GRACO INC
Form 4
April 26, 2005

FORM 4

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

STATEMENT OF CHANGES IN BENEFICIAL OWNERSHIP OF SECURITIES

Filed pursuant to Section 16(a) of the Securities Exchange Act of 1934, Section 17(a) of the Public Utility Holding Company Act of 1935 or Section 30(h) of the Investment Company Act of 1940

OMB APPROVAL

OMB Number:	3235-0287
Expires:	January 31, 2005
Estimated average burden hours per response...	0.5

Check this box if no longer subject to Section 16. Form 4 or Form 5 obligations may continue. *See* Instruction 1(b).

(Print or Type Responses)

1. Name and Address of Reporting Person *
MORFITT MARTHA A M

(Last) (First) (Middle)

88 11TH AVENUE NE

(Street)

MINNEAPOLIS, MN 55413

(City) (State) (Zip)

2. Issuer Name **and** Ticker or Trading Symbol
GRACO INC [GGG]

3. Date of Earliest Transaction (Month/Day/Year)
04/22/2005

4. If Amendment, Date Original Filed(Month/Day/Year)

5. Relationship of Reporting Person(s) to Issuer

(Check all applicable)

__X__ Director _____ 10% Owner
_____ Officer (give title below) _____ Other (specify below)

6. Individual or Joint/Group Filing(Check Applicable Line)
_X_ Form filed by One Reporting Person
___ Form filed by More than One Reporting Person

Table I - Non-Derivative Securities Acquired, Disposed of, or Beneficially Owned

1.Title of Security (Instr. 3)	2. Transaction Date (Month/Day/Year)	2A. Deemed Execution Date, if any (Month/Day/Year)	3. Transaction Code (Instr. 8)		4. Securities Acquired (A) or Disposed of (D) (Instr. 3, 4 and 5)			5. Amount of Securities Beneficially Owned Following Reported Transaction(s) (Instr. 3 and 4)	6. Ownership Form: Direct (D) or Indirect (I) (Instr. 4)	7. Nature of Indirect Beneficial Ownership (Instr. 4)
			Code	V	Amount	(A) or (D)	Price			

Reminder: Report on a separate line for each class of securities beneficially owned directly or indirectly.

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SEC 1474 (9-02)

Table II - Derivative Securities Acquired, Disposed of, or Beneficially Owned
(*e.g.*, puts, calls, warrants, options, convertible securities)

1. Title of Derivative Security (Instr. 3)	2. Conversion or Exercise Price of	3. Transaction Date (Month/Day/Year)	3A. Deemed Execution Date, if any (Month/Day/Year)	4. Transaction Code (Instr. 8)	5. Number of Derivative Securities Acquired	6. Date Exercisable and Expiration Date (Month/Day/Year)	7. Title and Amount Underlying Securitie (Instr. 3 and 4)

	Derivative Security			(A) or Disposed of (D) (Instr. 3, 4, and 5)							
				Code	V	(A)	(D)	Date Exercisable	Expiration Date	Title	Amou or Numb of Shares
Non-Qualified Stock Option (right to buy)	$ 37.13 (1)	04/22/2005		A		3,600		(1)	04/22/2015	Common Stock	3,60

Reporting Owners

Reporting Owner Name / Address	Relationships			
	Director	10% Owner	Officer	Other
MORFITT MARTHA A M 88 11TH AVENUE NE MINNEAPOLIS, MN 55413	X			

Signatures

By: Kristen C. Nelson For: Martha A. Morfitt	04/26/2005
**Signature of Reporting Person	Date

Explanation of Responses:

* If the form is filed by more than one reporting person, *see* Instruction 4(b)(v).

** Intentional misstatements or omissions of facts constitute Federal Criminal Violations. *See* 18 U.S.C. 1001 and 15 U.S.C. 78ff(a).

(1) Nonemployee director stock option granted pursuant to the Graco Inc. Stock Incentive Plan in a transaction exempt under Rule 16b-3. The stock option becomes exercisable in four equal annual installments, commencing one year after the date of the grant.

Note: File three copies of this Form, one of which must be manually signed. If space is insufficient, *see* Instruction 6 for procedure.
Potential persons who are to respond to the collection of information contained in this form are not required to respond unless the form displays a currently valid OMB number. onthly charges per use under a Managed Use Program. The Company has also developed a low-cost Light Emitting Diode (LED) instrument that adapts its Intellectual Properties to the beauty industry. The LED instrument uses inexpensive Light Emitting Diodes technology to measure color as opposed to other competitive instruments that use conventional color measurement systems with more expensive technology. The Company plans to market the LED instrument to brand marketers in the Beauty Aid industry who will use the device to provide their customers with a compatible skin tone match or corrective skin tone match for their foundation makeup and compatible color cosmetics such as lipstick, eyeshadow or blush. The Company has commenced its first mass manufacturing effort of the LED device, however initial testing of the first products demonstrated further research and development was required to provide certain additional specifications for the light emitting diodes for consistent accuracy when ordering and assembling large batches of the LED device for potential commercial use. MARKETING AND DISTRIBUTION In September 1997, the Company released the results of market research studies which analyzed the existing market for methods currently used to monitor newborn infant jaundice in infants in the United States and in the developed countries of Europe, South America and Canada combined, and Asia. The study indicated that the World Health Organization published annual birthrate is approximately 4,000,000 births in the United States, with approximately 10% of these births being premature infants. The Company estimates that individual bilirubin

heelstick blood tests on newborn infants, which are not part of a general panel blood test, total approximately 15,000,000 tests performed annually in the United States, based on data made available by the World Health Organization, the American Academy of Pediatrics, independent market studies commissioned by the Company, business proposals from potential marketing partners and its current distribution partner. Internationally, using the World Health Organization birth rates, independent market studies and research obtained from companies currently marketing neonatal medical devices in foreign countries, the Company estimates that the current European market for infant bilirubin tests is approximately the same size as the United States; South America and Canada combined represent approximately 25% of the United States market size, and the Southern Chinese and entire Japanese markets combined represent approximately the same size of market as the United States. On June 7, 1999, the Company executed a renewable, five-year agreement with Datex-Ohmeda, Inc. and its Ohmeda Medical Division ("DO") pursuant to which the Company appointed DO as the exclusive distributor in the United States of the Company's ColorMate(R) TLc-BiliTest(R) System for noninvasive monitoring of bilirubin (infant jaundice) in the hospital market, the non-consumer home healthcare market (in which the test is administered solely by a healthcare professional), the pediatrician office market and clinics within all such markets. The agreement also applies to the Company's TLc-Lensette(TM) 4 disposable standards that are used to calibrate measurements taken by the ColorMate(R) TLc-BiliTest(R) System. The terms of the agreement provide for minimum purchases of ColorMate(R) System units and TLc-Lensette(TM) disposable color-calibration and verification standards for the term of the agreement. There are no financial penalties for failure to meet these minimum levels. However, the Company has the option to terminate the agreement if these minimums are not met. As of March 26, 2002, DO had not achieved the minimum performance requirements set forth in the agreement and the Company is currently exploring acceptable business arrangements with DO. Following the marketing launch of the ColorMate(R) TLc-BiliTest(R) System by DO in February 2000, the Company experienced a slower than expected hospital evaluation process for the non-invasive technology, a reality not uncommon to other medical devices that attempt to become the standard of care. The Company discovered that the hospital market was taking longer to evaluate the device, which impacted its near-term revenue stream. The Company also encountered the widespread medical practice related to the early discharge of infants, which is moving the larger market potential to the pediatrician offices and home healthcare markets. The Company further discovered that while healthcare professionals are certainly interested in non-invasive devices for babies, establishing new protocols for the treatment of infantile jaundice requires continual education and medically sponsored awareness campaigns. The Company also received feedback that its monitoring device would require additional redesign and modifications to accommodate the busier hospital environment. In cooperation with our distributor, Ohmeda Medical, the Company is working to address these issues, has redesigned the product and obtained recent FDA clearances for the redesigned device in September 2001. Another key issue to the acceptance of the ColorMate(R) TLc-BiliTest(R) System was the fact that until recently a CPT (Current Procedural Terminology) code did not exist for a non-invasive procedure. Healthcare providers use CPT codes extensively for reporting medical procedures and services for administrative management and insurance reimbursement. A CPT code was issued for non-invasive testing for bilirubin which became effective January 1, 2001. The new code that is listed in CPT 2001 is 88400 bilirubin, total transcutaneous. Healthcare providers use the CPT codes when reporting medical procedures and services under public and private health insurance programs, and for administrative management in claims processing and developing guidelines for medical care review according to the AMA. As a result of the disappointing results achieved to date in pursuing the Company's business strategy through the distribution agreement with DO and the limited financial resources of the Company, the Company's current objective with regard to its medical business is to either arrive at acceptable revised business arrangements with DO or to identify a strategic partner in the medical industry to which the Company could sell, for an up-front fee and ongoing royalty, the exclusive market rights to the ColorMate(R) TLc-BiliTest(R) System. Due to the problems addressed above, revenues from the sale of the ColorMate(R) TLc-BiliTest(R) System were minimal in 2001. REGULATORY CLEARANCES In June 1996, the Company retained government regulatory consultants and legal counsel to oversee compliance with applicable federal and state regulations for commercialization of the ColorMate(R) TLc-BiliTest(R) System as an aid to the physician in monitoring the status of newborn babies for the development and progression of newborn infant jaundice, and for complying with any applicable European Community and other foreign government requirements. The initial clinical studies conducted at Mt. Sinai Hospital were completed with positive results and on November 14, 1996 the Company filed its application with the FDA for the medical application of its technologies, specifically, the adjunctive

non-invasive monitoring of newborn infant jaundice. On July 30, 1997, the Company received confirmation of marketing clearance pursuant to a "substantial equivalence" determination order, dated July 24, 1997, from the FDA's Center for Devices and Radiological Health (the "CDRH"), authorizing the Company to commercially distribute the system in the United States. In September 2001, the Company received confirmation of further marketing clearance pursuant to a "substantial equivalence" determination order from the FDA's Center for Devices and Radiological Health (the CDRH") authorizing the Company to commercially distribute an upgraded system in the United States. The "substantial equivalence" order states that the Company must comply with all relevant statutes enforced by and regulations promulgated by the FDA, including Quality System Regulation ("QSR") requirements, labeling, and the statutory prohibitions against adulteration and misbranding. The order states that the system is a "Class I Reserved device." The Company intends to maintain substantial compliance with any applicable requirements for purposes of commercial distribution. The Company's FDA market clearance authorizes use of the Company's technology as an aid to the physician in monitoring the status of newborn babies for the development and progression of newborn infant jaundice. 5 Following a physician's examination of a newborn within the first hours of birth, newborn babies would be measured initially and monitored periodically by the ColorMate(R) TLc-BiliTest(R) System for incremental changes in the yellow content of their skin color. Because the ColorMate(R) TLc-BiliTest(R) System can provide effective adjunctive non-invasive monitoring of newborn infant jaundice, it may have significant marketing advantages toward reducing the invasive, repeated, daily blood testing techniques currently used, which in many cases leads to blood transfusion of the infant. See "Risk Factors." However, because the medical community is relatively slow to adopt new technologies, there can be no assurance that practitioners will perceive a need for, or accept, the Company's technology, or be willing to commit funds to its development or the purchase of any such completed technology. Since receiving FDA marketing clearance in the United States, the Company has undertaken procedures towards obtaining required international regulatory clearances for its ColorMate(R) TLc-BiliTest(R) System. In March 1999, the Company received ISO-9001 and EN46001 certification, signifying that the Company's facility meets important international quality standards for product design and development, manufacturing, servicing and distribution. In April 1999, the Company also was granted permission by the European Union (EU) notified body, TUV Essen, to affix the CE Mark to its ColorMate(R) TLc-BiliTest(R) System. MANUFACTURING One element of the Company's business strategy is to outsource the production of the components and final assembly of the ColorMate(R) TLc-BiliTest(R) System and its TLc-Lensette(TM) disposable calibration and verification standards to third-party contract manufacturers. In November 1998, the Company reached an agreement with Nova Biomedical Corporation for the contract production of the ColorMate(R) TLc-BiliTest(R) System. Nova Biomedical is a medical device production contractor, is ISO 9001/EN46001 certified, and has advised the Company that it is in substantial compliance with all applicable regulatory requirements for the contract manufacture of medical devices for U.S. and European Union distribution, including requirements under the FDA's Quality System Regulation and the requirements applicable to the manufacture of medical devices for the European Union (including ISO 9001 and EN46001). Under this renewable, four-year medical device manufacturing agreement, the contract manufacturer is the exclusive manufacturer/assembler and packager of two models (a battery powered model and an electrically powered model) of the Company's ColorMate(R) TLc-BiliTest(R) System for distribution in the United States (subject to limited volume exceptions with respect to one model of the instrument). The manufacturer also has a right of first refusal to match third party bids to manufacture/assemble and package a third model of such instrument and a further right of first refusal to match third party bids to manufacture/assemble and package the two models referenced above for distribution outside the United States. In this regard, subject to any failure of Nova Biomedical to exercise its right of first refusal to match third party bids (thus permitting the Company to use other manufacturers), Nova Biomedical is the Company's sole source of supply for the instruments. Under the agreement, the Company is responsible for providing to Nova Biomedical, for assembly and packaging, certain component parts. In February 1999, the first manufacturing run of the Company's ColorMate(R) TLc-BiliTest(R) System (under the FDA's QSR as well as ISO-9001/EN46001 manufacturing regulatory requirements) for monitoring newborn jaundice was completed by Nova Biomedical. The Company commenced shipping the ColorMate(R) TLc-BiliTest(R) System to those hospitals having placed purchase orders for the systems under a limited time price offer which allowed the hospitals to obtain the device and evaluate its performance during a trial period. The Company also began in-servicing at hospitals and with physicians who placed initial orders. In the fourth quarter of 1999 the Company delivered the first 500 commercial units purchased by DO. Sales in the years 2000 and 2001 were less than $100,000 under this distribution

agreement and the Company is pursuing alternative business strategies at this time. 6 INTELLECTUAL PROPERTIES, PATENTS AND PATENT APPLICATIONS PENDING The Company owns U.S. Patent No. 4,909,632 (expiring in 2007) entitled "Method for Selecting Personal Compatible Colors," U.S. Patents Nos. 5,311,293 (expiring in 2007), 5,313,267 (expiring in 2011) both entitled "Method and Instrument For Selecting Personal Compatible Colors," 5,671,735 (expiring in 2014) entitled "Method and Apparatus for Detecting and Measuring Conditions Affecting Color," 6,067,504 (expiring in 2014) entitled "Method For Correctly Identifying Hair Color," 6,128,516 (expiring in 2014), 6,129,664 (expiring in 2014) and 6,157,445 (expiring in 2009) all entitled "Method and Apparatus For Detecting and Measuring Conditions Affecting Color". Additional U.S. Patents were granted to the Company in 2001, namely U.S. Patent Nos. 6,308,088 (expiring in 2014) entitled "Methods and Apparatus for Detecting and Measuring Conditions Affecting Color" and 6,314,372 (expiring in 2014) 6,330,341 (expiring in 2014), both entitled "Method and Apparatus for Hair Color Characterization and Treatment," U.S. Patent No. 6,178,341 (expiring in 2018), entitled "Color Measurement System with color Index for Skin, Teeth, Hair and Material Substances", U.S. Patent No. 6,271,920 (expiring in 2017), entitled "Methods and Apparatus for Color Calibration and Verification." The Company has developed intellectual property rights in color analysis, calibration and verification in a number of fields including medical, biological, dental, cosmetic and materials testing. The intellectual property rights include trade secrets, know how and pending patent application. The Company also has filed patent applications in a number of foreign jurisdictions which correspond, at least in part, to the Company's United States patents. The Company has been granted European Patent No. 0446512 entitled "Method for Selecting Personal Compatible Colors." That European patent has been nationalized in Great Britain and Hong Kong. The Company also has Australian, Canadian, Korean and Mexican patents corresponding, at least in part, to its U.S. Patent No. 4,909,632, Australian, Canadian, Taiwanese and Korean patents corresponding, at least in part, to its U.S. Patent No. 5,313,267 and an Australian Patent, a Canadian patent, a Singapore patent and two Taiwanese patents corresponding, at least in part, to its U.S. Patent No. 5,671,735 and an Australian patent corresponding, at least in part, to its U.S. Patent No. 6,178,341 (collectively, together with the United States patents, the "Patents"). The proprietary information claimed by the Patents includes, among other things: (i) a method of detecting a medical condition that involves a symptomatic, detectable change in a test subject's skin coloration, such as a method for monitoring newborn bilirubinemia (infant jaundice) in an infant test subject, (ii) a method and instrument for identifying skin color and categories of individuals, (iii) a method of determining color compatibility of an individual's skin with non-skin matter and (iv) a method of assigning a skin color compatibility classification to non-skin matter and color charts and sample assemblages made by that method. Proprietary information claimed by the Patents is incorporated in the proprietary software and measurement system used in the ColorMate(R) units. Although many of the individual hardware components of the ColorMate(R) System and the ColorMate(R) TLc-BiliTest(R) System are public and not proprietary to the Company, the color measurement system is manufactured to proprietary specifications of the Company and when those individual hardware components are assembled in conjunction with the Company's proprietary software they form the ColorMate(R) System and the ColorMate(R) TLc-BiliTest(R) System, the operation of which is covered by the claims of the Company's patents. The Company's TLc-Lensette (TM) disposable color-calibration and verification standard is entirely proprietary to the Company because the proprietary color formulation used is uniquely capable of effectively calibrating the ColorMate(R) TLc- BiliTest(R) system for use on human skin colors. The Company has registered its trademarks COLORMATE, MY COLORS BY CHROMATICS, TLC- BILITEST and the Baby Face Design in the United States Patent and Trademark Office ("USPTO"). The Company believes it also has established common law rights in the following marks: CCBRC, SITE FLAG, TLC, TLC BILI, TLC-LENSETTE, TLC LENSPAK, TLC SOFT AND TLC TOUCH and has filed applications with the USPTO to register the following marks: CCBRC, SITE FLAG and TLC BILI, TLC-LENSETTE, TLC SOFT and TLC TOUCH. Further, the Company believes it has copyright protection for all of the software used in the ColorMate(R) System and the ColorMate(R) TLc-BiliTest(R) System. After the respective expiration date of each of the Company's Patents, the proprietary technology and instrumentation disclosed in each Patent will be available for use by others without compensation to the Company, unless protected by the claims of other U.S. patents that may be issued to the Company. The Company has not applied for patent protection for many aspects of the Intellectual Properties (i.e., its proprietary trade secrets and other confidential information). The Company typically imposes on its key employees, consultants and advisers confidentiality obligations in connection with their employment, consulting or advisory relationship with the Company. See "Risk Factors Protection of Intellectual Property." COMPETITION

