended December 31, 2013. The decrease in the average yield on loans was primarily caused by lower average yields earned on new loan originations and payoffs of higher yielding seasoned loans during the period as a result of the current relatively low interest rate environment. The decrease in the average loan receivable balance was attributable to loan principal repayments, sales and payoffs exceeding new loan originations.

Interest Expense. Interest expense increased $106,000, or 3.3% to $3.3 million for the six months ended December 31, 2014 from $3.2 million for the six months ended December 31, 2013. The increase was primarily a result of a higher average balance of deposits and borrowings during the six months ended December 31, 2014.

Interest expense on deposits increased $37,000, or 1.4%, to $2.7 million during the six months ended December 31, 2014. The primarily reason for the increase in interest expense was due to an increase of $28.8 million in the average balance of deposits to $601.5 million for the six months ended December 31, 2014 from $572.7 million for the six months ended December 31, 2013 as a result of continued growth from the promotion of the relationship checking product. The average cost of deposits of 0.90% for the six months ended December 31, 2014 decreased slightly as compared to 0.93% for the six months ended December 31, 2013.

Interest expense on borrowings increased $69,000, or 12.9% to $605,000 during the six months ended December 31, 2014 as compared to $536,000 for the same period last year. The increase was primarily attributable to a 11 basis point increase in the average cost of borrowings from 1.60% for the six months ended December 31, 2013 to 1.71% for the six months ended December 31, 2014 as a result of the maturity of lower costing borrowings as well as an increase of $3.6 million in the average balance of borrowings to $70.7 million for the six months ended December 31, 2014 from $67.1 million for the six months ended December 31, 2013.

Provision for Loan Losses. Provision for loan losses reversal of $750,000 was recorded for the six months ended December 31, 2014 as compared to a $300,000 provision for loan losses reversal for the same period last year. The improvement in the provision during the current period was primarily a result of a lower level of criticized loans and a decline in net charge-offs and loss factors on loans collectively evaluated for impairment. Net recoveries of $84,000 recorded during the six months ended December 31, 2014 resulted in annualized net recoveries of 0.02% of average outstanding loans for the six months ended December 31, 2014 as compared to annualized net charge-offs of 0.09% of average outstanding loans for the same period last year. Non-performing assets decreased to $7.8 million, or 0.90% of total assets at December 31, 2014 as compared to $7.9 million, or 0.90% of total assets at June 30, 2014. Delinquent loans 60 days or more past due was $1.2 million or 0.18% of total loans at December 31, 2014 as compared to $1.1 million or 0.16% of total loans at June 30, 2014. Loans 30 to 59 days delinquent totaled $1.7 million, or 0.25% of total loans at December 31, 2014, as compared to $3.3 million, or 0.47% of total loans at June 30, 2014. Loans 30 to 59 days delinquent were either criticized or classified assets. Some loans 30 to 59 days delinquent were individually evaluated for impairment and others were collectively evaluated for impairment with additional qualitative adjustments factored in due to loan classification.

The reversal of provision for loan losses for the six months ended December 31, 2014 was comprised of a $366,000 reduction in provision on one-to-four family loans, a $416,000 reduction in provision on multi-family residential loans, a $354,000 reduction in provision on commercial real estate loans, a $282,000 provision on automobile loans, and a $104,000 provision on other loans. The decrease in provision on one-to-four family residential loans was primarily due to a decline in the overall historical loss factors on one-to-four family loans collectively evaluated for impairment and a decrease in the one-to-four family residential loan balance collectively evaluated for impairment. The decrease in provision on multi-family loans was primarily due to a lower level of criticized and classified multi-family loans as well as a decline in the overall historical loss factors and balance of multi-family loans collectively evaluated for impairment. The reduction in provision on commercial real estate loans was primarily due to a decline in the overall historical loss factors and a reduction in the balance of commercial real estate loans collectively evaluated for impairment.

The increase in provision on automobile loans and other loans was primarily caused by an increase in loss factors and higher balance of automobile loans and unsecured loans collectively evaluated for impairment. The provision reflects management’s continuing assessment of the credit quality of the Company’s loan portfolio, which is affected by various trends, including current economic conditions.

Noninterest Income. Our noninterest income decreased $167,000, or 5.9%, to $2.7 million for the six months ended December 31, 2014 as compared to $2.9 million for the six months ended December 31, 2013 due primarily to a $167,000 decrease in the fair values of mortgage banking derivative assets, a $71,000 decline in ATM fees and charges due to a reduced number of ATMs in service, partially offset by a $91,000 increase in service charges and fees primarily attributable to higher service charge income on non-interest bearing demand deposits. Management periodically reviews service charge rates to compensate for services provided while still maintaining a competitive position.

Noninterest Expense. Our noninterest expense decreased $621,000, or 4.9%, to $12.0 million for the six months ended December 31, 2014 as compared to $12.6 million for the six months ended December 31, 2013 primarily due to decreases in advertising and promotional expenses, salaries and benefits expense, professional services expense, other operating expense, and an increase in net gains on sales of real estate owned properties, partially offset by increases in legal fees related to the merger.
Advertising and promotional expenses decreased $425,000, or 68.7%, to $194,000 for the six months ended December 31, 2014 as compared to $619,000 for the same period last year. The decrease was primarily due to the overall reduction in branding and marketing campaign expenses.