The medical device industry in general is intensely competitive. The Company competes with other providers of infant jaundice diagnostic and monitoring products which have greater financial, technical, manufacturing, marketing, research and 7 development and management resources, such as Minolta Co., Ltd. ("Minolta"), Air Shields, Respironics, Inc. ("Respironics"), which acquired Healthdyne Technologies, Inc. ("Healthdyne"), and SpectRx, Inc. ("SpectRx"), among others. In addition, the invasive laboratory blood test detection methods currently in use for bilirubin infant jaundice, have already achieved acceptance by and are in widespread use in the medical community, unlike the Company's proposed method. See "Risk Factors." The Company believes that Minolta developed and Air Shields markets a screening device, the Minolta Jaundice Meter, to measure the amount of bilirubin in the skin of a newborn infant to determine whether a serum bilirubin measurement is required. The Company believes that the measurements obtained by the Minolta device, unlike the ColorMate(R) TLc- BiliTest(R) System, are not used when the infant is being treated by phototherapy for hyperbilirubinemia, and are affected by the infant's race and skin color, which the Company believes significantly limits its use in a heterogeneous population. As a result, the Company believes that the Minolta device is in limited use in the United States and that it is not used at all for infants who are receiving phototherapy. There can be no assurance that Minolta will not effect improvements to its device in the future to overcome these apparent limitations. See "Risk Factors." Based on public filings, the Company believes that in June 1996, SpectRx entered into a collaborative arrangement with Respironics in which Respironics was responsible for regulatory clearance and sales of SpectRx's device for infant jaundice analysis in the United States and Canada. Based on these filings SpectRx's infant jaundice device is intended to be a hand- held instrument, which incorporates a microspectrometer to collect spectroscopic information from the infant's skin. In February 1999, SpectRx announced that it had obtained 510(k) clearance for its device and that it would commence U.S. marketing of its device shortly. SpectRx also announced that during the third quarter of 1998 it entered into a distribution agreement with Atom Medical Corporation for distribution of the SpectRx's infant jaundice product in Japan, pending regulatory clearance from Japan's Ministry of Health and Welfare. Also, during the third quarter of 1998 SpectRx announced receipt of regulatory clearance to market its infant jaundice product in Canada and shipments to Respironics for sale in Canada commenced in the same quarter. The Spectrx infant jaundice device was recently given FDA clearance for commercial marketing for babies under phototherapy. See "Risk Factors." The Company's success depends in large part on the acceptance by the medical community of the Company's new technology. There can be no assurance that the ColorMate(R) TLc-BiliTest(R) System will effectively compete with any currently used systems. Furthermore, many of the Company's competitors have substantially greater financial, research, technical, manufacturing, marketing and distribution resources than the Company and have greater name recognition and lengthier operating histories in the health care industry. There can be no assurance that the Company will be able to effectively compete against these and other competitors, including those competitors who intend to promote their versions of non-invasive devices. Furthermore, there can be no assurance that the Company's competitors will not succeed in developing, during commercialization of the Company's products, devices and technologies that permit more efficient, less expensive non-invasive analysis of bilirubin (infant jaundice). It is also possible that one or more pharmaceutical or other health care companies will develop therapeutic drugs, treatments or other products that will substantially reduce the prevalence of infant jaundice or otherwise render the Company's products obsolete. Such competition could have a material adverse effect on the Company's business, financial condition and results of operation. The Company's ability to compete is affected by its product development and innovation capabilities, its ability to maintain or obtain additional regulatory clearances, as necessary, the marketing and manufacturing capabilities of the Company, its distributors, and its third party vendors, its ability to protect the proprietary technology of its products, its ability to attract and retain skilled employees, and, for products sold in managed care environments, its ability to maintain current distribution relationships and establish new distribution relationships. The cosmetics industry and fashion industry are particularly sensitive to changing consumer preferences and demands, which are difficult to predict and beyond the Company's control. Competition in the cosmetics industry is diverse and fragmented, but is nevertheless dominated by a number of large, established, well-known corporations having, among other things, significantly greater financial, marketing and human resources than the Company. Virtually all of such companies have in the past marketed, and continue to market, their products based on their own color analysis system and advertised claims of "color compatibility" with the personal color and/or wardrobe of the consumer. These competitors also have established presence in the market and their own cosmetic manufacturing facilities, unlike the Company. There can be no assurance that consumers will prefer products based on the Company's scientifically based color determinations,

rather than the products sold by the Company's competitors based on subjective techniques. 8 GOVERNMENT REGULATIONS The Company's advertising, sales practices, cosmetic products and medical products (including the labeling and packaging thereof) are and will be subject to applicable federal, state and local regulation (including regulation by the FDA, the Federal Trade Commission, and the Federal Communications Commission, under various laws such as the Fair Packaging and Labeling Act and/or any comparable state authority, agency or statute) and will be subject to regulation by comparable foreign authorities if the Company markets its ColorMate(R) units and products abroad. In addition, the research, development, testing, production and marketing of the Company's medical products are subject to extensive governmental regulation in the United States at the federal, state and local levels, and in certain other countries, that regulate direct selling activities. Non-compliance with applicable requirements may result in recall or seizure of products, total or partial suspension of production, refusal of the government to allow clinical testing or commercial distribution of products, civil monetary penalties, injunction and criminal prosecution. The FDA regulates the development, production, distribution and promotion of medical devices in the United States. The medical products being developed for manufacture and sale by the Company are subject to regulation as medical devices by the FDA. Pursuant to the Federal Food, Drug and Cosmetic Act (the "Act"), a medical device is classified as a Class I, Class II or Class III device. Class I devices are subject to general controls, including establishment registration, device listing, premarket notification (510(k)) clearance (in some cases), labeling requirements, QSR requirements, prohibitions on adulteration and misbranding, and reporting of certain adverse events (known as medical device reporting or "MDR"). In addition to general controls, Class II devices may be subject to special controls that could include performance standards, postmarket surveillance, patient registries, guidelines, recommendations and other actions as the FDA deems necessary to provide reasonable assurance of safety and effectiveness of the device. Class III devices must meet the most stringent regulatory requirements and must be approved as safe and effective by the FDA before they can be marketed. Such premarket (PMA) approval can involve extensive preclinical and clinical testing to prove safety and effectiveness of the device and generally is more costly and time consuming than a 510(k) submission. Unless otherwise exempt, all medical devices introduced to the market since 1976 are required by the FDA, as a condition of marketing, to secure 510(k) clearance or premarket approval through a PMA. A product will be cleared by the FDA under a 510(k) if it is found to be substantially equivalent in terms of safety, effectiveness, technology and intended use to another legally marketed medical device that was on the market prior to May 28, 1976 (that subsequently did not require a PMA application) or to a product that has previously received a 510(k) and is lawfully on the market. If a product is not substantially equivalent to such a medical device, and not otherwise exempt, the FDA must first approve a PMA application before it can be marketed. An approved PMA indicates that the FDA has determined the product has been proven, through the submission of clinical data and manufacturing and other information, to be safe and effective for its labeled indications. The PMA review process on average takes 411 days (based on FDA's fiscal year 2001 figures) and typically requires the submission of significant quantities of clinical data and supporting information. The process of obtaining a 510(k) currently takes, on average, approximately 96 days from the date of submission (based on FDA's fiscal year 2001 figures). However, the review process for a particular product may be shorter or substantially longer depending upon the circumstances. Moreover, there can be no assurance that a 510(k) will be cleared. A 510(k) must include submission of supporting information, including design details and draft labeling, and may be required to contain safety and efficacy data, possibly from clinical trials. Product modifications intended to be made to a cleared device also may require filing and clearance of a new 510(k) submission or filing and approval of a PMA supplement, during which time the modified product cannot be commercially distributed. The latest 510(k) clearance orderS obtained from the FDA's CDRH indicates that the Company's ColorMate(R) TLc- BiliTest(R) System is a "Class I Reserved" device, subjecting it to "general controls. The Company is not currently developing, manufacturing or distributing any Class III devices, although it may do so in the future. The Company also is subject to additional FDA and foreign statutes and regulations and/or may be subject to additional clearances or approvals to the extent the Company continues its efforts to test, manufacture and license the Intellectual Properties and lease the ColorMate(R) units to the medical community in additional or significantly modified forms or for new uses. See "Risk Factors." Although the Company has received FDA clearance on its ColorMate(R) TLc-BiliTest(R) System pursuant to a "substantial equivalence" determination order, in the form of letters dated July 1997 and September 2001 from the FDA's CDRH, authorizing the Company to commercially distribute its device for adjunctive monitoring of newborn infant jaundice by healthcare professionals in the United States, the Company also must comply with the other applicable statutes

enforced, and applicable rules and regulations promulgated, by the FDA, in order to legally market the device. The latest "substantial equivalence" order states that the Company must comply with the medical device general controls, e.g., device establishment 9 registration, medical device listing, good manufacturing practices (QSR requirements), medical device reporting, labeling requirements, and the statutory prohibitions against adulteration and misbranding. The process of obtaining marketing clearance or approval for medical products from the FDA can be costly and time consuming, and there can be no assurance that such required clearance or approval will be granted for the Company's products on a timely basis, if at all, or that FDA review will not involve delays that would adversely affect the Company's ability to commercialize additional or significantly modified products or to expand permitted uses of existing products. Regulatory clearance or approval to market a product from the FDA may entail limitations on the indicated uses of the product. The ability to market can be challenged (and possibly withdrawn) by the FDA due to failure to comply with regulatory standards or the occurrence of unforeseen problems following initial clearance. The Company's current 510(k) clearances can be withdrawn or limited by the FDA or the Company may be required to file further marketing applications with the FDA under certain circumstances, such as the addition of product claims or product redesign. The FDA also could limit or prevent the manufacture or distribution of the Company's products, and has the power to require the recall of such products, given certain circumstances. FDA regulations depend heavily on administrative interpretation and there can be no assurance that future interpretation made by the FDA or other regulatory bodies will not adversely affect the Company. There can be no assurance the Company will be able to maintain substantial compliance with FDA requirements. In order for the Company to market its products in Europe and certain other foreign jurisdictions, the Company and its distributors and agents obtained and must maintain required regulatory registrations and/or approvals and must otherwise comply with extensive regulations regarding safety, efficacy and quality in those jurisdictions. Specifically, certain foreign regulatory bodies have adopted various regulations, among other things, governing product standards, packaging requirements, labeling requirements, import restrictions, tariff regulations, duties and tax requirements. These regulations vary from country to country. After receiving FDA marketing clearance in the United States, the Company undertook the procedures to obtain European regulatory clearances for its ColorMate(R) TLc-BiliTest(R) System. To market its ColorMate(R) TLc-BiliTest(R) System in the European Union, the Company sought ISO- 9001/EN46001 certification and the right to affix the CE mark. ISO-9001/EN46001 certification recognizes that the Company has established a quality system for the design, development, manufacturing, servicing and distribution of its medical device. The CE mark is a symbol of quality and compliance with applicable European Union medical device directives. In March 1999, the Company received ISO-9001 and EN46001 certifications, signifying that the Company's New York facility meets important international quality standards for product design and development, manufacturing, servicing and distribution. In April 1999, the Company also was granted permission by the European Union (EU) notified body, TUV Essen, to affix the CE Mark to its ColorMate(R) TLc-BiliTest(R) System. Prior to April 1, 1999, the Company has passed a product inspection in February 1999 for purposes of receiving the right to affix the CE mark to such specific inspected product. Failure to maintain ISO-9001/EN46001 certification, CE mark rights or other foreign regulatory registrations or approvals for the Company's medical products would prevent the Company from marketing its medical products abroad, which would have a material adverse effect on the Company's business, financial condition and results of operations. There can be no assurance that the Company will obtain any other required regulatory registrations or approval in such countries or that it will not be required to incur significant costs in obtaining or maintaining such regulatory registrations or approvals. Delays in obtaining any registrations or approvals required to market the Company's products, failure to receive these registrations or approvals, or future loss or previously obtained certifications, rights, registrations or approvals could have a material adverse affect on the Company's business, financial condition and results of operations. The Company may rely on its third-party foreign distributors to comply with certain foreign regulatory requirements. The inability or failure of the Company or such foreign distributors to comply with varying foreign regulations or the imposition of new regulations could restrict the sale of the Company's products internationally and thereby adversely affect the Company's business, financial condition and results of operations. The Company and any third party with which it has made contract manufacturing or other regulated arrangements will be required to adhere to applicable FDA regulations, including the QSR requirements and similar regulations in other countries, which include, among other things, testing, control, and documentation requirements. Ongoing compliance with QSR requirements and other applicable regulatory requirements will be strictly enforced in the United States through periodic inspections by federal and possibly state agencies, including the FDA, and in foreign jurisdictions by

comparable agencies. The FDA revised the QSR requirements in 1996 which increases the cost of regulatory compliance for the Company. Failure to comply with applicable regulatory requirements could result in, among other things, warning letters, injunctions, civil monetary penalties, recall or seizure of products, total or partial suspension of production, refusal of the government to grant premarket clearance or premarket approval for devices, possible rescission or withdrawal of clearances or approvals previously obtained and criminal prosecution. The restriction, suspension or revocation of regulatory clearances or approvals, or government enforcement actions due to any failure to comply with regulatory requirements, could have a material adverse effect on the Company's business, financial condition and results of operations. 10 Future products developed by the Company and products currently under development may require FDA marketing authorization through either 510(k) or PMA application procedures. There can be no assurance that marketing clearances or approvals will be obtained on a timely basis or at all. Delays in receiving such clearances or approvals could have a material adverse effect on the Company. The FDA also regulates the commencement and conduct of clinical investigations to determine the safety and effectiveness of unapproved investigational devices, including investigations involving new intended uses of previously cleared or approved devices. Clinical investigations are regulated by the FDA under the Investigational Device Exemptions ("IDE") regulations. The IDE regulations include significant requirements that must be met, including, but not limited to, informed patient consent, institutional review board ("IRB") review and approval of research protocols, reporting obligations to the FDA, record keeping requirements and prohibitions against commercialization of investigational devices. A sponsor must obtain FDA approval of an IDE application before starting the investigation, unless the device is found to be a non- significant risk ("NSR") device by the sponsor and each IRB that reviews and approves the study. The FDA, however, has the authority to determine that a study designated as involving an NSR device by the sponsor and IRBs involves a significant risk device, and to require that an IDE application be submitted and approved before the study can resume. In addition, a study of an NSR device must still comply with the above-referenced and certain other IDE requirements. A violation of the IDE regulations can result in a variety of sanctions, such as warning letters, prohibition against additional clinical research, the refusal to accept data and criminal prosecution. The Company also may provide devices for use in FDA approved or recognized clinical trials as a contract manufacturer. There can be no assurance that any clinical study will comply with all elements of the FDA's regulations, including the FDA's IDE regulations, that a study will provide evidence of the safety or effectiveness of the device, or that a study will ultimately result in the clearance or approval of the device. A federal law commonly known as the "anti-kickback statute" prohibits the offer, solicitation, payment or receipt of anything of value (direct or indirect, overt or covert, in cash or in kind) which is intended to induce business for which payment may be made under a federal health care program, i.e., any plan or program that provides health benefits, whether directly or indirectly, through insurance, or otherwise, which is funded directly, in whole or in part, by the United States Government (e.g., Medicare, Medicaid and CHAMPUS). The type of remuneration covered by the anti-kickback statute is very broad. It includes not only kickbacks, bribes and rebates, but also proscribes any remuneration, whether made directly or indirectly, overtly or covertly, or in cash or in kind. Moreover, prohibited conduct includes not only remuneration intended to induce referrals, but also remuneration intended to induce purchasing, leasing, arranging or ordering of any goods, facilities, services, or items paid for by a federal health care program. In part to address concerns regarding the implementation of the anti-kickback statute, in 1991, the federal government published regulations that provide exceptions or "safe harbors" for certain transactions that are deemed not to violate the anti-kickback statute. Among the safe harbors included in the regulations are transactions involving discounts or the payment of certain administrative fees to group purchasing organizations. While the failure to satisfy all the criteria for a safe harbor does not necessarily mean that an arrangement is unlawful, engaging in a business practice for which there is a safe harbor may be regarded as suspect if the practice fails to meet each of the prescribed criteria of the safe harbor. Violations of the statute are punishable by civil and criminal penalties and/or exclusion of the provider from participation in the federal health care programs. Also, there is the risk that, in a civil lawsuit to enforce a contract that contains a structure in violation of the anti-kickback statute, a court might conclude that the contract is unenforceable as against public policy. Congress directed the Secretary of the United States Department of Health and Human Services ("HHS") to issue advisory opinions regarding compliance with the anti- kickback statute. Failure of a party to seek an advisory opinion, however, may not be introduced into evidence to prove that the party intended to violate the anti-kickback statute. Several states also have statutes or regulations prohibiting financial relationships with referral sources that are not limited to services for which a federal health care program pays. While the Company believes its