Salaries and benefits expense decreased $194,000, or 3.2%, to $5.9 million for the six months ended December 31, 2014 as compared to $6.1 million for the same period last year. The decrease in salaries and benefits expense was due primarily to a decrease in the number of full-time equivalent employees.

Professional services expense decreased $26,000, or 2.4%, to $1.0 million for the six months ended December 31, 2014 as compared to $1.1 million for the same period last year due to lower expenses in e-Commerce initiatives, management consulting and outsourced risk management services, partially offset by $258,000 in consulting expense related to the merger.

Other operating expense decreased $110,000, or 12.7%, to $756,000 for the six months ended December 31, 2014 as compared to $866,000 for the same period last year. The decrease was due primarily to lower expenses in travel and conferences, personnel, supplies, subscriptions and training expenses.

REO foreclosure expenses and sales, gains and losses yielded a net gain of $168,000 for the six months ended December 31, 2014 as compared to $15,000 in net expense for the same period last year due to a net gain on the sale of a REO property for $181,000 offset by foreclosure expenses.

Legal fees increased $327,000, or 375.9%, to $414,000 for the six months ended December 31, 2014 as compared to $87,000 for the same period last year. The increases were primarily due to $383,000 in legal fees related to the merger.

Income Tax Expense. Income tax expense increased $317,000, or 21.4% to $1.8 million for the six months ended December 31, 2014 as compared to $1.5 million for the six months ended December 31, 2013. The effective tax rates were 47.1% and 37.3% for the six months ended December 31, 2014 and 2013, respectively. This higher effective tax rate for the six months ended December 31, 2014 as compared to the same period last year was primarily the result of non-deductible professional services and legal fees associated with the merger transaction, the termination of the California enterprise zone tax deduction as well as the expiration of California affordable housing tax credits effective January 2014.

Asset Quality

General. We continue our disciplined lending practices including our strict adherence to a long standing regimented credit culture that emphasizes the consistent application of underwriting standards to all loans. In this regard, we fully underwrite all loans based on an applicant's employment history, credit history and an appraised value of the subject property. With respect to loans we purchase, we underwrite each loan based upon our own underwriting standards prior to making the purchase except for loans purchased with a credit guarantee. The credit guarantee requires the seller to substitute or repurchase any loans sold to the Bank that become 60 days or more delinquent at the Bank's option. The credit quality of the loans purchased in fiscal 2012 was to our satisfaction and did not result in substitution or repurchase of any loans purchased as of December 31, 2014.

The following underwriting guidelines, among other things, have been used by us as underwriting tools to further limit our potential loss exposure:

- All variable rate one-to-four family residential loans are underwritten using the fully indexed rate.
- We only lend up to 80% of the lesser of the appraised value or purchase price for one-to-four family residential loans without private mortgage insurance ("PMI"), and up to 97% with PMI.
- We only lend up to 75% of the lesser of the appraised value or purchase price for multi-family residential loans.
- We only lend up to 65% of the lesser of the appraised value or purchase price for commercial real estate loans.

Additionally, our portfolio has remained strongly anchored in traditional mortgage products. We do not originate or purchase construction and development loans, teaser option-ARM loans, negatively amortizing loans or high loan-to-value loans.

All of our real estate loans are secured by properties located in California. The following tables set forth our real estate loans and non-accrual real estate loans by county:

Real Estate Loans by County as of December 31, 2014

County	One-to-four family	Multi-family residential	Commercial real estate	Total	Percent	
	(Dollars in thousands)					
Los Angeles	$121,753	$278,843	$ 13,095	$413,691	66.37	%
Orange	37,407	9,107	7,757	54,271	8.71	
San Diego	19,754	9,017	—	28,771	4.62	
San Bernardino	21,850	4,570	2,293	28,713	4.61	
Riverside	15,813	2,599	5,746	24,158	3.88	
Santa Clara	14,679	474	—	15,153	2.43	
Alameda	10,121	3,828	436	14,385	2.31	
Other	37,124	4,832	2,150	44,106	7.07	
Total	$278,501	$313,270	$ 31,477	$623,248	100.00	%

Real Estate Loans by County as of June 30, 2014

County	One-to-four family	Multi-family residential	Commercial real estate	Total	Percent	
	(Dollars in thousands)					
Los Angeles	$122,763	$291,414	$ 16,201	$430,378	65.01	%
Orange	39,598	12,999	10,177	62,774	9.48	
San Diego	20,677	9,376	—	30,053	4.54	
San Bernardino	22,276	9,350	3,258	34,884	5.27	

Riverside	15,249	2,636	5,815	23,700	3.58	
Santa Clara	15,814	484	—	16,298	2.46	
Alameda	12,566	3,868	440	16,874	2.55	
Other	40,017	4,913	2,171	47,101	7.11	
Total	$288,960	$335,040	$ 38,062	$662,062	100.00	%

Non-accrual Real Estate Loans By County as of December 31, 2014

County	One-to-four family	Multi-family residential	Commercial real estate	Total	Percent of Non-accrual to Loans in Each Category	
	(Dollars in thousands)					
Los Angeles	$3,042	$—	$ 1,344	$4,386	1.06	%
San Diego	368	—	—	368	1.28	
San Bernardino	314	623	—	937	3.26	
Riverside	256	115	—	371	1.54	
Santa Clara	1,327	—	—	1,327	8.76	
Other	404	—	—	404	0.92	
Total	$5,711	$738	$ 1,344	$7,793	1.25	

Non-accrual Real Estate Loans by County as of June 30, 2014

County	One-to-four family	Multi-family residential	Commercial real estate	Total	Percent of Non-accrual to Loans in Each Category	
	(Dollars in thousands)					
Los Angeles	$2,226	$—	$ 1,460	$3,686	0.86	%
San Diego	658	—	—	658	2.19	
San Bernardino	626	654	—	1,280	3.67	
Riverside	272	127	—	399	1.68	
Santa Clara	1,608	—	—	1,608	9.87	
Total	$5,390	$781	$ 1,460	$7,631	1.15	

Delinquent Loans. The following table sets forth certain information with respect to our loan portfolio delinquencies at the dates indicated.