marketing programs meet the requirements of the anti-kickback statute and its implementing regulations, there is no guaranty that the HHS Office of the Inspector General would view all of the Company's marketing arrangements as meeting all of the requirements of the appropriate safe harbors. The Company has not sought, and has no present intention to seek, an HHS advisory opinion regarding any aspect of its current marketing arrangements. A finding of noncompliance with the anti- kickback laws by federal or state regulatory officials, including noncompliance with appropriate safe harbors, could have a material adverse effect on the Company. The Company's products are intended to be purchased or leased by health care providers or suppliers which submit claims for reimbursement for such products or their use to third-party payors such as Medicare, Medicaid and private health insurers. In the United States, patients, hospitals and physicians who purchase medical devices, generally rely on such third- party payors to reimburse them for all or a portion of the cost of the medical device or its use. Reimbursement for devices (or their use) that have received FDA clearance has generally been available in the United States. Third-party payors are increasingly challenging the prices charged for medical products and services. There can be no assurance that the Company's products will be considered cost effective and that reimbursement to the consumer will be or continue to be available, or sufficient to allow the Company to sell its medical device products on a competitive basis. Moreover, obtaining and maintaining health care payors' approval of reimbursement for the Company's products or their use, and the level of reimbursement made available, will be an important factor in establishing pricing, structure and market acceptance. The Company is unable to predict what changes will be made in the reimbursement methods utilized by third-party health care payors. Furthermore, the Company could be adversely affected by changes in reimbursement policies of governmental or private health care payors. Although the Company has no knowledge that third-party payors will adopt measures that would limit coverage of, or reimbursement for, its products or their use, any such measures that were applied to the Company's products could have a material adverse effect on the Company. American Medical Association ("AMA") CPT codes are generally used to facilitate the processing of insurance reimbursement claims and to provide a simplified reporting procedure. However, assignment of a code does not assure that the insurer will provide reimbursement or that the AMA endorses the medical procedure at issue. Effective January 1, 2001, the AMA assigned AMA CPT code 88400 bilirubin, total transcutaneous, for use with the Company's ColorMate(R)TLc-BiliTest(R) System. Health care providers use the CPT code when reporting medical procedures and services under public and private health insurance programs, and for administrative management in claims processing and developing guidelines for medical care review according to the AMA. The Company is unable to predict what changes will be made in the reimbursement methods utilized by third-party health care payors. Although the Company anticipates that hospitals and physicians will justify the use of the ColorMate(R) TLc- BiliTest(R) System by clinical benefits that the Company believes will be derived from the use of the ColorMate(R) TLc-BiliTest(R) System, there can be no assurance that this will be the case. Because the cost of health care delivery has been rising steadily and because the cost of a significant portion of medical care in the United States and other countries is typically funded by governmental insurance programs, there have been a number of government initiatives to reduce health care costs. Congress and various state legislatures have proposed changes in laws and regulations that, if ever enacted, could effect major restructuring of the health care industry. Although many of these proposals may seek to maintain or expand access to health care services, the common objective of the proposed legislation is to achieve cost containment in the health care sector. Changes in governmental support of health care services, the methods by which such services are delivered, the prices for such services or the regulations governing such services or mandated benefits all may have a material adverse effect on the Company. Even if the ultimate impact of any such changes on net sales is positive, no assurance can be given that the costs of complying with possible new requirements would not have a negative impact on the Company's future earnings. No assurance can be given that any such legislation will not have a material adverse effect on the Company. EMPLOYEES Since December 2000 the Company has reduced its number of employees. The Company currently employs 3 persons on a full-time basis. These employees are principally engaged in raising finances, as well as administration, research and development, regulatory and intellectual property functions. The Company has significantly reduced its operating expenses while focusing on its current objective of obtaining financing and identifying strategic partners for marketing its ColorMate(R) system in the beauty industry and to purchase exclusive market rights to the ColorMate(R) TLc-BiliTest(R) System. RECENT EVENTS Gordon Laboratories Sale and Repurchase Option On June 2, 2000 the Company acquired the common stock and certain debt of Gordon Laboratories, Inc. ("Gordon"), a Carson City, California based formulator and manufacturer of cosmetics, hair care and other personal care products. The Company

acquired an approximately 85% equity interest in Gordon for approximately $5.5 million, principally in stock, and acquired the remaining interest in June 2001, per the terms of the June 2000 agreement. 11 On July 3, 2001, Gordon was acquired by Abilene Investments Corp. and GAC-Labs, LLC for an aggregate purchase price of $1,000,000 paid to Gordon to be used for operating capital. Simultaneously, the shares of Gordon stock that were outstanding immediately prior to the closing of this transaction, all of which were owned by the Company, were redeemed for one dollar. In addition, the Company assigned to Abilene and GAC-Labs the indebtedness of Gordon and H.B. Gordon Manufacturing Co., Inc., its wholly-owned subsidiary, owed to the Company in the ratio of 20% to Abilene and 80% to GAC-Labs. As part of the same transaction, the Company was granted the option to purchase from Abilene and GAC-Labs the shares of Gordon stock issued to them and the indebtedness assigned to them within one year for an aggregate purchase price of $1,000,000 plus interest thereon at the rate of 14% per annum, subject to reduction under certain conditions. Stockholder Rights Offering The Company is now offering and selling up to 210,900,000 shares of our common stock, which are the subject of a prospectus filed with the Securities and Exchange Commission, to our existing stockholders. Current Cash Requirements/Financing Proposals The Company is currently lacking funds to continue material aspects of the Company's operations and business plan, including funds and necessary personnel to complete research and development on its new LED instrument and technology discovered during its first mass manufacturing process; complete filings, administration and maintenance for certain intellectual properties and regulatory requirements; supply upgraded products and sales support to its medical distributor; and complete regulatory filings. The Company has recently downsized its corporate offices and the Board of Directors is reviewing potential proposals for financing the Company, along with contingency plans in the event such financing cannot be completed. The Company is currently reviewing potential financings. One potential financing would be for a $3.5 million equity financing. Such proposals require negotiation of warrants to purchase the Company's stock and are subject to satisfactory completion of due diligence, negotiation, execution and delivery of definitive agreements by and between the parties. Nasdaq Delisting On November 29, 2001, the Company's common stock was delisted from the Nasdaq SmallCap Market. The Company's common stock is currently listed on the OTC Bulletin Board. Board of Directors Decrease The Board of Directors was decreased from nine to six members due to the resignations of three of its members. BEAUTY-AID PRODUCTS The ColorMate(R) System. Although it is not currently expanding in this activity as a result of its efforts to find a strategic partner for the ColorMate(R) TLc-BiliTest(R) System for medical application and the lack of necessary funding, the Company has engaged in efforts to commercialize its Intellectual Properties for beauty-related applications. The ColorMate(R) System consists of a color measurement instrument to be held against a subject's skin, hair, teeth or sample, a series of filters and a computer and related proprietary software all housed in a portable briefcase. The color measurement instrument used within the ColorMate(R) unit or as a handheld battery operated instrument is utilized in the Company's medical, cosmetic and other applications. The instrument is held against the subject's skin, hair, teeth or sample and performs color measurement of coloration and luminosity to a laboratory standard of accuracy. In skin color analysis, the software then analyzes the color measurements so obtained and assigns the subject to one of the approximately 200 skin color categories identified by the Company through its research and development effort. In the beauty-related applications the ColorMate(R) System matches each skin color type to a range of pre-tested compatible product colors. The unit is equipped with a printer and can provide the subject with a record of his or her skin color category and color compatible shades of specific products (including the Company's cosmetic products) appropriate for that skin color category and other product colors. The ColorMate(R) System also can be used to perform chromaticity studies of various product lines in manufactured or applied forms (for example, tooth enamel, hair coloring, hosiery, other cosmetic lines) on behalf of licensees. This capability 12 permits the organization of the licensee's products into precise color categories so that the consumer can be assisted with proper color coordination within the licensee's product line. My Colors by Chromatics(R) Cosmetics Line. The Company's cosmetics line ("My Colors by Chromatics(R)") divides the product shades into four color classifications. The product shades recommended by the ColorMate(R) System are individually prescribed for color coordination with each of the approximately 200 skin color categories. The Company's cosmetic line is precisely formulated and balanced to provide color coordinated products for the skin color of all races. In the past the Company has also marketed, through the use of the ColorMate(R) System, a line of fashion swatch packs consisting of 36 objectively measured colors, coordinated with each other and with the consumer's skin tone color to aid the consumer in selecting color compatible fabrics and fashion accessories. OTHER POTENTIAL PRODUCTS AND APPLICATIONS. The Company has conducted research and development and developed engineering

specifications for a mass manufacturing prototype regarding a hand-held light- emitting diode version of the ColorMate(R) System (the "LED Device"). This version may be marketed for medical use after collecting further clinical testing data and is subject to FDA approval or clearance (the Bilirubin LED Device). For non-medical applications, the LED Device may be marketed in various industries including the dental, beauty aid and fashion industries and also may be marketed directly to consumers for home and personal use. The Company expects the new LED versions will also be capable of being manufactured at a cost substantially less than the cost incurred in manufacturing the Company's existing ColorMate(R) System units because of technological improvements which have resulted in substantially lower component part costs. The Company believes that the Intellectual Properties and ColorMate(R) System have commercial applications in (i) healthcare relating to the non-invasive detection and monitoring of certain chromogenic diseases, such as skin diseases, and anemia and (ii) dental care (i.e., the color matching of teeth and tooth enamel). Additional medical applications for the Intellectual Properties require extensive and lengthy clinical testing and will be subject to various federal and state regulatory requirements, including FDA clearances or approvals, and may be subject to comparable foreign regulatory approvals to the extent the Company markets such applications abroad. There can be no assurance that the Company will obtain any additional FDA or foreign approvals or clearances or will be able to comply with such regulatory requirements for additional applications. The Company also believes that the Intellectual Properties and ColorMate(R) System may have commercial applications in industrial color measurement applications, in order to achieve and confirm uniformity of color shades within a given product line or between two products of the same line (i.e., paint, textile and food products). To that end, the Company intends to increase its efforts to lease the ColorMate(R) System and license the Intellectual Properties, including the Company's chromaticity study capabilities, to industrial companies such as paint, textile and food companies, that use or could use existing color measurement technologies in the manufacturing and marketing of their own products. Many companies in these industries currently use color measurement instruments to ensure uniformity of product line colors (e.g., that manufacturing facilities are producing different dye lots and/or goods of the same color). These instruments are generally available at prices well in excess of the price at which the Company would market the ColorMate(R) System for such application, because the Company has been able to mass manufacture its color measurement technology, thereby taking advantage of the economies of scale and lower unit prices available through large volume orders from component parts suppliers. In addition, the ColorMate(R) System provides machine- to-machine stability and reproducibility (i.e., that each machine will achieve results consistent with that of other machines). RISK FACTORS Liquidity Crisis. The Company is currently experiencing a liquidity crisis and requires an immediate infusion of cash in order to continue operations. As of December 31, 2001, the Company had cash and cash equivalent of $55,000, current liabilities of $4,499,000 and an accumulated deficit of $61,996,000. The Company will be unable to continue operations, maintain its existing distribution arrangements or pursue its strategy to identify a strategic partner in the medical industry to which the Company could sell, for an up-front fee and ongoing royalties, the exclusive market rights to the ColorMate(R) TLc- BiliTest(R) System unless it obtains an immediate infusion of cash. No assurance can be given that the Company will be successful in obtaining the needed cash infusion to fund it's immediate needs and if it is unsuccessful the Company may be forced to seek protection from its creditors under the Bankruptcy Code. Nasdaq SmallCap Market Delisting. Effective November 29, 2001 the Company's Common Stock was delisted from trading on the Nasdaq Small Cap Market as a result of the Company's failure to satisfy certain minimum conditions. As a result of 13 this delisting, the ability of holders of the Company's Common Stock to sell such securities has been adversely affected. In order for the Company to have its Common Stock relisted on the Nasdaq Small Cap Market, it would need to meet certain minimum requirements for relisting including receiving significant additional equity funding in order to satisfy the initial listing requirements of the Nasdaq Small Cap Market. No assurance can be given that such funding will be obtained or that the Company's common stock will become eligible for relisting on the Nasdaq Small Cap Market in the future. When the Company was delisted from the Nasdaq SmallCap Market and the price per share dropped below $5.00, then the Common Stock became subject to certain penny stock rules promulgated by the Securities and Exchange Commission (the "Commission"). The penny stock rules require a broker-dealer, prior to a transaction in a penny stock not otherwise exempt from the rules, to deliver a standardized risk disclosure document prepared by the Commission that provides information about penny stocks and the nature and level of risks in the penny stock market. The broker-dealer must also provide the customer with current bid and offer quotations for the penny stock, the compensation of the broker-dealer and its salesperson in the transaction and monthly account statements showing the market value of each

penny stock held in the customer's account. In addition, the penny stock rules require that prior to a transaction in a penny stock not otherwise exempt from such rules, the broker- dealer must make a special written determination that the penny stock is a suitable investment for the purchaser and receive the purchaser's written agreement to the transaction. These disclosure requirements may have the effect of reducing the level of trading activities in the secondary market for the Company's stock subject to the penny stock rules. Additionally investors may find it more difficult to sell their Common Stock. Limited Operating History. The Company has a limited operating history upon which its prospects can be evaluated. Such prospects must be considered in light of the substantial risks, expenses and difficulties encountered by entrants into the medical device industry, which is characterized by an increasing number of participants, intense competition and a high failure rate. Until 1986, the Company was principally engaged in research and development relating to the Intellectual Properties, ColorMate(R) units and the Company's Beauty-Aid Products. From early 1986 through October 1987, the Company was engaged in limited test-marketing of certain of the Intellectual Properties and Beauty-Aid Products through its former licensees. From October 1987 until June 1991, the Company was principally engaged in the Avon Project. Since 1991, the Company has been engaged in the research and development of its ColorMate(R) TLc-BiliTest(R) System for the monitoring of newborn bilirubinemia (infant jaundice), the development of prototypes of additional versions of the ColorMate(R) unit and the refinement of its technologies for other applications. There can be no assurance that the Company will generate material revenues from the sale of its products. The Company's business is subject to the risks inherent in the development of new products using new technologies and approaches, many of which are beyond the Company's control, such as unanticipated development, manufacturing and regulatory delays and expenses. There can be no assurance that unforeseen problems will not develop with these technologies or applications, that the Company will be able to successfully address technological challenges it encounters in its research and development program or that commercially feasible products will ultimately be successfully developed and marketed by the Company. Operating Losses. The Company has incurred significant losses from operations for the years ended December 31, 2001 and December 31, 2000 ($7,918,000 and $19,496,000, respectively). These continuing losses raise substantial doubt about the Company's ability to continue as a going concern and the audit report of the Company's independent accountants for the year ended December 30, 2000 and December 31, 2001 contained a "going concern" qualification. Prior to the delisting of the Common Stock in November, 2001, the Company had funded its operating losses with the proceeds raised from sales to third party investors of its Common Stock and securities convertible into Common Stock. For the fiscal year ended December 31, 2001, 2000 and 1999, the Company raised $0, $9,152,000 and $9,104,000 respectively in net proceeds from these offerings. The delisting of the Company's common stock from the Nasdaq Small Cap Market has adversely affected the Company's ability to continue to fund these operating losses from the proceeds of such sales to third party investors. As a result, the Company has incurred short-term indebtedness of $1,699,000 since the second quarter of 2001 to fund its operating losses. No assurance can be given that the Company will be able to generate sufficient cash proceeds from its operations or financing activities to fund its operating losses. In the event that such cash proceeds are not obtained, the Company may be forced to seek protection from its creditors under the Bankruptcy Code. If the Company is successful in raising financing required to continue operations, the Company will continue to incur significant additional costs and expenses in connection with FDA Regulatory costs and patent application costs, manufacturing and other regulations, state regulatory requirements and foreign market clearances and other requirements. In addition, the Company expects to incur significant expenses relating to manufacturing expenses, product liability insurance, legal and regulatory compliance, including QSR/GMP quality system substantial compliance, as well as research and 14 development, and implementation of the next phase of its efforts to successfully commercialize the medical and beauty applications of its technology. See "Liquidity and Capital Resources". No Assurance of Successful Commercialization of ColorMate(R) TLc-BiliTest(R) System. For the years ended December 31, 2001, 2000 and 1999, the Company's sales have been $8,000, $80,000 and $1,103,000. While the Company believes the non-invasive nature of its ColorMate(R) TLc- BiliTest(R) System for monitoring newborn bilirubinemia (infant jaundice) provides benefits to patients, no assurance can be given that the medical community will accept and support the Company's medical device. Physicians and other health care professionals will not recommend or use the ColorMate(R) TLc- BiliTest(R) System unless they determine, based on experience, clinical data, relative cost, and other factors such as competitive products, that the ColorMate(R) TLc-BiliTest(R) System is an attractive alternative for reducing the current traumatic blood tests that have a long history of safe and effective use or other competitive products. The Company believes that recommendations by physicians and clinicians

will be essential for the market acceptance of these products, but there can be no assurance that any such recommendations will be obtained. To the extent the Company is able to market and distribute its ColorMate(R) TLc-BiliTest(R) System, broad market acceptance of the Company's device will require the training of numerous physicians and clinicians, and the time required to complete such training could result in a delay of successful commercial distribution to the medical market. Moreover, obtaining and maintaining health care payors' approval of reimbursement for the Company's products, and the level of reimbursement made available, will be an important factor in establishing pricing, structure and market acceptance. In addition, purchase decisions for the device will be greatly influenced by health care administrators who are subject to increasing pressures to reduce costs. Some purchasers, such as hospitals, pediatrician's offices and home health care facilities, also might be reluctant to purchase products from a company that has not demonstrated the ability to satisfy ongoing delivery requirements. In addition, hospitals, clinics and pediatricians may be unwilling or unable to commit funds to the purchase of the Company's ColorMate(R) TLc-BiliTest(R) System due to institutional budgetary constraints. User acceptance of these products will depend on many factors, including physician recommendations, the degree, rate and severity of potential complications, the cost and benefits compared to competing products or alternative medical treatments, available reimbursement and other considerations. In addition, the Company's pricing policies could adversely impact market acceptance of these products as compared to competing products and alternative treatments. If any of the Company's marketing or development programs are not successfully completed, required regulatory approvals or clearances are not obtained or maintained, or products for which approvals or clearances are obtained (such as the ColorMate(R) TLc-BiliTest(R) System for monitoring infant jaundice) are not commercially successful, the Company's business, financial condition and results of operations would be materially adversely affected. There can be no assurance that the Company will be able to successfully address any problems that may arise during the commercialization process of its ColorMate(R) TLc-BiliTest(R) System. Early Stage of Development of Other Potential Applications. The Company's development programs for other applications of its technology are at a very preliminary stage and substantial additional research and development and for medical applications, further clinical trials will be necessary before commercial versions of any additional proposed products are produced for such applications. Because of the Company's current liquidity issues, the development of these other potential applications is not being actively pursued and no assurance can be given regarding the successful development of any of these other potential applications. Assumptions Regarding Medical Business Plan and Strategy. The Company has formulated its medical business plan and strategy based upon certain assumptions provided by the Company's medical distribution partner and other medical distribution companies regarding the size of the bilirubin monitoring market, the Company's anticipated short term and eventual share of this market, the price at which the Company believes it will be able to sell or lease its products, and consumer acceptance of the Company's products. There can be no assurance that these assumptions will prove to be correct. The Company's ability to operate in the future will depend upon many factors, including technological advances and product obsolescence; levels of competition, including the entry into the market of additional competitors and increased success by existing competitors; and changes in general economic conditions. Failure by the Company to manage its business plan effectively could have a material adverse effect on the Company's business, financial condition and results of operations. Lack of Marketing and Sales Experience. The Company has not previously licensed its Intellectual Properties for use in any industry other than the beauty aid, hosiery and cosmetics industries and management of the Company has not had any experience in marketing the Intellectual Properties, ColorMate(R) units or Beauty-Aid Products in any other field. Prior to licensing the Company's Intellectual Properties in any industry, including the cosmetic, beauty aids and fashion industries, the Company will be required to develop additional marketing skills relevant to such industries and conduct significant further marketing activity, and in certain of these industries, overcome regulatory hurdles, professional skepticism and develop specific practical applications therefor. There can be no assurance its own marketing efforts or those of the 15 Company's medical distributors will successfully generate commercial levels of sales. There can be no assurance that the Company will be able to maintain existing distribution agreements or enter into additional marketing and sales agreements with third parties on acceptable terms. Dependence on Marketing and Distribution Arrangements with Third Parties. The Company has established a distribution partnership with Datex-Ohmeda, Inc. and its Ohmeda Medical Division to support its marketing efforts and has entered into a separate third party manufacturing agreement for the ColorMate(R) TLc-BiliTest(R) System. The Company's business strategy for the commercialization of its medical products depends upon the Company's ability to either maintain existing or selectively enter into and maintain