	Loans Delinquent:					
	60-89 Days		90 Days or More		Total Delinquent Loans	
	Number of Loans	Amount	Number of Loans	Amount	Number of Loans	Amount
	(Dollars in thousands)					
At December 31, 2014						
Real estate loans:						
One-to-four family	1	$160	3	$967	4	$1,127
Other loans:						
Automobile	5	49	—	—	5	49
Other	8	20	3	2	11	22
Total loans	14	$229	6	$969	20	$1,198
At June 30, 2014						
Real estate loans:						
One-to-four family	1	$409	1	$301	2	$710
Commercial	—	—	1	399	1	399
Other loans:						
Automobile	1	15	1	2	2	17
Other	3	4	2	15	5	19
Total loans	5	$428	5	$717	10	$1,145

Delinquent loans 60 days or more past due totaled $1.2 million or 0.18% of total loans at December 31, 2014 as compared to $1.1 million or 0.16% of total loans at June 30, 2014. Delinquent one-to-four family residential loans increased to $1.1 million at December 31, 2014 from $710,000 at June 30, 2014 due to prolonged delinquency of two one-to-four family residential loans which were less than 60 days delinquent as of June 30, 2014. There were no delinquent multi-family loans at December 31, 2014 and June 30, 2014. There were no delinquent commercial real estate loans at December 31, 2014 as compared to $399,000 at June 30, 2014. The delinquent commercial real estate loan of $399,000 at June 30, 2014 was brought current during the six months ended December 31, 2014. There were no real estate loans that were over 90 days delinquent at December 31, 2014 and in the process of foreclosure.

Non-Performing Assets. Non-performing assets consist of non-accrual loans and foreclosed assets. Loans to a customer whose financial condition has deteriorated are considered for non-accrual status whether or not the loan is 90 days and over past due. All loans past due 90 days and over are classified as non-accrual. At the time the loan is placed on non-accrual status, interest previously accrued but not collected is reversed and charged against current income. Payments received on non-accrual loans are recorded as a reduction of principal. Non-accrual loans also include troubled debt restructurings that are on non-accrual status. At December 31, 2014 and June 30, 2014 there were no loans past due more than 90 days and still accruing interest. Included in non-accrual loans were troubled debt restructurings of $2.6 million and $2.9 million as of December 31, 2014 and June 30, 2014, with specific valuation allowances of $61,000 and $79,000 respectively.

During the six months ended December 31, 2014, there were no new loans that were modified as troubled debt restructurings. At December 31, 2014, there were seven non-accrual restructured loans, all of which were one-to-four family residential loans with an aggregate balance of $2.6 million. Of the seven non-accrual restructured loans, five loans with an aggregate balance of $1.9 million were performing in accordance with their revised contractual terms. At June 30, 2014, there were eight non-accrual restructured loans, all of which were one-to-four family residential loans with an aggregate balance of $2.9 million. Of the eight non-accrual restructured loans, three loans with an aggregate outstanding balance of $915,000 were performing in accordance with their revised contractual terms.

Troubled debt restructured loans are included in non-accrual loans until there is a sustained period of payment performance (usually six months or longer and determined on a case by case basis) and there is reasonable assurance that timely payment will continue. During the six months ended December 31, 2014, one troubled debt restructuring with an outstanding balance of $203,000 was returned to accrual status as a result of the borrower paying the modified terms as agreed for a sustained period of more than six

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months and reasonable assurance that timely payment will continue. This compares to eight troubled debt restructurings with an aggregate outstanding balance of $2.8 million that were returned to accrual status during the same period last year. At December 31, 2014 and June 30, 2014, accruing troubled debt restructurings totaled $7.6 million and $9.6 million, respectively. There were no further commitments to customers whose loans were troubled debt restructurings at December 31, 2014 and June 30, 2014.
Any changes or modifications made to loans are carefully reviewed to determine whether they are troubled debt restructurings. The modification of the terms of loans that are reported as troubled debt restructurings included one or a combination of the following: a reduction of the stated interest rate of the loan; an extension of the maturity date at a stated rate of interest lower than the current market rate for new debt with similar risk; or a permanent reduction of the recorded investment in the loan. There are other changes or modifications made for borrowers who are not experiencing financial difficulties. During the three and six months ended December 31, 2014, seven loans in the amount of $2.7 million and seventeen loans in the amount of $5.8 million were modified and not accounted for as troubled debt restructurings. During the three and six months ended December 31, 2013, ten loans in the amount of $3.1 million and sixteen loans in the amount of $5.4 million were modified and not accounted for as troubled debt restructurings. The modifications were made to refinance the credits to maintain the borrowing relationships and generally consisted of term or rate modifications. The borrowers were not experiencing financial difficulty and the modifications were made at market terms.

The following table sets forth the amounts and categories of our non-performing assets at the dates indicated.

	At December 31, 2014		At June 30, 2014	
	(Dollars in thousands)			
Non-accrual loans:				
Real estate loans:				
One-to-four family	$3,077		$2,481	
Multi-family	738		781	
Commercial	1,344		1,460	
Other loans:				
Automobile	—		2	
Other	6		15	
Troubled debt restructurings:				
One-to-four family	2,634		2,909	
Total non-accrual loans	$7,799		$7,648	
Other real estate owned and repossessed assets:				
Real estate:				
One-to-four family	$—		$284	
Total non-performing assets	$7,799		$7,932	
Ratios:				
Non-performing loans to total loans [1]	1.14	%	1.06	%
Non-performing assets to total assets	0.90	%	0.90	%
Total accruing troubled debt restructurings	$7,615		$9,569	

(1) Total loans are net of deferred fees and costs.

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Non-performing loans of $7.8 million, or 1.14% of total loans at December 31, 2014 remained relatively unchanged as compared to $7.6 million or 1.06% of total loans at June 30, 2014.
At December 31, 2014, there were $5.7 million of one-to-four family residential mortgage loans on non-accrual for which valuation allowances individually evaluated totaling $61,000 have been applied. Of the $5.7 million in one-to-four family residential mortgage loans on non-accrual status, the terms or rates of $2.6 million of such loans were modified as troubled debt restructurings.
At December 31, 2014, there were $2.1 million of multi-family residential and commercial real estate loans ("income property") on non-accrual for which no valuation allowances individually evaluated have been applied and were not modified as troubled debt restructurings. Included in the $2.1 million of income property loans on non-accrual status were two multi-family residential loans totaling $737,000 and two commercial real estate loans totaling $1.3 million.

Real Estate Owned. Real estate owned and repossessed assets consist of real estate and other assets which have been acquired through foreclosure on loans. At the time of foreclosure, assets are recorded at fair value less estimated selling costs, with any write-down charged against the allowance for loan losses. The fair value of real estate owned is determined by a third party appraisal of the property. As of December 31, 2014, the Company had no real estate owned properties. This compared to one real estate owned property in the amount of $284,000 at June 30, 2014.
Classified and Criticized Assets. We regularly review potential problem assets in our portfolio to determine whether any assets require classification in accordance with applicable regulations. The total amount of classified and criticized assets represented 22.7% of our equity capital and 3.6% of our total assets at December 31, 2014, as compared to 27.2% of our equity capital and 4.2% of our total assets at June 30, 2014. At December 31, 2014 and June 30, 2014, there were $7.8 million and $7.6 million in non-accrual loans included in classified assets, respectively.
The aggregate amount of our classified and special mention assets at the dates indicated were as follows:

	December 31, 2014	June 30, 2014
	(Dollars in thousands)	
Classified and Criticized Assets:		
Loss	$6	$17
Doubtful	92	1
Substandard	17,244	16,164
Special Mention	13,989	21,082
Total	$31,331	$37,264

Allowance for Loan Losses. We maintain an allowance for loan losses to absorb probable incurred losses inherent in the loan portfolio. The allowance is based on ongoing, quarterly assessments of the probable losses inherent in the loan portfolio. In accordance with generally accepted accounting principles the allowance is comprised of general valuation allowances and valuation allowances on loans individually evaluated for impairment.
The general component covers non-impaired loans and is based both on our historical loss experience as well as significant factors that, in management's judgment, affect the collectability of the portfolio as of the evaluation date. Loans that are classified as impaired are individually evaluated. We consider a loan impaired when it is probable that we will be unable to collect all amounts due according to the terms of the loan agreement and determine impairment by computing a fair value either based on discounted cash flows using the loan's initial interest rate or the fair value of the collateral, less estimated selling costs, if the loan is collateral dependent.
The overall appropriateness of the general valuation allowance is determined based on a loss migration model and qualitative considerations. The migration analysis looks at pools of loans having similar characteristics and analyzes their loss rates over a historical period. Historical loss factors derived from trends and losses associated with each pool over a specific period of time are utilized. The loss factors are applied to the outstanding loans to each loan grade within each pool of loans. Loss rates derived by the migration model are based predominantly on historical loss trends that may not be indicative of the actual or inherent loss potential. As such, qualitative and environmental factors are

utilized as adjusting mechanisms to supplement the historical results of the classification migration model. Significant factors reviewed in determining the allowance for loan losses included loss ratio trends by loan product; levels of and trends in delinquencies and impaired loans; levels of and trends in classified assets; levels of and trends in charge-offs and recoveries; trends in volume of loans by loan product; effects of changes in lending policies and

practices; industry conditions and effects of concentrations in geographic regions. Qualitative and environmental factors are reflected as percent adjustments and are added to the historical loss rates derived from the classified asset migration model to determine the appropriate allowance amount for each loan pool.

Valuation allowances on real estate loans that are individually evaluated for impairment are charged-off when management believes a loan or part of a loan is deemed uncollectible. Subsequent recoveries, if any, are credited to the allowance when received. A loan is generally considered uncollectible when the borrower's payment is six months or more delinquent.