arrangements with additional leading marketing and distribution companies in the medical field. There can be no assurance that the Company will be able to do so. Any revenues to be received by the Company from its ColorMate(R) TLc-BiliTest(R) System will be dependent on arrangements with third parties for marketing, distribution and sales of the products. As of March 26, 2002, DO has not achieved the minimum performance requirements set forth in the distribution agreement. The Company and DO are currently exploring potential business arrangements under these circumstances. The obligation of any existing or additional third party to fund or undertake the marketing, distribution and/or sale of the product covered by any arrangements with the Company may be dependent upon the satisfaction of certain goals or "milestones" by certain specified dates, some of which are outside the Company's control. To the extent that the obligations of any third party to fund or undertake the foregoing activities are not contingent upon the satisfaction of certain goals or milestones, a third party may retain a significant degree of discretion regarding the timing of these activities and the amount and quality of financial, personnel and other resources that they devote to these activities. Furthermore, there can be no assurance that disputes will not arise between the Company and any third party regarding their respective rights and obligations under the arrangements. Finally, there can be no assurance that a third party will not be able, due to financial, regulatory or other reasons, to satisfy its obligations under its collaborative arrangement with the Company or will not intentionally or unintentionally breach its obligations under the arrangement. There can be no assurance that any third party will not, for competitive reasons, support, directly or indirectly, a company or product that competes with the Company's business. Furthermore, any dispute between the Company and a third party might require the Company to initiate or defend expensive litigation or arbitration proceedings. Any significant dispute with or breach, or termination of any arrangement with such third party would require the Company to seek and reach an agreement with another third party or to assume, to the extent possible and at its own expense, all the responsibilities being undertaken by the first such third party. There can be no assurance that the Company would be able to reach an agreement with a replacement third party. If the Company were not able to find a replacement third party, there can be no assurance that the Company would be able to perform or fund the activities for which the first such third party would be responsible. Even if the Company were able to perform and fund these activities, the Company's capital requirements would increase substantially. In addition, the further manufacture, development, marketing, distribution and sale of the product covered by such arrangement would be significantly delayed. Dependence on Medical Device and other Product Manufacturers. The Company does not itself manufacture the ColorMate(R) units, the ColorMate(R) TLc-BiliTest(R) System or the Beauty-Aid Products, and in the past has been wholly dependent on third-party OEMs of parts, assemblers, cosmetics suppliers and textile suppliers. The Company may encounter various problems in establishing and maintaining manufacturing relationships and/or operations, resulting in inefficiencies and delays. Specifically, companies often encounter difficulties in scaling up production, including problems involving production yield, quality control and assurance, and shortages of qualified personnel. In addition, the manufacturing facilities retained by the Company to manufacture its ColorMate(R) products for medical applications are subject to FDA QSR requirements and other regulatory requirements, international quality standards (such as ISO 9001/EN46001) and other regulatory requirements. Currently, the Company is dependent on the sole source manufacturer of the ColorMate(R) TLc- BiliTest(R) System under the existing exclusivity arrangements. The Company will have to maintain relationships with such manufacturer and third party suppliers of component parts for the production of its devices. There can be no assurance the Company will be able to maintain its relationships with its current manufacturer, or will be able to maintain arrangements with the other parts suppliers or assemblers on terms satisfactory to the Company. Although the Company believes that a number of manufacturers are capable of manufacturing and assembling the ColorMate(R) TLc-BiliTest(R) System, any change in manufacturers, or the retention of additional subcontractors, could result in additional costs and delays. Difficulties encountered by the Company in subcontracting to third-party manufacturers, scaling up production or failure by the Company to utilize manufacturing facilities in substantial compliance with FDA requirements, international quality standards or other regulatory requirements, could result in a delay or termination of production or regulatory enforcement action, which could have a material adverse effect on the Company's business, financial condition and results of operations. In connection with manufacturing of the ColorMate(R) units, the Company could be required to make significant advance payments, obtain letters of credit, cause potential customers or licensees to advance funds under their agreements entered 16 into with the Company or otherwise secure its payment obligations to third-party manufacturers. See "Management's Discussion and Analysis of Financial Condition and Results of Operations."

Although the Company's existing manufacturing agreement for the ColorMate(R) TLc-BiliTest(R) System does not require such obligations, there can be no assurance the Company will be able to maintain the existing relationship, or that the Company will be able to enter into replacement agreements that do not provide for such obligations and are otherwise on acceptable terms. There can be no assurance the Company will be able to secure its payment obligations itself or by having customers and/or licensees advance funds, or otherwise be able to manufacture the ColorMate(R) units or obtain further manufacture of the ColorMate(R) units or its products. To the extent the Company obtains any required FDA clearance for and markets the Bilirubin LED Device or markets the ColorMate(R) LED Device, the Company will need to outsource the production and assembly of the components of the Bilirubin LED Device and the ColorMate(R) LED Device to third party manufacturers and assemblers. One of the components of the Bilirubin LED Device is available from only one supplier. The Company is reliant on that one source of supply and these products would require a major redesign in order to incorporate any substitute components. Lack of Market Penetration in Other Industries. The Company has not yet achieved commercial market penetration in any industry, and there can be no assurance the Company will be able to do so in the future. The Company has not achieved significant levels of cosmetics sales from its ColorMate(R) System. The Company also believes, based on its operating history since February 1993, that obtaining any cosmetic or beauty aid sales revenue will require significant additional financing and personnel. In order to implement its marketing plans the Company will have to develop additional marketing skills. There can be no assurance the Company's marketing plan will be successful. Legal Proceedings. In April 2000 the United States District Court for the Southern District of New York dismissed three putative class actions that had been filed against the Company and certain of its officers and directors. On January 16, 2001, a lawsuit was commenced against the Company and Darby Macfarlane in the federal district court for the Southern District of New York entitled Richard Sommers and Linda Sommers v. Chromatics Color Sciences International, Inc. and Darby S. Macfarlane. The plaintiffs alleged that certain statements purportedly made by or on behalf of the Company concerning the Company's success, the extent of use of the ColorMate(R) System and the Company's cash flow constituted violations of Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5 promulgated thereunder and Section 12(a)(2) of the Securities Act of 1933 as well as common law claims alleging fraudulent misrepresentation, concealment and nondisclosure and seek unspecified charges in an amount to be proven at trial. On March 1, 2001, the defendants moved to dismiss the complaint for failure to make a claim upon which relief can be granted, for failure to plead fraud with requisite particularity and for failure to comply with the statutory requirements for federal securities fraud claims. Oral argument was held before the court (Grisea, J.) on January 17, 2002, and the court entered an order granting the defendants' motion and dismissing the case without prejudice, but with leave for the plaintiffs to refile. A Second Amended Complaint, dated February 7, 2002 has been filed, and defendants believe that the claims asserted against them are without merit and intend to vigorously defend this action. Prior Marketing Attempts. Other than the Company's marketing efforts with Avon, arrangements with IMS and its beauty salon placements the Company's own attempts to license and/or lease its Intellectual Properties and the ColorMate(R) units and to market its Beauty- Aid Products independently and/or through licensees never proceeded beyond the test marketing stage. There can be no assurance the Company will in the future achieve commercial leasing of its ColorMate(R) units and commercial licensing of the Intellectual Properties or the sale of the Beauty- Aid Products. In addition, other than the Company's distribution partnership with Datex-Ohmeda, Inc. and its Ohmeda Medical Division for the sale of its ColorMate(R) TLc-BiliTest(R) System (which is generating insignificant revenue), the Company's revenue generating activities have been primarily conducted in conjunction with its former licensees (i.e., Clairol, Hanes and Avon), that provided substantial economic, administrative, marketing and advertising support. There can be no assurance that without the support of a marketing partner with financial resources, an advertising budget, market presence and consumer recognition, the Company will be able to achieve successful operations, including for medical applications of its products and technologies. Further, there can be no assurance the Company will ever develop a commercial market for the licensing or leasing of its ColorMate(R) units and Intellectual Properties, for the sale of the Beauty-Aid Products or for any medical applications of its technologies. Competition. The medical products market in general is highly competitive. The Company's ability to compete in the monitoring of newborn bilirubinemia (infant jaundice) market depends primarily on the acceptance by the medical community of the Company's new technology, which can be influenced by factors such as price, product quality and features, technical capability, breadth of product line and distribution capabilities. The Company will be competing with companies, some of which are more established and which have greater financial, technical, manufacturing, marketing, 17

research and development and management resources than the Company (including companies such as Minolta Co., Ltd., AirShields, Respironics, Inc., which acquired Healthdyne Technology, Inc., and SpectRx, Inc., among others), and some of which have greater name recognition and lengthier operating histories in the health care industry. The Company believes the only commercially available non-invasive bilirubinometers with FDA marketing clearance in the United States are the ColorMate(R) TLco BiliTest(R) System, the Minolta Jaundice Meter and the SpectRx Bilicheck. In addition, there will be other companies with which the Company will compete regarding other potential medical applications which the Company may pursue. Furthermore, the laboratory blood test method currently in use for monitoring of newborn bilirubinemia (infant jaundice) has already achieved acceptance by and is in widespread use in the medical community, unlike the Company's proposed methods. There can be no assurance that the Company's proposed method will be accepted by the medical community. There can be no assurance that the Company will be able to effectively compete against these and other competitors, including those competitors who intend to promote their versions of non-invasive devices. Additionally, there can be no assurance that the Company's competitors will not succeed in developing, either during or after the commercialization of the Company's product, devices and technologies that permit more efficient, less expensive non-invasive detection and monitoring of infant jaundice. It is also possible that one or more pharmaceutical or other health care companies will develop therapeutic drugs, treatments or other products that will substantially reduce the prevalence of infant jaundice or otherwise render the Company's products obsolete. There can be no assurance that the Company will be able to upgrade its medical applications and devices to compete with such competitors or with persons who may in the future develop products or monitoring methods competitive with the Company's proposed medical applications and devices. The Company is competing with other companies that have experienced and well-funded marketing and sales operations. In addition, the Company's ColorMate(R) TLc-BiliTest(R) System, as well as any future medical or beauty applications marketed by the Company, will compete with existing devices, technologies and methods in achieving acceptance in the medical community or beauty industry and in attracting support from independent device distribution organizations which sell equipment to the anticipated target markets (i.e., hospitals, pediatrician's offices and home health care services, beauty salons, consumer beauty outlets, etc.). Independent medical or beauty supply distributors who may be retained by the Company will distribute other products which may compete with those of the Company or which would provide greater revenues to such distributors than would be provided by the Company's products. In addition, many medical or beauty supply companies with which the Company's proposed applications and devices will compete, and which have significantly greater financial research, technical, manufacturing, and distribution resources and broader product lines than the Company, have their own in-house marketing and distribution capabilities and have established relationships with potential customers for the Company's proposed medical or beauty application, such as pediatricians and hospitals. In addition, many of the Company's competitors offer broader product lines than the Company, which may be a competitive advantage in obtaining contracts with health care purchasing groups. No assurance can be given that the Company will successfully and effectively market its products against these and other competitors or contract with health care providers. The cosmetics industry and fashion industry are particularly sensitive to changing consumer preferences and demands, which are difficult to predict and beyond the Company's control. Competition in the cosmetics industry is diverse and fragmented, but is nevertheless dominated by a number of large, established, well-known corporations having, among other things, significantly greater financial, marketing and human resources than the Company. Virtually all of such companies have in the past marketed, and continue to market, their products based on their own color analysis system and advertised claims of "color compatibility" with the personal color and/or wardrobe of the consumer. These competitors also have established presence in the market and their own cosmetic manufacturing facilities, unlike the Company. There can be no assurance that consumers would prefer products based on the Company's scientifically based color determinations, rather than the products sold by the Company's competitors based on subjective techniques. Protection of Intellectual Property. The Company depends on its ability to obtain and maintain patent protection for its products and processes, to preserve its trade secrets, and to operate without infringing upon the proprietary rights of third parties. The validity and breadth of claims covered in technology patents involve complex legal and factual questions and therefore, may be highly uncertain. No assurance can be given that the Company will have adequate funds to protect its intellectual property or that the scope of any patent protection under the Company's current patents, or under any patent the Company might obtain in the future, will exclude competitors or provide competitive advantages to the Company; that any of the Company's patents will not be held invalid if subsequently challenged; or that others will not claim rights in or

ownership of the patents and other proprietary rights held by the Company. 18 After the expiration of a U.S. Patent owned by the Company, the proprietary technology and instrumentation disclosed in each Patent will be available for use by others without compensation to the Company, unless protected by the claims of other U.S. patents that may be issued to the Company. The Company has developed intellectual property rights in color analysis, calibration and verification in a number of fields including medical, biological, dental, cosmetic and materials testing. The intellectual property rights include trade secrets, know how and pending patent applications. These rights also include various foreign patent applications corresponding, at least in part, to the U.S. Patents and the U.S. patent application. There can be no assurance that patents will issue based on these patent applications or that any patent claims will provide sufficient protection to exclude others from the Company's proprietary technology and instrumentation. There can be no assurance that the Company will not be involved in litigation to protect its trade secrets and know how or that the Company will prevail in such litigation. There can be no assurance that challenges will not be instituted against the validity or enforceability of any patents owned by or issued in the future to the Company, or that such challenges will not be successful. There can be no assurance that patent infringement claims will not be asserted against the Company and found to have merit, that the Company will not be enjoined from using its proprietary technology and instrumentation and from manufacturing and selling certain of its Products, or would not be forced to obtain a license and pay future royalty fees as well as past damages to the party claiming infringement in amounts not presently determinable. There can be no assurance that any such license will be available to the Company. Conversely, to the extent third parties infringe upon the Company's patented Intellectual Properties, the Company may have to litigate against such third parties in order to prevent further infringement. There can be no assurance the Company will have the resources to prosecute any such litigation, or that any such litigation would be resolved in favor of the Company. In the event it is unable to bring such litigation or obtain a favorable outcome, the Company's operations could be materially adversely affected in that the Company's failure to enforce its Patents could result in increased competition. If the Patents are declared invalid, the Company would lose patent protection for certain of its Intellectual Properties, which could have a material adverse effect on its operations. There can be no assurance that the Company's Intellectual Properties will provide it with a competitive advantage in that it may be possible for a competitor independently to develop non-infringing technologies, independently duplicate the Company's unpatented technology through reverse engineering, design around the patented aspects of the Company's technology, or otherwise independently develop scientifically accurate processes, instruments or color charts to measure skin coloration, skin tone color categories and conduct comparative color analysis, color calibration and color verification without infringing the Company's Patents. The Company's U.S. Patents apply only to the United States. The Company has filed patent applications in a number of foreign jurisdictions which correspond, at least in part, to the Company's U.S. Patents. The Company has been granted European Patent No. 0446512, nationalizations of that European Patent in Great Britain and Hong Kong, as well as Australian, Canadian, Korean and Mexican Patents corresponding, at least in part, to its U.S. Patent No. 4,909,632, Australian, Canadian, Taiwanese and Korean Patents corresponding, at least in part, to its U.S. Patent No. 5,313,267 an Australian Patent, a Canadian Patent, a Singapore Patent and two Taiwanese Patents corresponding, at least in part, to its U.S. Patent No. 5,671,735 and an Australian patent corresponding, at least in part, to its U.S. Patent No. 6,178,341. The Company has not yet been granted any other foreign patents for its Intellectual Properties and there can be no assurance that it will be granted any such patents. Consequently, wherever the Company does not have foreign patents, third parties currently could exploit, outside the United States, the technology disclosed in the U.S. Patents, thereby increasing competition in such foreign markets. In addition, persons gaining access to the Company's unpatented proprietary information and technology and who are not bound by confidentiality agreements with the Company would have the ability to exploit the Company's unpatented proprietary information and technology both inside and outside the United States, thereby increasing competition. There can be no assurance that one or more of the Patents held by the Company will not be successfully challenged or circumvented or that the Company will otherwise be able to rely on such Patents. In addition, there can be no assurance that competitors, many of whom have substantial resources and have made substantial investments in competing technologies, will not seek to apply for and obtain patents that prevent, limit or interfere with the Company's ability to make, use and sell its products either in the United States or in foreign markets. If the Company's right or ability to manufacture its products were to be proscribed or limited, the Company's ability to continue to manufacture and market its Products could be adversely affected, which would likely have a material adverse effect upon the Company's business, financial condition and results of operations. The Company has not applied for patent protection