Senior management reviews these conditions quarterly in discussions with our senior credit officers. To the extent that any of these conditions is evidenced by a specifically identifiable problem credit or portfolio segment as of the evaluation date, management's estimate of the effect of such conditions may be reflected as an allowance specifically applicable to such credit or portfolio segment. Where any of these conditions is not evidenced by a specifically identifiable problem credit or portfolio segment as of the evaluation date, management's evaluation of the loss related to this condition is reflected in the general allowance. The evaluation of the inherent loss with respect to these conditions is subject to a higher degree of uncertainty because they are not identified with specific problem credits or portfolio segments.

Given that management evaluates the adequacy of the allowance for loan losses based on a review of individual loans, historical loan loss experience, the value and adequacy of collateral and economic conditions in our market area, this evaluation is inherently subjective as it requires material estimates, including the amounts and timing of future cash flows expected to be received on impaired loans that may be susceptible to significant change. Large groups of smaller balance homogeneous loans that are collectively evaluated for impairment are excluded from loans individually evaluated for impairment; their allowance for loan losses is calculated in accordance with the allowance for loan losses policy described above.

Because the allowance for loan losses is based on estimates of losses inherent in the loan portfolio, actual losses can vary significantly from the estimated amounts. Our methodology as described above permits adjustments to any loss factor used in the computation of the formula allowance in the event that, in management's judgment, significant factors which affect the collectability of the portfolio as of the evaluation date are not reflected in the loss factors. By assessing the estimated losses inherent in the loan portfolio on a quarterly basis, we are able to adjust individual and inherent loss estimates based upon any more recent information that has become available. We continue to review our allowance for loan losses methodology for appropriateness to keep pace with the size and composition of the loans and the changing economic conditions and credit environment. We believe that our methodologies continue to be appropriate given our size and level of complexity. In addition, management's determination as to the amount of our allowance for loan losses is subject to review by the Office of the Comptroller of the Currency ("OCC") and the FDIC, which may require the establishment of additional general allowances or allowances on loans individually evaluated for impairment based upon their judgment of the information available to them at the time of their examination of our Bank.

During the three and six months ended December 31, 2014, a $400,000 and $750,000 reversal of provision for loan losses was recorded as compared to a $300,000 reversal of provision for loan losses for the three and six months ended December 31, 2013. The improvement in the provision during the current period was primarily a result of a lower level of criticized and classified loans and a decline in net charge-offs and loss factors on loans collectively evaluated for impairment. Net recoveries of $84,000 recorded during the six months ended December 31, 2014 resulted in annualized net recoveries of 0.02% of average outstanding loans for the six months ended December 31, 2014 as compared to annualized net charge-offs of 0.09% of average outstanding loans for the same period last year. Non-performing assets decreased to $7.8 million, or 0.90% of total assets at December 31, 2014 as compared to $7.9 million, or 0.90% of total assets at June 30, 2014. Delinquent loans 60 days or more past due was $1.2 million or 0.18% of total loans at December 31, 2014 as compared to $1.1 million or 0.16% of total loans at June 30, 2014. The allowance for loan losses to non-performing loans was 50.19% at December 31, 2014 as compared to 59.88% at

June 30, 2014. The decrease in the allowance for loan losses to non-performing loans was primarily a result of a decrease in the allowance for loan losses for the six months ended December 31, 2014. The provision reflected management’s continuing assessment of the credit quality of the Company’s loan portfolio, which is affected by various trends, including current economic conditions.

The distribution of the allowance for losses on loans at the dates indicated is summarized as follows.

	December 31, 2014		June 30, 2014	
	Amount	Percent of Loans in Each Category to Total Loans	Amount	Percent of Loans in Each Category to Total Loans
	(Dollars in thousands)			
Real estate loans:				
One-to-four family	$1,934	40.69 %	$2,300	40.14 %
Multi-family	577	45.76	993	46.54
Commercial	950	4.60	1,051	5.29
Other loans:				
Automobile	297	7.06	136	6.35
Home equity	2	0.09	2	0.09
Other	154	1.80	98	1.59
Total allowance for loan losses	$3,914	100.00 %	$4,580	100.00 %

Liquidity, Capital Resources and Commitments

Liquidity may increase or decrease depending upon the availability of funds and comparative yields on investments in relation to the return on loans. Historically, we have maintained liquid assets at levels above the minimum requirements previously imposed by our regulator and above levels believed to be adequate to meet the requirements of normal operations, including potential deposit outflows. Cash flow projections are regularly reviewed and updated to assure that adequate liquidity is maintained.

Our liquidity, represented by cash and cash equivalents, interest earning accounts and mortgage-backed and related securities, is a product of our operating, investing and financing activities. Our primary sources of funds are deposits, amortization, prepayments and maturities of outstanding loans and mortgage-backed and related securities, and other short-term investments and funds provided from operations. While scheduled payments from the amortization of loans and mortgage-backed related securities and maturing investment securities and short-term investments are relatively predictable sources of funds, deposit flows and loan prepayments are greatly influenced by general interest rates, economic conditions, and competition. In addition, we invest excess funds in short-term interest earning assets, which provide liquidity to meet lending requirements. We also generate cash through borrowings. We utilize FHLB advances to leverage our capital base and provide funds for our lending and investment activities as well as enhance our interest rate risk management.

Liquidity management is both a daily and long-term function of business management. Excess liquidity is generally invested in short-term investments such as overnight deposits. On a longer-term basis, we maintain a strategy of investing in various investment securities and lending products. We use our sources of funds primarily to meet ongoing commitments, to pay maturing certificates of deposit and savings withdrawals, to fund loan commitments and to maintain our portfolio of mortgage-backed and related securities. At December 31, 2014, total approved loan commitments amounted to $1.3 million and the unadvanced portion of loans was $2.1 million.

Certificates of deposit scheduled to mature in one year or less at December 31, 2014, totaled $84.6 million. There are no advances from the FHLB scheduled to mature in one year or less as of December 31, 2014. Based on historical experience, management believes that a significant portion of maturing deposits will remain with the Bank and we anticipate that we will continue to have sufficient funds, through deposits and borrowings, to meet our current commitments.

At December 31, 2014, we had $65.0 million FHLB advances outstanding and available additional advances from FHLB of San Francisco in the amount of $280.0 million. We also had a short-term line of credit with the Federal Reserve Bank of San Francisco of $40.5 million at December 31, 2014, which has not been drawn upon.

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Contractual Obligations

In the normal course of business, we enter into contractual obligations that meet various business needs. These contractual obligations include certificates of deposit to customers, borrowings from the FHLB, lease obligations for facilities, and commitments to purchase, sale and/or originate loans.

The following table summarizes our long-term contractual obligations at December 31, 2014.

	Total	Less than 1 year	1 – 3 Years	Over 3 – 5 Years	More than 5 years
	(Dollars in thousands)				
FHLB advances	$65,000	$—	$35,000	$30,000	$—
Operating lease obligations	1,519	851	261	152	255
Loan commitments to originate	1,334	1,334	—	—	—
Available home equity and unadvanced lines of credit	2,064	2,064	—	—	—
Certificates of deposit	240,997	84,592	119,482	36,923	—
Total commitments and contractual obligations	$310,914	$88,841	$154,743	$67,075	$255

Off-Balance Sheet Arrangements

As a financial service provider, we routinely are a party to various financial instruments with off-balance sheet risks, such as commitments to extend credit and unused lines of credit. While these contractual obligations represent our future cash requirements, a significant portion of commitments to extend credit may expire without being drawn upon. Such commitments are subject to the same credit policies and approval process accorded to loans we make.

Capital

The table below sets forth Simplicity Bank's capital position relative to its regulatory capital requirements at December 31, 2014 and June 30, 2014. The definitions of the terms used in the table are those provided in the capital regulations issued by the OCC.

	Actual			Minimum Capital Requirements			Minimum Required to be Well Capitalized Under Prompt Corrective Actions Provisions		
December 31, 2014	Amount	Ratio		Amount	Ratio		Amount	Ratio	
	(Dollars in thousands)								
Total capital (to risk-weighted assets)	$130,966	24.10	%	$43,466	8.00	%	$54,332	10.00	%
Tier 1 capital (to risk-weighted assets)	127,052	23.38		21,733	4.00		32,599	6.00	
Tier 1 (core) capital (to adjusted tangible assets)	127,052	14.77		34,415	4.00		43,019	5.00	

	Actual			Minimum Capital Requirements			Minimum Required to be Well Capitalized Under Prompt Corrective Actions Provisions		
June 30, 2014	Amount	Ratio		Amount	Ratio		Amount	Ratio	
	(Dollars in thousands)								
Total capital (to risk-weighted assets)	$128,372	21.66	%	$47,417	8.00	%	$59,271	10.00	%
Tier 1 capital (to risk-weighted assets)	123,792	20.89	%	23,709	4.00	%	35,563	6.00	%

Tier 1 (core) capital (to adjusted tangible assets)	123,792	14.13	%	35,056	4.00	%	43,820	5.00	%

Consistent with our goal to operate a sound and profitable financial organization, we actively seek to continue as a “well capitalized” institution in accordance with regulatory standards. At December 31, 2014, Simplicity Bank was a “well-capitalized” institution under regulatory standards.

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Impact of Inflation

The unaudited consolidated financial statements presented herein have been prepared in accordance with GAAP. These principles require the measurement of financial position and operating results in terms of historical dollars, without considering changes in the relative purchasing power of money over time due to inflation.

Our primary assets and liabilities are monetary in nature. As a result, interest rates have a more significant impact on our performance than the effects of general levels of inflation. Interest rates, however, do not necessarily move in the same direction or with the same magnitude as the price of goods and services, since such prices are affected by inflation. In a period of rapidly rising interest rates, the liquidity and maturity structure of our assets and liabilities are critical to the maintenance of acceptable performance levels.

The principal effect of inflation, as distinct from levels of interest rates, on earnings is in the area of noninterest expense. Such expense items as employee compensation, employee benefits and occupancy and equipment costs may be subject to increases as a result of inflation.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Our Risk When Interest Rates Change. The rates of interest we earn on assets and pay on liabilities generally are established contractually for a period of time. Market interest rates change over time. Our fixed rate loans generally have longer maturities than our fixed rate deposits. Accordingly, our results of operations, like those of other financial institutions, are impacted by changes in interest rates and the interest rate sensitivity of our assets and liabilities. The risk associated with changes in interest rates and our ability to adapt to these changes is known as interest rate risk and is our most significant market risk.

How We Measure Our Risk of Interest Rate Changes. As part of our attempt to manage our exposure to changes in interest rates and comply with applicable regulations, we monitor our interest rate risk. In monitoring interest rate risk we continually analyze and manage assets and liabilities based on their payment streams and interest rates, the timing of their maturities, and their sensitivity to actual or potential changes in market interest rates.