for many aspects of the Intellectual Properties (i.e., its proprietary trade secrets and other confidential information). The Company typically imposes on its consultants, key employees and advisers confidentiality obligations in connection with their employment, consulting or advisory relationship with the Company. There can be no assurance that such confidentiality obligations will be observed or that the Company will have adequate remedies if those obligations are breached. To the extent that consultants, key employees or other advisors apply 19 technological information taken from the Company in violation of confidentiality obligations, disputes may arise as to the proprietary rights to such information which may not be resolved in favor of the Company. There can be no assurance that others will not independently develop technology that is substantially equivalent or superior to that included in the Company's Intellectual Properties which are not protected by patents. There can be no assurance that the Company's copyright protection for the software used in the ColorMate(R) Systems will provide it with a competitive advantage in that it may be possible for a competitor independently to develop similar software, design around the Company's copyrighted software or otherwise independently develop software with the capacity to accurately measure skin tone categories and conduct comparative color analysis. The medical device industry has been characterized by extensive litigation regarding patents and other intellectual property rights, particularly with respect to newly developed technology. In addition, re-examination or interference proceedings may be instituted in the United States Patent and Trademark Office ("USPTO"). There can be no assurance that the Company will not become subject to patent infringement claims brought by third parties, or re-examination of previously issued patents by the USPTO or interference proceedings instituted in the USPTO to determine the priority of inventions. The defense and prosecution of intellectual property suits, USPTO re-examination and interference proceedings and related legal and administrative proceedings are both costly and time consuming. Litigation may be necessary to enforce patents issued to the Company, to protect trade secrets or know-how owned by the Company or to determine the enforceability, scope and validity of the proprietary rights of the Company and others. Any litigation or interference proceedings brought against, initiated by or otherwise involving the Company may require the Company to incur substantial legal and other fees and expenses and may require some of the Company's employees to devote all or a substantial portion of their time to the prosecution or defense of such litigation or proceedings. An adverse determination in litigation or interference proceedings to which the Company may become a party, including any litigation that may arise against the Company, could subject the Company to significant liabilities to third parties, disputed rights to be licensed from such third parties or prevent the Company from selling its products in certain markets, or at all. If third-party patents containing claims affecting the Company's technology were issued, and such claims were determined to be valid, there can be no assurance that the Company would be able to obtain licenses to such patents at costs reasonable to the Company, if at all, or be able to develop or obtain alternate technology. Although patent and intellectual property disputes regarding medical devices are often settled through licensing or similar arrangements, there can be no assurance that the Company would be able to reach a satisfactory settlement of such a dispute that would allow it to license necessary patents or other intellectual property. Even if such a settlement were reached, the settlement process may be expensive and time consuming, and the terms of the settlement may require the Company to pay substantial royalties. An adverse determination in a judicial or administrative proceeding or the failure to obtain a necessary license could prevent the Company from manufacturing and selling its products, which would have a material adverse effect on the Company's business, financial condition and results of operations. The Company is aware that others have obtained and are pursuing patent protection for various aspects of infant jaundice diagnostic and monitoring products and their use, including products that are non-invasive. There can be no assurance that the Company's technology, current or future products or activities will not be deemed to infringe upon the patent rights of others. Failure to Obtain and Maintain Third-Party Reimbursement. In the United States and elsewhere, sales of medical products and their use are dependent, in part, on the ability of consumers of these products to obtain reimbursement for all or a portion of their cost from third-party payors, such as government and private insurance plans. Third-party payors are increasingly challenging the prices charged for medical products and services. As the Company brings its ColorMate(R) TLc-BiliTest(R) System or other future products to market, there can be no assurance that such products will be considered cost effective and that reimbursement to the consumer will be or continue to be available, or sufficient to allow the Company to sell its medical device products on a competitive basis. Moreover, obtaining and maintaining health care payors' approval of reimbursement for the Company's products or their use, and the level of reimbursement made available, will be an important factor in establishing pricing, structure and market acceptance. The Company is unable to predict what changes will be made in the reimbursement methods utilized by third-party

health care payors. Furthermore, the Company could be adversely affected by changes in reimbursement policies of governmental or private health care payors. Market acceptance of the Company's products in international markets will be dependent in part upon the availability of reimbursement within prevailing health care payment systems. Reimbursement and health care payment systems in international markets vary significantly by country and include both government sponsored health care and private insurance. Although the Company intends to seek international reimbursement approvals, there can be no assurance that such approvals will be obtained in a timely manner, if at all. Failure to obtain and maintain third-party reimbursement coverage for use of the 20 ColorMate(R) TLc- BiliTest(R) System will have a material adverse effect on the Company's ability to commercialize its technology for medical applications. Government Regulations. The Company's advertising, sales practices, and products (including the labeling and packaging thereof) are and will be subject to applicable federal, state and local regulation (including regulation by the FDA, the Federal Trade Commission, and the Federal Communications Commission, under various laws such as the Fair Packaging and Labeling Act and/or any comparable state authority, agency or statute) and will be subject to regulation by comparable foreign authorities if the Company markets its products abroad. The Company will also be subject to regulation by various governmental agencies that regulate direct selling activities. Although the Company has received FDA marketing clearance of its ColorMate(R) TLc-BiliTest(R) System pursuant to a "substantial equivalence" determination orders, in the form of letters dated July 1997 and September 2001 from the FDA's CDRH, authorizing the Company to commercially distribute its ColorMate(R) TLc-BiliTest(R) System for adjunctive monitoring of newborn bilirubinemia (infant jaundice) by healthcare professionals in the United States, the Company also must maintain such clearances and comply with the other applicable statutes and applicable rules and regulations promulgated by the FDA, in order to legally market the device. The latest "substantial equivalence" order states that the Company must comply with the medical device general controls, e.g., device establishment registration, medical device listing, good manufacturing practices (QSR requirements), medical device reporting, labeling, and the statutory prohibitions against adulteration and misbranding. In the United States, the FDA regulates the introduction of medical devices as well as, among other things, manufacturing, labeling and record keeping procedures for such products. The process of obtaining marketing clearance for new medical products from the FDA can be costly and time consuming, and there can be no assurance that such clearance will be granted for the Company's future products on a timely basis, if at all, or that FDA review will not involve delays that would adversely affect the Company's ability to commercialize additional or significantly modified products or to expand permitted uses of existing products. Regulatory clearance to market a product from the FDA may entail limitations on the indicated uses of the product. The ability to market can be challenged (and possibly withdrawn) by the FDA due to failure to comply with regulatory standards or the occurrence of unforeseen problems following initial clearance. The Company may be required to file further marketing applications with the FDA under certain circumstances, such as the addition of product claims or product redesign. FDA regulations depend heavily on administrative interpretation, and there can be no assurance that future interpretation made by the FDA or other regulatory bodies, will not adversely affect the Company. In order for the Company to market its products in Europe and certain other foreign jurisdictions, the Company and its distributors and agents must maintain required regulatory registrations or approvals and otherwise comply with extensive regulations regarding safety, efficacy and quality in those jurisdictions. Specifically, certain foreign regulatory bodies have adopted various regulations, among other things, governing product standards, packaging requirements, labeling requirements, import restrictions, tariff regulations, duties and tax requirements. These regulations vary from country to country. To market its ColorMate(R) TLc-BiliTest(R) System in the European Union, the Company sought ISO-9001/EN46001 certification and the right to affix the CE mark. ISO- 9001/EN46001 certification recognizes that the Company has established a quality system for the design, development, manufacturing, servicing and distribution of its medical device. The CE mark is a symbol of quality and compliance with applicable European Union medical device directives. In March 1999, the Company received ISO-9001/EN46001 certification. In April 1999, the Company also was granted permission by the European Union notified body, TUV Essen, to affix the CE Mark to its ColorMate (R) TLc-BiliTest (R) System. Prior to April 1, 1999, the Company passed a product inspection in February 1999 for purposes of receiving the right to affix the CE mark to such specific inspected product. Failure to maintain ISO 9001/EN 46001 certification, CE mark rights or other foreign regulatory approvals for the Company's medical products would prevent the Company from marketing its medical products abroad, which would have a material adverse effect on the Company's business, financial condition and results of operations. There can be no assurance that the Company will obtain any other required regulatory

registrations or approval in such countries or that it will not be required to incur significant costs in obtaining or maintaining such regulatory registrations or approvals. Delays in obtaining any registrations or approvals required to market the Company's products, failure to receive these registrations or approvals, or future loss of previously obtained registration or approvals could have a material adverse effect on the Company's business, financial condition and results of operations. The Company may rely on its third-party foreign distributors to comply with certain foreign regulatory requirements. The inability or failure of the Company or such foreign distributors to comply with varying foreign regulations or the imposition of new regulations could restrict the sale of the Company's products internationally and thereby adversely affect the Company's business, financial condition and results of operations. 21 The Company and any third party with which it has made contract manufacturing or other regulated arrangements is required to adhere to applicable FDA regulations, including the QSR requirements and similar regulations in other countries as required, which include, among other things, testing, control, and documentation requirements. Ongoing compliance with QSR requirements and other applicable regulatory requirements will be strictly enforced in the United States through periodic inspections by federal and possibly state agencies, including the FDA, and in foreign jurisdictions by comparable agencies. Failure to comply with applicable regulatory requirements could result in, among other things, warning letters, injunctions, civil monetary penalties, recall or seizure of products, total or partial suspension of production, refusal of the government to grant premarket clearance or premarket approval for devices, possible rescission or withdrawal of clearances or approvals previously obtained and criminal prosecution. The restriction, suspension or revocation of regulatory clearances or approvals or government enforcement actions due to any other failure to comply with regulatory requirements would have a material adverse effect on the Company's business, financial condition and results of operations. Product Liability. The medical products industry is subject to substantial product liability litigation, and the Company faces an inherent business risk of exposure to product liability claims in the event that the use of its products is alleged to have resulted in adverse effects to a patient or product user. Any such claims could have a material adverse effect on the Company, including on market acceptance of its ColorMate(R) TLc-BiliTest(R) System. As the ColorMate(R) TLc-BiliTest(R) System enters commercial use, the Company will be in a field where it may become subject to product liability claims by patients and/or users and might become a defendant in product liability litigation. The Company maintains its own product liability insurance with respect to medical, cosmetic and beauty aid applications. There can be no assurance that such insurance will be adequate to protect the Company from claims that may be brought against it by users of the ColorMate(R) units or its Beauty-Aid Products. The Company has not established any reserves against any of the foregoing liabilities. In the event of an uninsured or inadequately insured product liability claim in the future based on the performance of the Company's ColorMate(R) TLc-BiliTest(R) System, its ColorMate(R) units or Beauty-Aid Products, the Company's business and financial condition could be materially adversely affected and the Company could be forced to cease operations. Control; Dependence on Management. The Company is dependent primarily on the services of Darby Simpson Macfarlane, Chairperson and Chief Technology Officer, and David Kenneth Macfarlane, Vice President, Research and Development. The loss of either of their services could have a material adverse effect on the Company. Although the Company has purchased key-man life insurance policies in the amounts of $1,000,000 on the lives of both Mrs. and Mr. Macfarlane, there can be no assurance that the proceeds from such policies would enable the Company to retain suitable replacements for them. Lack of Public Market; Possible Volatility of Stock Price. There is no assurance that a regular trading market for the Company's securities will be restored or, if restored, that it will be sustained. The market price for the Company's Common Stock may be significantly affected by such factors as the Company's financial performance, the results of the Company's efforts to license its Intellectual Properties and to market its products, and various factors affecting the color science industry, the medical communities and the beauty aid and cosmetics industries generally. Additionally, in recent years, the stock market has experienced a high level of price and volume volatility for many companies, particularly small and emerging growth companies traded in the over-the-counter market, and these wide price fluctuations are not necessarily related to the operating performance of these companies. Accordingly, there may be significant volatility in the market for the Company's securities. Exercise of Outstanding Placement Agent Warrants and Warrants and Conversion of Debentures and Preferred Stock. The price which the Company will receive for the Common Stock issued upon exercise of the Placement Agent Warrants and Warrants and the conversion of Debentures and Preferred Stock is expected to be substantially less than the market price of the Common Stock at the time such Placement Agent Warrants and Warrants are exercised or such Debentures or Preferred Stock are converted. For the life of such Placement Agent Warrants, Warrants, Debentures

and Preferred Stock, the holders thereof are given, at little or no cost, the opportunity to profit from a rise in the market price of the Common Stock, if any, without assuming the risk of ownership. So long as such Placement Agent Warrants and Warrants remain unexercised and Debentures and Preferred Stock remain unconverted, the terms under which the Company could obtain additional equity financing may be adversely affected. Moreover, the holders of such Placement Agent Warrants, Warrants, Debentures and Preferred Stock may be expected to exercise (or convert, as applicable) them at a time when the Company would, in all likelihood, be able to obtain any needed capital by a new offering of securities on terms more favorable than those provided by such securities. To the extent of any exercise or conversion of Placement Agent Warrants, Warrants, Debentures or Preferred Stock, the interests of the Company's shareholders will be diluted proportionately. 22 Additional Authorized Preferred Stock. The Company's Amended Certificate of Incorporation (the "Certificate of Incorporation") authorizes the Board of Directors to issue, without shareholder approval, up to 10,000,000 shares of preferred stock with voting, conversion and other rights and preferences that could adversely affect the voting power or other rights of the holders of Common Stock. The issuance of preferred stock or of rights to purchase preferred stock could be used to discourage an unsolicited acquisition proposal. In addition, the possible issuance of preferred stock could discourage a proxy contest, make more difficult the acquisition of a substantial block of the Company's Common Stock or limit the price that investors might be willing to pay in the future for shares of the Company's Common Stock. Item 2. Properties The Company's executive offices, consisting of approximately 2,000 sq. ft. of space, are located in Riverdale, New York and are occupied pursuant to a month to month sublease which space is subleased by the Company from Darby Simpson Macfarlane, a director, officer and principal shareholder of the Company; such rent is equal to Mrs. Macfarlane's actual lease cost for such premises. Rentals under such sublease (including storage facilities) currently are being paid at the rate of $2,200 per month, plus occupancy costs. The Company paid $26,400 for such space in 2001. The Company also maintains approximately 1,000 sq. ft. of space at 10 Old Jackson Avenue, Hastings-on-Hudson, New York, at the residence of Mrs. Macfarlane which is used for research and development activities and administrative offices for extensive overtime hours spent on management and research and development. The Company paid approximately $10,980 for such space in 2001. In 2000, the Company also occupied approximately 1,000 sq. ft. of space located in Milford, Connecticut which was leased pursuant to a month to month lease at a cost of $1,670 per month, and used primarily as office space for the Company's medical marketing, sales and distribution support division. The Company ceased to occupy such space in February 2001. Item 3. Legal Proceedings In April 2000 the United States District Court for the Southern District of New York dismissed three putative class actions that had been filed against the Company and certain of its officers and directors. On January 16, 2001, a lawsuit was commenced against the Company and Darby Macfarlane in the federal district court for the Southern District of New York entitled Richard Sommers and Linda Sommers v. Chromatics Color Sciences International, Inc. and Darby S. Macfarlane. The plaintiffs allege that certain statements purportedly made by or on behalf of the Company concerning the Company's success, the extent of use of the ColorMate (Registered Trademark) System and the Company's cash flow constituted violations of Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5 promulgated thereunder and Section 12(a)(2) of the Securities Act of 1933 as well as common law claims alleging fraudulent misrepresentation, concealment and nondisclosure and seek unspecified damages in an amount to be proven at trial. On March 1, 2001, the defendants moved to dismiss the complaint for failure to state a claim upon which relief can be granted, for failure to plead fraud with requisite particularity and for failure to comply with the statutory requirements for federal securities fraud claims. Oral argument was held before the court (Grisea, J.) on January 17, 2002, and the court entered an order granting the defendants' motion and dismissing the case without prejudice, but with leave for the plaintiffs to refile. A Second Amended Complaint, dated February 7, 2002, has been filed, and defendants believe that the claims asserted against them are without merit and intend to vigorously defend this action. Item 4. Submission of Matters to a Vote of Security Holders On October 31, 2001, at a Special Meeting of the Shareholders held at the Legends Hotel and Conference Center in McAfee, New Jersey, the shareholders: (i) approved an Amendment to the Company's Certificate of Incorporation to effect a one share for up to forty shares reverse stock split of the Company's issued and outstanding shares of common stock, as determined by the Company's Board of Directors; and (ii) approved an amendment to the Company's Certificate of Incorporation to increase the number of authorized shares of common stock, $.001 par value per share, from 50,000,000 to 550,000,000. The following table sets forth the votes cast for each proposal presented at the Special Meeting of the Shareholders: 23 Amendment of the Company's Certificate of Incorporation to effect a one share for up to forty shares reverse stock split of the Company's issued and