In order to minimize the potential for adverse effects of material and prolonged increases in interest rates on our results of operations, we have adopted investment/asset and liability management policies to better match the maturities and repricing terms of our interest-earning assets and interest-bearing liabilities. The board of directors sets and recommends the asset and liability policies of Simplicity Bank, which are implemented by the asset/liability management committee.

The purpose of the asset/liability management committee is to communicate, coordinate and control asset/liability management consistent with our business plan and board approved policies. The committee establishes and monitors the volume and mix of assets and funding sources taking into account relative costs and spreads, interest rate sensitivity and liquidity needs. The objectives are to manage assets and funding sources to produce results that are consistent with liquidity, capital adequacy, growth, risk, and profitability goals.

The asset/liability management committee generally meets at least monthly to review, among other things, economic conditions and interest rate outlook, current and projected liquidity needs and capital position, anticipated changes in the volume and mix of assets and liabilities and interest rate risk exposure limits versus current projections pursuant to net present value of portfolio equity analysis and income simulations. The asset/liability management committee recommends appropriate strategy changes based on this review. The chairman of the committee or his designee is responsible for reviewing and reporting on the effects of the policy implementations and strategies to the board of directors at least monthly.

In order to manage our assets and liabilities and achieve the desired liquidity, credit quality, interest rate risk, profitability and capital targets, we have focused our strategies on: (1) maintaining an adequate level of adjustable rate loans; (2) originating a reasonable volume of short-term and intermediate-term loans; (3) managing our deposits to establish stable deposit relationships; and (4) using FHLB advances, and pricing on fixed-term non-core deposits to align maturities and repricing terms.

At times, depending on the level of general interest rates, the relationship between long-term and short-term interest rates, market conditions and competitive factors, the asset/liability management committee may determine to increase our interest rate risk position somewhat in order to maintain our net interest margin.

The asset/liability management committee regularly reviews interest rate risk by forecasting the impact of alternative interest rate environments on net interest income and economic value of portfolio equity, which is defined as the net present value of an institution's existing assets, liabilities and off-balance sheet instruments, and evaluating such impacts against the maximum potential

changes in net interest income and economic value of portfolio equity that are authorized by the board of directors of Simplicity Bank.

An independent third party provides the Bank with the information presented in the following tables, which are based on information provided by the Bank. The tables present the sensitivity of net interest income for the 12-month period subsequent to the six months ended December 31, 2014 and the year ended June 30, 2014, and the immediate, permanent and parallel movements in interest rates of +/-100, +200 and +300 basis points, as well as the change in the Bank's net portfolio value at December 31, 2014 that would occur upon an immediate change in interest rates without giving effect to any steps that management might take to counteract that change.

December 31, 2014		June 30, 2014	
Basis Point (bp) Change in Rates	Change in Net Interest Income	Basis Point (bp) Change in Rates	Change in Net Interest Income
+300 bp	(0.85)%	+300 bp	(4.49)%
+200	(0.05)	+200	(2.81)
+100	0.04	+100	(1.45)
-100	(1.31)	-100	0.58

	December 31, 2014				
		Estimated Increase (Decrease) in NPV		NPV as a percentage of Present Value of Assets [3]	
Change in Interest Rates (basis points) [1]	Estimated NPV [2]	Amount	Percent	NPV ratio [4]	Increase (Decrease) (basis points)
	(Dollars in thousands)				
+400	$108,901	$(36,515)	(25.11)%	13.71%	(268)
+300	120,311	(25,105)	(17.26)	14.72	(167)
+200	130,847	(14,569)	(10.02)	15.55	(84)
+100	139,605	(5,811)	(4.00)	16.14	(25)
—	145,416	—	—	16.39	—
-100	146,572	1,156	0.79	16.19	(20)

(1) Assumes an instantaneous uniform change in interest rates at all maturities.
(2) NPV is the discounted present value of expected cash flows from assets, liabilities and off-balance sheet contracts.
(3) Present value of assets represents the discounted present value of incoming cash flows on interest-earning assets.
(4) NPV Ratio represents NPV divided by the present value of assets.

The analysis uses certain assumptions in assessing interest rate risk. These assumptions relate to interest rates, loan prepayment rates, deposit decay rates, and the fair values of certain assets under differing interest rate scenarios, among other things.

As with any method of measuring interest rate risk, shortcomings are inherent in the method of analysis presented in the foregoing tables. For example, although assets and liabilities may have similar maturities or periods to repricing, they may react in different degrees to changes in the market interest rates. Also, the interest rates on certain types of assets and liabilities may fluctuate in advance of changes in market interest rates, while interest rates on other types may lag behind changes in market rates. Additionally, certain assets, such as adjustable rate mortgage loans, have features, that restrict changes in interest rates on a short-term basis and over the life of the asset. Further, if interest rates change, expected rates of prepayments on loans and early withdrawals from certificates of deposit could deviate significantly from those assumed in calculating the table.