outstanding shares of common stock, as determined by the Company's Board of Directors ---------- Votes For Votes Against Abstentions ---------- ---------- ---------- 18,078,177 1,052,519 84,550 Amendment of the Company's Certificate of Incorporation to increase the number of authorized shares of common stock, $.001 par value per share, from 50,000,000 to 550,000,000 ---------- Votes For Votes Against Abstentions ---------- ---------- ---------- 18,110,383 1,033,794 71,069 PART II Item 5. Market For the Company's Common Equity and Related Stockholder Matters The Company has registered the Common Stock with the Commission under the provisions of Section 12(g) of the Exchange Act of 1934, as amended (the "Exchange Act"). Registration under the Exchange Act requires the Company to comply with certain reporting, proxy solicitation and other requirements of the Exchange Act. Prior to February 8, 1993, the date on which the Common Stock was approved for quotation on the Nasdaq Stock Market SmallCap Market ("NASDAQ"), there was no public market for the Common Stock. The quotations reflect inter-dealer prices, without retail mark-up, mark-down or commissions, and may not necessarily reflect actual transactions. On March 23, 2001, the Company's Common Stock was suspended from trading on the Nasdaq Small Cap Market as a result of the Company's failure to satisfy certain conditions. On November 29, 2001 the Company's common stock delisted from NASDAQ SmallCap Market. However, the common stock continues to be listed on the OTC Bulletin Board. There were 152 holders of record of the Common Stock as of February 1, 2002, including nominees for an unknown number of beneficial holders. Common Stock The following tables set forth the high and low bid prices of our common stock for each of the periods indicated. Prices reported subsequent to November 29, 2001 reflect inter-dealer prices, without retail mark-up, mark-down or commission, and may not reflect actual transactions. Period Price ---------- ---------- High Low -------- -------- January 1, 2000 to March 31, 2000 $7.938 $5.375 April 1, 2000 to June 30, 2000 5.375 2.875 July 1, 2000 to September 30, 2000 5.063 0.625 October 1, 2000 to December 31, 2000 2.125 0.250 January 1, 2001 to March 31, 2001 $1.031 $0.063 April 1, 2001 to June 30, 2001 0.310 0.100 July 1, 2001 to September 30, 2001 0.220 0.040 October 1, 2001 to December 31, 2001 0.110 0.010 Dividend Policy The Company has never paid and has no present intention to declare or pay, cash dividends on the Common Stock in the foreseeable future. The Company intends to retain any earnings which it may realize in the foreseeable future to finance its 24 operations. The Company has outstanding 1,380,000 shares of the Class A Preferred Stock entitled to an annual non- cumulative dividend of $0.001 per share, when and as declared by the Board of Directors of the Company, payable quarterly, which dividend must be paid before any cash dividend may be paid with respect to the Common Stock. The Company's Class B Preferred Stock is to not entitled to any dividends. Item 6. Selected Financial Data The following information has been derived from the Company's consolidated financial statements. The selected consolidated financial data should be read in conjunction with the Consolidated Financial Statements and the notes thereto and "Management's Discussion and Analysis of Financial Condition and Results of Operations" elsewhere in this report. Years Ended December 31, ---------- 2001 2000 1999 1998 1997 ---------- ---------- ---------- ---------- ---------- Total Assets $1,312,000 $4,914,000 $8,110,200 $7,878,200 $10,752,600 Senior Convertible Debentures including accrued interest -- -- 4,661,600 -- -- Redeemable Preferred Stock -- 14,000 2,942,500 13,800 13,800 Stockholders' Equity (Deficiency) (3,187,000) 3,386,000 (503,700) 6,569,200 9,896,300 Revenues 8,000 80,000 1,103,200 46,600 11,500 Net Loss (7,918,000) (19,496,000) (12,808,000) (7,284,800) (5,053,100) Net Loss per common share - Basic and diluted(*) (0.41) (1.40) (0.93) (0.49) (0.40) ---------- (*) Loss per share was retroactively adjusted to reflect the three for two split Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations Results of Operations Fiscal Year 2001 Compared to Fiscal Year 2000 The Company incurred net losses of $7,918,000 and $19,496,000 for the fiscal years ended December 31, 2001 and 2000, respectively. Loss per share was $0.41 for 2001 and $1.40 for 2000. The reduction in net loss is primarily a result of the Company pairing back its expenses to preserve cash and the completion of the developmental stage of its medical product, and a reduced impact from continued operations. Revenues for the fiscal year ended December 31, 2001 were $8,000 compared to $80,000 in the prior fiscal year. The lack of significant revenue is primarily attributable to the Company's inability to successfully market and distribute its medical product. A combination of factors contributed to disappointing sales results during 2000 and 2001. There were many upgrades to the instrument requested by the end user including ease of use features such as rechargeable batteries, shortened length of test and accelerated modem transfer of test results to a central server for tracking patient

tests after hospital discharge. These and numerous other upgrades required additional FDA applications and FDA clearances which were not obtained until the third quarter of 2001. Additionally, the length of the hospital evaluation period was much longer than expected, including multi-site studies, which were completed in the years 2000 and 2001. These post market studies were submitted in the Company's FDA application in 2001 which received FDA clearances in the third quarter of 2001. These clearances allow the Company to upgrade the medical instruments to accommodate the end users requirements. However, further funding of the Company is required to perform these upgrades on the Company's medical distributor's inventory. Costs of sales were $1,000 and $760,000 (which includes an impairment charge of $733,000 on the Company's inventory) for the fiscal years ended December 31, 2001 and 2000 respectively. Cost of sales primarily relate to the sales to Ohmeda of which there was a $1,000 charge for the December 31, 2001 period. In order to support the extended length of time hospitals required to conduct the Company's medical instrument evaluations, and post-market studies required for FDA applications for upgrades, additional parts and raw materials were required and therefore purchased. Also the Company was required to keep minimum backup inventories under its contractual agreements with its medical distributor. In light of the serious liquidity and other problems at the Company and because of the lack of viable levels of sales of its medical equipment the Company recorded $1,338,000 and $1,508,000 of impairment charges in 2001 and 2000, respectively. These charges include $647,000 and $581,000 reductions in carrying costs for patents, a $258,000 reduction in carrying costs for demo equipment in 2000, $300,000 and $315,000 reduction in carrying costs for ColorMate(R) units 25 in 2001 and 2000, a $354,000 reduction of deferred contract costs incurred during the Datex-Ohmeda contract negotiations in 2000, a $53,000 reduction of software costs in 2001, and a reduction of inventory of $338,000 in 2001. Sales, marketing and trade show costs were $285,000 in 2001 as compared to $2,047,000 in 2000. The decrease was primarily attributable to Datex-Ohmeda, the Company's distributor, taking over these responsibilities. Medical regulatory expenses were $304,000 in 2001 as compared to $840,000 in 2000. The decrease was primarily attributable to Datex-Ohmeda, the Company's distributor, assuming some of the regulatory expenses and the completion of the majority of the expenses for FDA applications. Research and development costs were $745,000 for the fiscal year ended December 31, 2001 as compared to $1,257,000 in the prior fiscal year. The decrease in 2001 is primarily a result of the completion of the majority of the work for FDA applications for upgrades to the TLc-BiliTest(R) medical instrument in 2000, and pairing back expenses on further research and development required on the LED instrument. The LED Instrument is a significantly lower cost instrument made using low cost light emitting diodes (LEDs) to measure color. This instrument allows the Company to offer lower cost instruments for use in mass market applications where cost per instrument is critical to mass marketing such as in the beauty industry for salons, door-to-door or retail sales of cosmetics and hair color, for dentist offices, or home use by the consumer. The Company recorded a provision for payments for termination clauses in employee contracts of $795,000 in 2001. Compensation - Officers, employees and consultants were $1,389,000 for the fiscal year ended December 31, 2001 as compared to $2,390,000 for the prior fiscal year. The decrease in these costs in 2001 is a result of the reduction of personnel, including executive and senior level personnel to pare back its expenses to preserve cash and a reduction in compensation costs relating to stock options. Total General and administrative costs were $3,261,000 for the fiscal year ended December 31, 2001 as compared to $5,631,000 in the prior year. The decrease primarily results from the above-mentioned decrease in compensation costs, a decrease in depreciation and amortization costs and a significant reduction in overall operating costs to preserve cash. Interest and financing costs were $662,000 in the fiscal year ended December 31, 2001 as compared to $1,437,000 in the prior period. The decrease is due to a reduction in the amortization of original issue discount on the senior convertible debentures. Due to the sale of Gordon in 2001 the operations of Gordon, which was acquired in June 2000, was retroactively treated as a discontinued operation. The loss from discontinued operations in 2000 was $5,973,000 of which $697,000 represents Gordon's operating losses for the 7 months in 2000 and $5,276,000 represents the impairment of goodwill related to the acquisition of Gordon. The decision to sell Gordon was directly related to Gordon's lack of liquidity and continued reliance on cash inflows from the Company. Due to the lack of funds the Company experienced beginning in 2000 and Gordon's simultaneous default on a $2.7 million loan from Boeing, also requiring a large infusion of capital, the Company could no longer supply Gordon's capital requirements and so it made the decision to sell Gordon Laboratories. The loss from discontinued operations in 2001 through the disposal date was $1,250,000. The Company reflected a gain of $759,000 on disposal, representing the net liabilities of Gordon. Deemed dividend on preferred stock was $293,000 in the fiscal year ended December 31, 2001 as compared to $3,900,000 in the prior year. The decrease is due to the effect in 2000

of the amortization of a new series of preferred stock which was completed in 2000 and the impact of a new accounting release in 2000 causing a large one time catch up charge. The deemed dividend is a result of the Company issuing preferred stock at a discount, consisting of a below market conversion price, warrants issued with the preferred stock, and, in certain cases, redemption premiums. Although the Company has substantially reduced personnel and ongoing operating expenses, the Company expects that it will continue to incur costs in connection with the required research and development on its new LED instrument and technology, complete filings, administration and maintenance for certain intellectual properties and regulatory requirements; supply updated products and sales support to its medical distributor; complete FDA filings for upgrades to its medical products, and explore the possibility of either renegotiating its current distribution agreement for its medical products or selling the exclusive rights to its medical products and technology. The Company anticipates that it will continue to incur new losses for the foreseeable future as expenses are incurred in implementing its long-term business plan. Fiscal Year 2000 Compared to Fiscal Year 1999 26 The Company incurred net losses of $19,496,000 and $12,808,000 for the fiscal years ended December 31, 2000 and 1999, respectively. Loss per share was $1.40 for 2000 and $.93 for 1999. Revenues for the fiscal year ended December 31, 2000 were $80,000 compared to $1,103,000 in the prior fiscal year. The decrease in revenues for the fiscal year is primarily attributable to a reduction of sales of products to Datex-Ohmeda, the Company's medical distributor. Sales in 1999 were primarily due to the distribution agreement signed with Datex-Ohmeda, and consisted of minimum inventory purchase obligations by Datex-Ohmeda. A combination of factors contributed to disappointing sales results during 2000 and 2001. There were many upgrades to the instrument requested by the end user including ease of use features such as rechargeable batteries, shortened length of test and accelerated modem transfer of test results to a central server for tracking patient tests after hospital discharge. These upgrades and numerous other upgrades required additional FDA applications and FDA clearances which were not obtained until the third quarter of 2001. Additionally, the length of the hospital evaluation period was much longer than expected, including multi-site studies, which were completed in the years 2000 and 2001. These post market studies were submitted in the Company's FDA application in 2001 which received FDA clearances in the third quarter of 2001. These clearances allow the Company to upgrade the medical instruments to accommodate the end users requirements. However, further funding of the Company is required to perform these upgrades on the Company's medical distributor's inventory. Costs of sales were $760,000 (which includes an impairment charge of $733,000 on the Company's inventory) for the fiscal year ended December 31, 2000 as compared to $898,000 in the prior year. Cost of sales primarily relate to the sales to Ohmeda. The impairment charge was incurred due to the lack of success in marketing and sales under the Ohmeda contract. In light of the serious liquidity and other problems at the Company and because of the lack of viable levels of sales of its medical equipment the Company recorded $1,508,000 of impairment charges in 2000. These charges include a $581,000 reduction in carrying costs for patents, a $258,000 reduction in carrying costs for demo equipment, a $315,000 reduction in carrying costs for ColorMate(R) units, and a $354,000 reduction of deferred contract costs incurred during the Datex-Ohmeda contract negotiations. Sales, marketing and trade show costs were $2,047,000 in 2000 as compared to $2,512,000 in 1999. The decrease was primarily attributable to Datex-Ohmeda assuming some of the marketing expenses in 2000. Medical regulatory expenses were $840,000 in 2000 as compared to $1,323,000 in 1999. The decrease was primarily attributable to Datex-Ohmeda assuming some of the regulatory expenses in 2000. Research and development costs were $1,257,000 for the fiscal year ended December 31, 2000 as compared to $996,000 in the prior fiscal year. The increase in 2000 is primarily a result of the further development of the Company's LED machine, and research and development for upgrades to the Company's medical product for FDA applications. Compensation - Officers, employees and consultants were $2,390,000 for the fiscal year ended December 31, 2000 as compared to $2,089,000 for the prior fiscal year. The increase in these costs in 2000 is a result of the addition of executive and senior level personnel to implement the Company's business plan. Total General and administrative costs were $5,631,000 for the fiscal year ended December 31, 2000 as compared to $4,936,000 in the prior year. The increase primarily results from the above-mentioned increase in compensation costs, an increase in consultants, an increase in depreciation and amortization costs. Interest and non-cash financing costs were $1,437,000 in the fiscal year ended December 31, 2000 as compared to $3,313,000 in the prior period. The decrease is due to a reduction in the amortization of original issue discount on the senior convertible debentures. Due to the sale of Gordon in 2001 the operations of Gordon, which was acquired in June 2000, was retroactively treated as a discontinued operation. The loss from discontinued operations in 2000 was $5,973,000 of which $697,000 represents Gordon's operating losses for the 7 months in 2000 and

$5,276,000 represents the impairment of goodwill related to the acquisition of Gordon. The decision to sell Gordon was directly related to Gordon's lack of liquidity and continued reliance on cash inflows from the Company, which in 2001 the Company ceased being able to provide. Deemed dividend on preferred stock was $3,900,000 in the fiscal year ended December 31, 2000 as compared to $1,558,000 in the prior year. The increase is due to the amortization of a new series of preferred stock which was not issued in 1999 and the impact of a new accounting release in 2000 causing a large one time catch up charge. The deemed dividend is a result of the Company issuing preferred stock at a discount, consisting of a below market conversion price, warrants issued with the preferred stock, and, in certain cases, redemption premiums. 27 Although the Company has substantially reduced personnel and ongoing operating expenses, the Company expects that it will continue to incur costs in connection with the required research and development on its new LED instrument and technology, complete filings, administration and maintenance for certain intellectual properties and regulatory requirements; supply updated products and sales support to its medical distributor; complete FDA filings for upgrades to its medical products, and explore the possibility of either renegotiating its current distribution agreement for its medical products or selling the exclusive rights to its medical products and technology. The Company anticipates that it will continue to incur new losses for the foreseeable future as expenses are incurred in implementing its long-term business plan. Liquidity and Capital Resources Current Assets were $447,000 at December 31, 2001 as compared to $2,496,000 at December 31, 2000. This decrease is primarily attributable to decrease in cash due to the operating losses and an impairment charge that reduced inventory. With respect to the Bridge financing received in 2001 notes payable totaling $1,699,000, are payable in one year and carry annual interest charges of 6% to 14%. In addition to the interest charges, 26,750,000 warrants to purchase the Company's common stock at $.10 per share and 6,500,000 warrants to purchase the Company's stock at $.06 per share were issued in connection with the bridge notes. During the year ended December 31, 2000, the Company generated net cash flows from financing activities of $7,792,000 of which $5,480,000 was generated from the issuance of preferred stock and warrants. A complete summary of the preferred stock and warrant agreements are available in the Notes to the Financial Statements. As indicated in the Consolidated Statement of Cash Flows, the Company continues to experience significant negative net cash flows from operating activities. The 2001 net cash outflow from operating activities is primarily attributed to the Company's net loss partially offset by depreciation and amortization expense and increases in accounts payable. The Company lacks funds to continue its operations and business plan, including funds and necessary personnel to complete research and development on its new LED instrument and technology which it became aware of during its first mass manufacturing process; complete filings, administration and maintenance for certain intellectual properties and regulatory requirements and supply upgraded products and sales support to its medical distributor. After completion of the first mass manufacturing prototype of the LED Instrument, the first mass manufacturing run of products was attempted. During this process, the batch to batch variability of the light emitting diodes caused errors in accuracy of the instruments. This can be corrected in a number of ways, including additional calibration procedures, which require more research and development to complete. 28 Additional funding is required to complete this research and development. The Company's inability to complete required filings, administration and maintenance related to its intellectual property would result in the loss of these related sections of its intellectual property. The Company's current objective with regard to its medical business is to arrive at acceptable revised terms of the existing agreement with the distributor or to identify a strategic partner in the medical industry to whom the Company could sell, for an up-front fee and ongoing royalty, the exclusive market rights to the ColorMate(R) TLc-BiliTest(R) System. The Independent Auditors' Reports on the December 31, 2001 and December 31, 2000 financial statements describe conditions that raise substantial doubt about the Company's ability to continue as a going concern. Gordon was sold in 2001. The Company's business plan is to maintain reduced operating costs while seeking additional financing and attempting to either arrive at acceptable revised business arrangements with its current medical distributor or to sell to a strategic partner the exclusive rights to its medical technology for monitoring infant jaundice for an up-front fee and ongoing royalties. If it is successful in these efforts to raise funds for continued operations, then the Company plans to hire new management, continue its research and development on the LED instrument and implement its business plan for marketing its technology and instruments to the beauty industry including cosmetics, fashion and hair color markets. The Company is experiencing a major liquidity crisis and requires an immediate infusion of cash to continue operations. The Company is seeking additional capital to facilitate liquidity and is reviewing various potential financings and has taken steps to significantly reduce costs. If the Company is unable to obtain such financing, or sell its assets to obtain a cash infusion, it may be forced to seek

protection from its creditors in bankruptcy. Even if the Company is successful in obtaining this cash infusion, the Company will require additional future financing to further execute its long range business plan. If the Company is not able to attract additional future financing, generate significant revenue from operations and/or successfully market its products and technologies, it may have to significantly curtain and/or cease operations and be forced to seek protection from its creditors in bankruptcy. In August 2001, the Company retained Janssen Partners, Inc. to serve as its placement agent in connection with an offering of 10,333,333 shares of common stock and warrants to raise $620,000 in proceeds, of which $25,000 has been subscribed to as of April 22, 2002. Attached to each share is a Series A Common Stock Purchase Warrant which vests immediately, has a five-year life and is exercisable at $0.10 per share after registration of the underlying shares. Upon the exercise of each Series A Common Stock Purchase Warrant, the holder will receive a Series B Common Stock Purchase Warrant which vests immediately, has a five-year life from date of issuance and is exercisable at $0.15 per share after registration of the underlying shares. The Company is contemplating issuing an additional proxy to obtain stockholder approval for an additional proposed private placement by the Company involving potential issuance of additional shares of common stock by the Company in an aggregate amount in excess of 20% of the Company's common stock outstanding immediately prior to such private placement at a price per share less than the market value of the common stock. On October 31, 2001, at a special shareholder meeting an amendment to the Company's Certificate of Incorporation to increase the number of authorized shares of common stock, $.001 par value per share, from 50,000,000 to 550,000,000 was approved by the following votes: 18,110,383 for, 1,033,794 against and 71,069 abstained. Additionally, an amendment to the Company's Certificate of Incorporation to effect a one share for up to forty shares reverse stock split of the Company's issued and outstanding shares of common stock, as determined by the Company's Board of Directors was approved by the following votes: 18,078,117 for, 1,052,519 against; and 84,550 abstained. Due to the delisting of the Company's securities from NASDAQ SmallCap market, the Company's Board of Directors does not see the necessity to execute a reverse split in the Company's common stock at this time, but reserves the right to reconsider this action at a later date within time frames proposed in the Proxy which were approved by the Company's shareholders at the October 31, 2001 Special Meeting of the Shareholders. Some of the information presented herein constitutes "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. Although the Company believes that its expectations are based on reasonable assumptions, within the bounds of its knowledge of its business and operations, there can be no assurance that actual results will not differ materially from its expectations. Factors that could cause actual results to differ from expectations including, among other things: (i) the inability of the Company to resolve the current liquidity crisis, (ii) the inability of the Company to 29 secure additional financing, (iii) the failure of the Company to implement its business plan for various applications of its technologies, including medical and industrial technologies, (iv) government regulation and (v) the loss of key personnel. Item 8. Financial Statements INDEX TO CONSOLIDATED FINANCIAL STATEMENTS Page ------ Independent Auditors' Reports..... * Consolidated Balance Sheets as of December 31, 2001 and 2000..... * Consolidated Statements of Operations for the years ended December 31, 2001, 2000, and 1999..... * Consolidated Statements of Changes in Stockholders' Equity (Deficit) for the years ended December 31, 2001, 2000, and 1999..... * Consolidated Statements of Cash Flows for the years ended December 31, 2001, 2000, and 1999..... * Notes to Consolidated Financial Statements..... * [* FINANCIAL STATEMENTS LOCATED AT END OF DOCUMENT] Item 9. Changes In And Disagreements With Accountants On Accounting And Financial Disclosure. On March 8, 2002, the Audit Committee of the Company appointed Richard A. Eisner & Company, LLP ("Eisner") as its independent auditors to replace BDO Seidman, LLP, ("BDO") as BDO declined to be reappointed as the Company's independent auditors because the Company does not currently meet its client profile. BDO's reports on the Company's financial statements for the past two years did not contain an adverse opinion, disclaimer of opinion, or qualification or modification as to uncertainty, audit scope, or accounting principles, except the report contained a going concern explanatory paragraph. During the two most recent fiscal years and the subsequent interim period preceding March 8, 2002, there have been no disagreements with BDO on any matter of accounting principles or practices, financial statement disclosure, or auditing scope or procedure which, if not resolved to the satisfaction of BDO, would have caused it to make reference to the subject matter of the disagreements in connection with its report. BDO furnished a letter addressed to the Securities and Exchange Commission stating it agreed with the above statements. The Company (or someone on its behalf) has not consulted Eisner during the two most recent fiscal years and the subsequent interim period preceding March 8, 2002 regarding

the application of accounting principles to a specified transaction or the type of audit opinion that might be rendered on the Company's financial statements. 30 PART III Item 10. Directors, Executive Officers, Promotees and Control Persons, Compliance with Section 16(a) of the Exchange Act Certain information concerning directors and executive officers of the Company is set forth below: Name Age Position(s) ---------- --- --------- ---------- Darby Simpson Macfarlane 57 Director, Chairperson of the Board of Directors, Chief Technology Officer, Treasurer Brian T. Fitzpatrick 48 Director, Acting Chief Executive Officer, President David Kenneth Macfarlane 55 Director, Vice President Research and Development Leslie Foglesong 46 Director, Secretary, Assistant Treasurer Edmund Vimond*++ 66 Director Ed Mahoney*++ 51 Director ---------- * Member of the Audit Committee of the Board of Directors. ++ Member of the Compensation Committee of the Board of Directors. Directors are elected annually by the shareholders and hold office until the next annual meeting and until their respective successors are elected and qualified. Executive officers are elected by the Board of Directors, serve at the direction of the Board of Directors and hold office until their respective successors are elected and qualified. There is no current arrangement or understanding between any director or executive officer and any other person pursuant to which such person was or is to be selected as a director or executive officer of the Company. Mrs. Macfarlane and Mr. Macfarlane were formerly married to one another. There are no other family relationships among the directors or executive officers of the Company. Set forth below is certain additional information with respect to the directors, executive officers and certain consultants of the Company. Mrs. Macfarlane co-founded the Company in March 1984. She has been Chairperson of the Board, Chief Executive Officer, Chief Technology Officer, Treasurer or Assistant Treasurer and a director of the Company since formation and also served in the capacity of President until April 9, 1995. Prior to such time, Mrs. Macfarlane was the co-founder in 1974 of Personalized Colors, Inc. Commencing in 1978, Mrs. Macfarlane and Mr. Macfarlane led and directed the Company's research and development and mass-manufacturing efforts of the color science technology, instrumentation and cosmetic and related products now offered by the Company. Mr. Macfarlane co-founded the Company and is also one of the primary inventors of the patented technologies used in the ColorMate(R)System. In addition, Mr. Macfarlane developed the manufacturing, technical and engineering specifications necessary to have miniaturized and mass manufactured the ColorMate(R)System. Mr. Macfarlane has been Vice President- Research and Development, and a director of the Company since formation. Prior to 1984, Mr. Macfarlane held a variety of executive positions with finance, sales, marketing, research and development and manufacturing companies in Europe, South Africa and the United States, including International Technical Research and Development, Ltd., and Trumach, Inc. Leslie Foglesong has been the Secretary, Treasurer or Assistant Treasurer and a director of the Company since its formation. Mr. Edmund G. Vimond has previously provided consulting services to the Company. On December 1, 1997, Mr. Vimond was appointed to the Company's Board of Directors and currently acts as Chairman of the Company's Compensation Committee. From 1991 to 1997, Mr. Vimond was the President and Chief Executive Officer of Ocurest Laboratories, Inc. Mr. Vimond was responsible for managing all functions of the business, including marketing, sales, contract manufacturing, personnel and finance and systems. Prior to 1991, Mr. Vimond held positions in various executive capacities with RJR Nabisco Inc., American Cyanamid Co., Johnson & Johnson and Warner-Lambert Company. Mr. Vimond received BSBA and MBA degrees from Northwestern University. 31 Edward Mahoney, a certified public accountant, was appointed to the Board of Directors on January 26, 1998, and currently acts as Chairman of the Company's Audit Committee. Since January 1998, Mr. Mahoney has owned and operated a certified public accounting firm and was a tax partner with the accounting firm of BDO Seidman LLP from 1994 to 1997 and Price Waterhouse from 1973 to 1994. Mr. Mahoney received a Bachelor of Science in Accounting degree from Brooklyn College of the City University of New York. Brian T. Fitzpatrick was appointed Acting Chief Executive Officer and a director of the Company on August 14, 2000. He previously served in the capacity of President and Chief Operating Officer of the Company, which role he assumed upon the Company's June 2000 acquisition of Gordon Laboratories, Inc., a Carson City, California based formulator and manufacturer of cosmetics, hair care and other personal care products. Mr. Fitzpatrick had been the President, Chief Executive Officer and Chairman of Gordon since April 1996, and continues to retain the title of President. Prior to Gordon, Mr. Fitzpatrick served as President of several electronic manufacturing companies and worked for the Polaroid Corporation in its industrial marketing division. Mr. Fitzpatrick earned an M.B.A. in Finance and Marketing from Adelphi University in 1986 and a B.S. in Marketing from Seton Hall University in 1975. Darby S. Macfarlane and David Kenneth Macfarlane are the founders of the Company and, as such, may be deemed "promoters" of the Company as those terms are defined in the rules and regulations promulgated under the Securities

Act of 1933, as amended. There is no family relationship among any other directors or executive officers of the Company. Medical Advisory Board The Company established a Medical Advisory Board consisting of Dr. Fred W. Billmeyer, Dr. Ian Holzman and Dr. Jeffrey Maisels, independent consultants/advisors to the Company. Dr. Fred W. Billmeyer, Jr., Professor Emeritus at Rensselaer Polytechnic Institute, a color scientist and recognized expert in the color science field for more than 40 years, has been a consultant to the Company since 1984 and is a member of the Company's Medical Advisory Board. Dr. Billmeyer has published numerous books and articles in the field of color science. The consulting agreement with Dr. Billmeyer provides that he will provide color consulting services to the Company at a fee of $125 per hour. Such services include providing advice and supervisory assistance in connection with any further research and development, modification, enhancement or marketing activity relating to the ColorMate(R) System and Intellectual Properties in specific applications and assisting in obtaining patent protection for the unpatented Intellectual Properties. In addition, Dr. Billmeyer is entitled to receive a royalty in the amount of 2% of the selling price less the cost of manufacture of any device sold by the Company. In 2000 and 1999, the Company paid Dr. Billmeyer $2,800 and $4,827 respectively. Dr. Ian Holzman, a physician with the Department of Pediatrics, Division of Newborn Medicine, Mt. Sinai Medical Center, is a member of the Medical Advisory Board. Dr. Holzman is presently the Chief of the Division of Newborn Medicine at Mt. Sinai Medical Center and a member of the Attending Staff at each of Mt. Sinai Medical Center and City Hospital Center at Elmhurst. In addition, Dr. Holzman is a Professor of Pediatrics, Obstetrics and Gynecology and Reproductive Medicine, at Mt. Sinai School of Medicine. Dr. Holzman has published numerous journal articles, book chapters and medical abstracts in the field of pediatric treatment and medicine. Dr. Jeffrey Maisels, a physician with the Department of Pediatrics, William Beaumont Hospital, is a member of the Medical Advisory Board. Dr. Maisels is presently the Chief of the Department of Pediatrics at William Beaumont Hospital and is also a Clinical Professor of Pediatrics at Wayne State University School of Medicine. Dr. Maisels has published numerous journal articles, book chapters and medical abstracts in the field of pediatric treatment and medicine including publications relating to bilirubin infant jaundice and phototherapy. Consultants The Company relies on the services of certain other consultants and advisors. The consultants are not executive officers of the Company but make or are expected to make significant contributions to the business of the Company. Mr. Frederick Frank, Vice Chairman of Lehman Brothers, an investment banking firm, has been an advisor to the Company since December 1, 1997, providing financial, strategic and business advisory services. The consulting agreement with Mr. Frank expired December 1, 1998 but was renewed by mutual agreement of the Company and Mr. Frank until July 1, 2002. The Company also employs certain other consultants and temporary personnel for various purposes such as FDA and regulatory matters, the Bilirubin Project and marketing, engineering, research and development associated with the Intellectual properties, Beauty-Aid Products, the ColorMate(R) Bilirubin Device and ColorMate(R) units. The Company has also retained consultants to provide public relations, shareholder relations, financial, administrative, licensing and investment banking services. In 2001, these consultants and temporary personnel were paid an aggregate of $874,700. All consultants 32 may be reimbursed by the Company for reasonable out-of-pocket expenses incurred by them in connection with the services each consultant provides the Company. Compliance with Section 16(a) of the Exchange Act The Company became subject to the reporting requirements of Section 13 of the Exchange Act on February 5, 1993 and, accordingly, the Company's officers, directors and greater than 10 percent beneficial owners were subject to the reporting requirements of Section 16(a) of the Exchange Act during the year ended December 31, 1993. The Company believes that during the fiscal year ended December 31, 2001 all filing requirements under Section 16(a) applicable to its officers, directors and greater than ten percent beneficial owners were complied with on a timely basis. Item 11. Executive Compensation Summary Compensation Table The following table summarizes all plan and non-plan compensation awarded to, earned by or paid to the Company's Chief Executive Office and its three other executive officers who were serving as such during and at the end of fiscal 2001 for services rendered in all capacities to the Company in the last three fiscal years. Name and Principal Position Year Annual Compensation Long-Term Compensation ------------------------------ ------ ------------------------- ---------------------------------- Salary ($) Bonus ($) Awards Payouts ------------ ------------ ------------- ----------------- All Other Options (#) (1) Compensation ($) ----------------- ------------------ Darby S. Macfarlane, 2001 $225,000 Chairperson 2000 $224,000 $20,000 1999 $175,000 David Kenneth Macfarlane, 2001 $150,000 $100,000(3) Vice President 2000 $125,000 1999 $125,000 Leslie Foglesong, 2001 $135,000 Secretary 2000 $134,000 1999 $100,000 $10,000 Brian T. Fitzpatrick, 2001 $150,000 Acting Chief Executive Officer 2000 $115,000(2) 250,000 ---------- (1) In February 1998, the Company effected a three-for-two forward stock split. The

number of shares issuable upon the exercise of stock options granted under the 1992 Plan presented above give effect to the stock split. (2) For 6 months. (3) Replacement of escrow benefits. 33 Aggregated Option/SAR Exercises in Last Fiscal Year and Fiscal Year End Option/SAR Value Table The following table sets forth information with respect to stock options exercised during the fiscal year ended December 31, 2001 and the value at December 31, 2001 of unexercised stock options held by the Chief Executive Officer and the other executive offers of the Company. The number of shares presented gives effect to the Stock Split: Number of Securities Value of Unexercised Underlying Unexercised In-the-Money Options at Options at Fiscal Year-End Fiscal Year-End (1) ---------- ---------- ---------- ---------- Shares acquired Value Name on Exercise (#) Realized Exercisable/Unexercisable (#) Exercisable/Unexercisable ---------- ---------- ---------- ---------- ---------- ---------- Darby S. Macfarlane 450,000/0 Brian T. Fitzpatrick 83,334/166,666 David Kenneth Macfarlane 300,000/0 Leslie Foglesong 250,000/0 ---------- (1) Options were not in-the-money at year end Compensation of Directors Directors who are officers of the Company do not receive additional compensation for serving on the Board of Directors or for their attendance at Board of Directors' meetings. Edmund Vimond and Edward Mahoney each received a monthly director's fee of $6,000. Currently these fees are in arrears. In addition, Mr. Mahoney received options to purchase 37,500 (on January 26, 1998) shares of the Company's Common Stock under the 1992 Plan and each of Messrs. Mahoney and Vimond received options to purchase 20,000 (on October 30, 1998) shares of the Company's Common Stock under the 1992 Plan. The stock options granted to Mr. Vimond and Mr. Mahoney vest in equal installments on the first, second and third anniversaries of the date of grant and are exercisable at $9.25 (Mahoney's grant on January 26, 1998) all of which became exercisable on January 26, 2001) and $5.375 (grants on October 30, 1998) (two-thirds became exercisable at October 30, 2001) per share, respectively. Mr. Vimond also received 22,500 stock options on December 1, 1997, all of which became exercisable on December 1, 2001 and expires on December 1, 2007 and are exercisable at $9.71 per share. In addition, on July 15, 1997, Mr. Vimond received 15,000 stock options, all of which options were fully exercisable on July 15, 2000, expire on July 15, 2007 and are exercisable at $5.42 per share. Employment Agreements The Company has entered into separate employment agreements with each of Darby Simpson Macfarlane and David Kenneth Macfarlane, providing for Mrs. Macfarlane's employment as Chairperson and Chief Executive Officer and for Mr. Macfarlane's employment as Vice President, Research and Development, each extendable at the employee's option until February 1, 2003. These Agreements were amended in August 2000 to provide for conforming severance benefits in accordance with the terms of these employment agreements when Brian T. Fitzpatrick was appointed Acting Chief Executive Officer and Ms. Macfarlane was appointed as Chief Technology Officer and continued as Chairperson of the Company. The agreements with Mrs. and Mr. Macfarlane provide for annual base salaries in 2001 of $225,000 and $150,000, respectively, subject to annual increases as provided for in their agreements. Under the employment agreements, the Company is obligated to provide Mr. Macfarlane with a $300,000 and Mrs. Macfarlane with a $1,000,000 term life insurance policy and disability insurance. The Company maintains key-man life insurance of each of Mrs. and Mr. Macfarlane in the amount of $1,000,000. The employment agreements also provide for the payment of termination benefits by the Company if employment thereunder is terminated (i) by the Company for any reason other than death or disability as set forth therein or (ii) by reason of death or disability. If Mr. or Mrs. Macfarlane's employment is terminated by the Company or the employee for any reason the Company is required by each agreement to pay to the terminated employee an amount equal to (a) the aggregate base salary payable for the remainder of the employment period of the agreement and (b) the aggregate base salary payable thereunder for three years, plus, in each case, and for each year, an amount not less than any bonus granted by the Board of Directors of the Company to the employee in the year immediately preceding the year in which termination occurred. If the employee's 34 employment is terminated by reason of death or disability, the Company is required to pay to Mrs. Macfarlane and Mr. Macfarlane, as application, an amount equal to three years aggregate base salary in the case of Mrs. Macfarlane, and two year's base salary in the case of Mr. Macfarlane, plus in each case and for each year, an amount not less than the pro rata portion of any bonus granted to the employee in the year immediately preceding the year in which such termination occurs. In addition, the Company entered into a five-year employment agreement with Brian T. Fitzpatrick, commencing on April 17, 2000, pursuant to which he serves as the Chief Operating Officer, President and Acting Chief Executive Officer of the Company. As compensation, Mr. Fitzpatrick is entitled under the agreement to an annual base salary of $200,000, plus options under the 1992 Stock Option Plan to purchase an aggregate of 250,000 shares of Common Stock at an exercise price of $5.03, the closing bid price of the stock on June 2, 2000. The options vest in equal installments upon