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Item 4. Controls and Procedures
Our management evaluated, with the participation of our Chief Executive Officer and Chief Financial Officer, the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934 (the “Act”)) as of the end of the period covered by this report. The Company’s Chief Executive Officer and Chief Financial Officer concluded that the Company’s disclosure controls and procedures as of the end of the period covered by this report are effective in ensuring that the information required to be disclosed by the Company in the reports it files or submits under the Act is (i) accumulated and communicated to the Company’s management (including the Chief Executive Officer and Chief Financial Officer) in a timely manner, and (ii) recorded, processed, summarized, and reported within the time periods specified in the SEC’s rules and forms. There have been no changes in our internal control over financial reporting (as defined in Rule 13a-15(f) under the Act) that occurred during the quarter ended December 31, 2014 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.
Part II. OTHER INFORMATION
Item 1. Legal Proceedings
From time to time, we are involved as plaintiff or defendant in various legal actions arising in the normal course of business. We do not anticipate incurring any material liability as a result of this litigation or any material impact on our financial position, results of operations or cash flows.

Current Litigation Relating to the Merger

On October 10, 2014, Stephen Bushansky (the "Plantiff") filed a stockholder class action lawsuit in the Superior Court of Los Angeles County, California against the Company, the directors of the Company and HomeStreet. The lawsuit purports to be brought on behalf of all of the Company’s public stockholders, excluding the directors of the Company. The complaint alleges that the directors of the Company breached their fiduciary duties to the stockholders by failing to take adequate measures to ensure that the interests of Simplicity’s stockholders are properly protected and by conducting a merger process that prevents competitive bidding. The complaint further alleges that HomeStreet aided and abetted the alleged breaches of fiduciary duty by the Company’s directors. The lawsuit sought to enjoin the proposed merger from proceeding and seeks unspecified compensatory damages on behalf of the Company’s stockholders and/or rescission of the proposed merger transaction.

On January 8, 2015, the Company, the individual director defendants of the Company and HomeStreet entered into a Memorandum of Understanding (the “MOU”) with the Plaintiff regarding the settlement of the lawsuit. Pursuant to the MOU, the Company agreed to provide additional information to Simplicity stockholders in its definitive proxy statement filed with the SEC on January 6, 2015. The Company, HomeStreet and the other defendants deny all of the allegations in the lawsuit. The Company and the individual director defendants of the Company believe the disclosures in the preliminary proxy statement of the Company filed with the SEC on December 10, 2014 were adequate under the law. Nevertheless, the Company, HomeStreet and the other defendants agreed to additional disclosures in the Company’s definitive proxy statement to settle the lawsuit in order to avoid the costs, disruption, and distraction of further litigation.

Item 1A. Risk Factors
Termination of the Merger Agreement with HomeStreet could adversely impact the Company.

If the Merger Agreement is terminated, there may be various consequences. For example, the Bank’s business may have been impacted adversely by the failure to pursue other beneficial opportunities due to the focus of management on the merger, without realizing any of the anticipated benefits of completing the merger. The Company has incurred substantial costs in connection with the Merger Agreement, including legal, accounting and investment banking fees.

Additionally, if the Merger Agreement is terminated, the market price of the Company’s common stock could decline to the extent that the current market price reflects a market assumption that the merger will be completed. If the Merger Agreement is terminated under certain circumstances, the Company will be required to pay HomeStreet a termination fee of $5.3 million. This may make it more difficult or expensive for another company to acquire the Company if the Merger Agreement is terminated, which may have a disproportionately adverse impact on the price of the Company’s common stock.

The Company will be subject to business uncertainties and contractual restrictions on its operations while the merger is pending.

The Company will be subject to business uncertainties and contractual restrictions on its operations while the merger is pending. For instance, uncertainty about the effect of the merger on employees and customers may have an adverse effect on the Company. These uncertainties may impair the Company’s ability to attract, retain and motivate key personnel until the merger is completed, and could cause customers and others that deal with the Bank to seek to change their existing business relationships. Retention of certain employees by the Company may be challenging while the merger is pending, as certain employees may experience uncertainty about their future roles. If key employees, or a significant number of employees, depart because of issues relating to the uncertainty and difficulty of integration or a desire not to remain with the Company or the surviving corporation, the Company’s business could be harmed. In addition, subject to certain exceptions, the Company has agreed to operate its business in the ordinary course, and to comply with certain other operational restrictions, prior to closing.

There have been no other material changes to the risk factors that were previously disclosed in the Company’s annual report on Form 10-K for the fiscal year ended June 30, 2014.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

Purchases of Equity Securities by the Issuer

Period	Total Number of Shares Purchased	Weighted Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans*	Maximum Number of Shares That May Yet be Purchased Under the Plan
10/1/14 – 10/31/14	—	$—	—	240,079
11/1/14 – 11/30/14	—	—	—	240,079
12/1/14 – 12/31/14	—	—	—	240,079
Total	—	$—	—	240,079

* Since November 11, 2011, the Company has repurchased 2,312,765 shares under stock repurchase programs.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Mine Safety Disclosures

Not applicable

Item 5. Other Information

None.

Item 6. Exhibits

31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act
31.2	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act
32.1	Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act
32.2	Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document
101.CAL	XBRL Taxonomy Calculation Linkbase Document
101 DEF	XBRL Taxonomy Extension Definition Linkbase Document
101 LAB	XBRL Taxonomy Label Linkbase Document
101.PRE	XBRL Taxonomy Presentation Linkbase Document

SIMPLICITY BANCORP, INC. AND SUBSIDIARY
SIGNATURES
Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.
SIMPLICITY BANCORP, INC.

Dated: February 9, 2015

/s/ Dustin Luton
Dustin Luton
President and Chief Executive Officer

/s/ Jean M. Carandang
Jean M. Carandang
Chief Financial Officer