each of the first, second and third anniversaries of the start date. In addition, Mr. Fitzpatrick is to receive with respect to each fiscal year a bonus to be determined by the Compensation Committee of the Company. The Company may terminate the agreement by reason of physical or mental disability, but in such case Mr. Fitzpatrick would remain entitled to full compensation and benefits during the period prior to such termination. If Mr. Fitzpatrick's employment were terminated by reason of his death, the Company would have no further obligations under the agreement other than his stock options. If his employment were terminated for any reason other than death, disability, "cause," voluntary resignation or a "change of control," then the Company would pay Mr. Fitzpatrick his base salary for the 24 months following such termination. Additionally, the Company entered into a four-year employment agreement with Leslie Foglesong commencing on December 15, 1997, pursuant to which she serves as Secretary and Treasurer (or Assistant Treasurer) of the Company. The term of the agreement has been extended for an additional year at Ms. Foglesong's option. The agreement provides for an annual base salary of $100,000, subject to an increase as of January 1, 2000 to $135,000, plus a bonus with respect to each fiscal year to be determined by the Board of Directors, as well as options under the 1992 Stock Option Plan. The Company may terminate the agreement by reason of physical or mental disability, but in such case Ms. Foglesong would remain entitled to full compensation and benefits during the period prior to such termination. If Ms. Foglesong's employment were terminated by reason of her death, the Company would have no further obligations under the agreement other than allowing her stock options to be exercised by her estate for a period of five years after such termination. If her employment were terminated for any reason other than death, disability or "cause," then Ms. Foglesong would be entitled to her base salary for the 24-month period following such termination or the remaining term of the agreement, whichever is greater; in addition, her stock options would continue to be exercisable for a period of five years after such termination. The agreements described above prohibit disclosure of proprietary and confidential information regarding the Company and its business to anyone outside the Company both during and subsequent to employment and provide certain non-competition and non-solicitation restrictions on the employee for the duration of employment with the Company, and for one year thereafter. Payments due under these agreements are currently in arrears. Compensation Committee Interlocks and Insider Participation There are no reportable compensation committee (Board of Directors) interlocks or insider participation transactions. Compensation Committee Report on Executive Compensation The Compensation Committee of the Board of Directors is responsible for establishing compensation policies applicable to the Company's executive officers; evaluating and recommending to the Board the compensation of the chief executive officer and other executive officers; and recommending to the Board individual stock option grants for executive officers from the 1992 Plan. The following report relates to the Company's compensation policies and the compensation paid to the chief executive officer for the year ending December 31, 2001. Compensation Policies: The Company's compensation policies for all employees, including executive officers, are designed to provide compensation levels that are competitive with those of small capitalization early stage technology companies, with whom the Company must compete in the recruitment and retention of highly qualified, motivated personnel. The Company's executive compensation program is structured to (1) compensate its executive officers on an annual basis with a cash salary and discretionary bonus at a sufficient level to retain and motivate these officers and (2) provide long-term incentives to those executives through periodic grant of stock options. The salary component of executive compensation and any bonuses granted in the Company's discretion, is based on each executive's level of responsibility in comparison to similar positions in comparable companies. The Company believes a competitive base salary, and bonus when warranted, is essential to the development and retention of capable management. 35 Base salaries for executive officers are reviewed periodically, based on a review of competitive salaries obtained from published data and other sources, and discretionary performance bonuses, if any, are used to augment salary in circumstances where special achievement is to be rewarded. The long-term incentive component recognizes the importance of stock ownership by employees and reflects the use of stock options as an integral part of each executive's compensation. The Company believes the opportunity for stock appreciation through stock options which vest over time promotes the relationship between long-term interests of executive officers and shareholders. The size of specific grants takes into account the executive officer's salary, number of options previously granted, and overall individual contributions to the Company. Item 12. Security Ownership of Certain Beneficial Owners and Management The following tables sets forth, as of March 26, 2001, the beneficial ownership of the common stock: (i) by each shareholder known by the Company to beneficially own more than 5% of the common stock; (ii) by each director of the Company; (iii) by the Company's Chief Executive Officer; and (iv) by all executive officers and directors of the

Company as a group. Except as otherwise indicated below, each named beneficial owner has sole voting and investment power with respect to the shares of common stock listed. common stock Percent of Name and Address of Beneficial Owner Number of Shares Class ---------- ---------- ---------- Darby Simpson Macfarlane 3,611,895(1) 15.21% 2500 Johnson Ave., Riverdale, NY 10463 David Kenneth Macfarlane 3,611,895(2) 15.21% 2500 Johnson Ave., Riverdale, NY 10463 Brian T. Fitzpatrick 199,033(3) * c/o Gordon Laboratories, Inc. 751 East Artesia Boulevard, Carson, CA 90746 Leslie Foglesong 265,000(4) 1.25% c/o Chromatics Color Sciences International, Inc. 2500 Johnson Ave., Riverdale, NY 10463 Edmund Vimond 57,500(5) * 6967 Country Lakes Circle, Sarasota, FL 34243 Edward Mahoney 57,500(6) * 140 Jones Creek Drive, Jupiter, FL 33458 LB I Group, Inc. 2,163,951(7) 9.35% 745 Seventh Ave., New York, NY 10019 Peter Janssen 636,250(8) 3.03% c/o Janssen Partners, Inc. 1345 Old Northern Blvd., Roslyn, NY 11576 Janssen Partners, Inc. 636,250(9) 3.03% 1345 Old Northern Blvd., Roslyn, NY 11576 Crescent International, Ltd. 4,195,800(10) 17.57% c/o The Robinson-Humphrey Company LLC 3333 Peachtree Road, N.E., Atlanta, GA 30326 GAC-LABS, LLC 1,600,000(11) 7.08% 1936 Lee Road, Winter Park, FL 32789 Millennium Partners, LP 4,195,800(12) 17.30% 666 5th Avenue, New York, NY 10103 All directors and executive officers as a group 4,190,928(13) 17.33% (6 persons) ---------- * indicates less than 1% 36 (1) Includes 861,895 issued and outstanding shares of the common stock beneficially owned by Mrs. Macfarlane, 2,000,000 warrants which are exercisable upon registration of the underlying securities, 450,000 shares issuable upon the exercise of options granted to Mrs. Macfarlane and 300,000 shares issuable upon the exercise of options granted to Mr. Macfarlane which options are currently exercisable. As a result of a certain voting agreement between them, Mrs. Macfarlane is entitled to sole voting power and sole power of disposition over all shares of common stock held or acquired by Mr. Macfarlane. (2) Includes 861,895 issued and outstanding shares of common stock and 2,000,000 warrants which are exercisable upon the registration of the underlying securities beneficially owned by Mrs. Macfarlane, 450,000 shares issuable upon the exercise of options granted to Mrs. Macfarlane and 300,000 shares issuable upon the exercise of options granted to Mr. Macfarlane which options are currently exercisable. (3) Includes 83,333 shares of common stock issuable upon the exercise of options which are currently exercisable. (4) Includes 250,000 shares of common stock issuable upon the exercise of options which are currently exercisable. (5) Represents 57,500 shares of common stock issuable upon the exercise of options which are currently exercisable. (6) Represents 57,500 shares of common stock issuable upon the exercise of options which are currently exercisable. (7) Represents 1,388,889 shares of common stock issuable upon the conversion of Class B Series 2 and Class B Series 3 Convertible Preferred Stock and 775,062 shares of common stock issuable upon the exercise of currently exercisable warrants. Frederick Appel is the investment manager for these shares. (8) Represents 636,250 shares of common stock owned by Peter Janssen. Mr. Janssen is the principal shareholder of Janssen Partners, Inc. (9) Represents 636,250 shares of common stock owned by Peter Janssen. Mr. Janssen is the principal shareholder of Janssen Partners, Inc. (10) Includes 1,311,304 shares of common stock, 270,000 warrants which are currently exercisable, and 2,614,496 issuable upon the conversion of Class B Series 4 Preferred Stock totaling shares not in excess of 20% of the current outstanding shares of the Company's common stock. Mel Craw is the investment manager of these shares. (11) Represents 1,600,000 warrants, which are currently exercisable. John Schmook and Thomas Little are managers for GAC-Labs. (12) Includes 3,623,326 shares issuable to Millennium that are not in excess of 20% of the current outstanding shares of the Company's common stock. Daniel Cardella is the investment manager for these shares. (13) Includes 3,198,333 options and warrants which are currently exercisable. Item 13. Certain Relationships and Related Transactions Since August 1990, the Company has occupied office space leased under Darby Simpson Macfarlane's name. The Company pays $2,260 per month under the lease (representing the actual lease cost for such premises), which rent increased from $1,965 in August 2001. For the year ended December 31, 2000 the Company paid $21,000 in connection with such lease and $26,320 for the year 2001. In addition, the Company also paid approximately $10,980 for the year ended December 31, 2000 and approximately $10,980 for the year ended December 31, 2001 under a lease for the use of her residence as offices of the Company, which operates after normal business hours and on weekends. On July 3, 2001, Gordon issued 200 shares of its common stock, par value $.001 per share, to Abilene Investments Corp. and 800 shares to GAC-Labs, LLC for an aggregate purchase price of $1,000,000 paid to Gordon to be used for operating capital. Simultaneously, the shares of Gordon stock that were outstanding immediately prior to the closing of this transaction, all of which were owned by the Company, were redeemed for one dollar. In addition, the Company assigned to Abilene and GAC-Labs the indebtedness of Gordon and H.B. Gordon Manufacturing Co., Inc., its wholly-owned subsidiary, owed to the

Company in the ratio of 20% to Abilene and 80% to GAC-Labs. As part of the same transaction, the Company was granted the option to purchase from Abilene and GAC-Labs the shares of Gordon stock issued to them and the indebtedness assigned to them within one year for an aggregate purchase price of $1,000,000 plus interest thereon at the rate of 14% per annum, subject to reduction under certain conditions, as described below. 37 Furthermore, the Company granted to Abilene and GAC-labs one-year warrants to purchase (i) an aggregate of 2,000,000 shares of our common stock at the exercise price of $.50 per share, if the Company does not consummate a rights offering prior to the expiration of such warrants, or (ii) an aggregate of 11,200,000 shares of our common stock at the exercise price of $.10 per share, if the Company consummates a rights offering prior to the expiration of such warrants and obtain shareholder approval for the increase in warrants. If (i) the Company exercises its option to purchase the shares of Gordon stock issued to Abilene and GAC-Labs and the indebtedness assigned to them, (ii) the Company has not effected a reverse stock split of its common stock in a ratio greater than ten to one, (iii) the Company has consummated a rights offering and (iv) the market price of the Company's common stock exceeds $1.00 per share for at least ten consecutive trading days from the date of exercise, the warrants will be subject to mandatory exercise. In the event of such a mandatory exercise, the Company will accept as payment of the aggregate exercise price the shares of Gordon stock that the Abilene and GAC-Labs acquired last year, and the purchase price under the repurchase option agreement will be reduced to one dollar. The warrants are also subject to mandatory exercise if (i) a registration statement, filed by us with respect to the shares of our common stock issuable upon exercise of the warrants has been declared effective by the Securities and Exchange Commission, (ii) the Company has not effected a reverse stock split of our common stock in a ratio greater than ten to one, (iii) the Company has consummated a rights offering and (iv) the market price of our common stock exceeds $1.00 per share for at least ten consecutive trading days from and after the effective date of such registration statement. In the event of such a mandatory exercise, the Company will accept payment of the aggregate exercise price through the terms of a broker's cashless exercise transaction. Brian T. Fitzpatrick, the President and Secretary of Gordon and the President, Acting Chief Executive Officer and a director of the Company, is also the President of GAC-Labs. Management believes that each of the transactions described above were obtained on terms at least as favorable as could have been obtained from unaffiliated third parties. PART IV Item 14. Exhibits, Financial Statement Schedules and Reports on Form 8-K (a) and (d)1. Financial Statements Independent Auditors Reports Consolidated Balance Sheets as of December 31, 2001 and 2000 Consolidated Statements of Operations for the years ended December 31, 2001, 2000, and 1999 Consolidated Statements of Changes in Stockholders' Equity (Deficit) for the years ended December 31, 2001, 2000, and 1999 Consolidated Statements of Cash Flows for the years ended December 31, 2001, 2000, and 1999 Notes to Consolidated Financial Statements (a) and (d)2. Financial Statements Schedules All schedules have been omitted because they are not applicable, are not required or because the required information is included in the Financial Statements or notes thereto. (b) Reports on Form 8-K: 38 Form 8-K dated March 13, 2002 - the Company filed a Form 8-K relative to the change in the Company's accountants. (c) The following exhibits are included in this report: Number Description of Document ------ ---------- 2.1 Agreement of Purchase and Sale (the "Gordon Purchase Agreement"), dated as of April 17, 2000, among Chromatics Color Sciences International, Inc. and the shareholders and certain noteholders of Gordon Acquisition Corp. (incorporated by reference to Exhibit 2.1 to the Form 8-K filed on June 19, 2000). 2.2 Amendment No. 1 to the Gordon Purchase Agreement, dated May 15, 2000 (incorporated by reference to Exhibit 2.2 to the Form 8-K filed on June 19, 2000) 2.3 Amendment No. 2 to the Gordon Purchase Agreement, dated May 25, 2000 (incorporated by reference to Exhibit 2.3 to the Form 8-K filed on June 19, 2000). 2.4 Amendment No. 3 to the Gordon Purchase Agreement, dated May 31, 2000 (incorporated by reference to Exhibit 2.4 to the Form 8-K filed on June 19, 2000). 3.1 Restated Articles of Incorporation of the Company (incorporated by reference to Exhibit 3.1 to the Form 10-Q filed on August 23, 1999). 3.1.1 Certificate of Amendment to the Certificate of Incorporation of the Company. 3.2 By-Laws of the Company. 4.1 Specimen form of the Common Stock Certificate (incorporated by reference to Exhibit 4.1 to the Company's Registration Statement on Form S-1 (File No. 33-54256), filed on November 5, 1992, as amended (the "Registration Statement")). 4.2 Shareholders' Rights Plan, adopted by the Company on December 31, 1998 (incorporated by reference as Exhibit 1 to the Form 8-A dated January 5, 1999). 4.3 Subscription Agreement, dated April 15, 1999 (incorporated by reference to Exhibit 4.2 to the Form 8-K dated April 30, 1999). 4.4 Form of 14%Convertible Debentures Due April 15, 2002 (incorporated by reference to Exhibit 4.3 to the Form 8-K dated April 30, 1999). 4.5 Preferred Stock Purchase Agreement, dated as of June 11, 1999, by and between the Company and LB I Group Inc. (incorporated by reference to Exhibit 4.1 to the Form 8-K, filed on July 1,

1999). 4.6 Warrant Agreement, dated as of June 11, 1999, by and between the Company and LB I Group Inc. (incorporated by reference to Exhibit 4.2 to the Form 8-K, filed on July 1, 1999). 4.7 Preferred Stock Purchase Agreement, dated as of February 11, 2000, by and between the Company and LB I Group Inc. 4.8 Warrant Agreement, dated as of February 11, 2000, by and between the Company and LB I Group Inc. 4.9 Securities Purchase Agreement, dated as of August 16, 2000, between the Company and Millennium Partners, L.P. ("Millennium") (incorporated by reference to Exhibit 4.1 to the Form 8-K, filed on September 1, 2000). 4.10 Warrant, dated as of August 16, 2000, made by the Company in favor of Millennium (incorporated by reference to Exhibit 4.2 to the Form 8-K, filed on September 1, 2000). 4.11 Warrant No. C W 1, dated as of August 16, 2000, made by the Company in favor of Millennium (incorporated by reference to Exhibit 4.3 to the Form 8-K, filed on September 1, 2000). 4.12 Registration Rights Agreement, dated as of August 16, 2000, between the Company and Millennium (incorporated by reference to Exhibit 4.4 to the Form 8-K, filed on September 1, 2000). 4.13 Warrant No. CW2, dated as of August 16, 2000, made by the Company in favor of Wharton Capital Partners, Ltd. (incorporated by reference to Exhibit 4.11 to the Form S-3, filed on September 18, 2000). 4.14 Warrant Agreement, dated as of June 30, 2000, between the Company and Josephthal & Co. Inc. (incorporated by reference to Exhibit 4.12 to the Form S-3, filed on September 18, 2000). 4.15 Warrant Certificate No. W-01, dated as of June 30, 2000 made by the Company in favor of X Securities, Ltd. (incorporated by reference to Exhibit 4.13 to the Form S-3, filed on September 18, 2000). 4.16 Warrant Certificate No. W-02, dated as of June 30, 2000, made by the Company in favor of John O'Brien (incorporated by reference to Exhibit 4.14 to the Form S-3, filed on September 18, 2000). 4.17 Warrant Certificate No. W-03, dated as of June 30, 2000, made by the Company in favor of Edmund Belak (incorporated by reference to Exhibit 4.15 to the Form S-3, filed on September 18, 2000). 4.18 Financial Advisory and Investment Banking Agreement, dated as of June 12, 2000, between Chromatics and Josephthal & Co. Inc. (incorporated by reference to Exhibit 4.16 to the Form S-3, filed on September 18, 2000). 4.19 Stock Purchase Agreement, dated as of October 31, 2000, between the Company and Crescent International Ltd. ("Crescent") (incorporated by reference to Exhibit 4.1 to the Form 8-K, filed on November 3, 2000). 39 Number Description of Document ------ ---------- 4.20 Warrant, dated as of October 31, 2000, made by the Company in favor of Crescent (incorporated by reference to Exhibit 4.2 to the Form 8-K, filed on November 3, 2000). 4.21 Registration Rights Agreement, dated as of October 31, 2000, between the Company and Crescent (incorporated by reference to Exhibit 4.3 to the Form 8-K, filed on November 3, 2000). 4.22 Certificate of Amendment of the Certificate of Incorporation of the Company, dated as of October 31, 2000 (incorporated by reference to Exhibit 4.4 to the Form 8-K, filed on November 3, 2000). 4.23 Letter Agreement, dated as of October 11, 2000, between the Company and Millennium (incorporated by reference to Exhibit 4.1 to the Form 8- K, filed on November 3, 2000). 4.24 Certificate of Amendment of the Certificate of Incorporation of the Company, dated November 1, 2000, relating to the Class B Series 2 Preferred Stock of the Company (incorporated by reference to Exhibit 4.2 to the Form 8-K, filed on November 3, 2000). 4.25 Certificate of Amendment of the Certificate of Incorporation of the Company, dated November 1, 2000, relating to the Class B Series 3 Preferred Stock of the Company (incorporated by reference to Exhibit 4.3 to the Form 8-K, filed on November 3, 2000). 4.26 Letter Agreement, dated as of October 11, 2000, between the Company and LB I Group Inc. ("Lehman") (incorporated by reference to Exhibit 4.4 to the Form 8-K, filed on November 3, 2000). 4.27 Letter Agreement, dated as of November 1, 2000, between the Company and Lehman (incorporated by reference to Exhibit 4.5 to the Form 8-K, filed on November 3, 2000). 4.28 Letter Agreement, dated as of August 16, 2000, between the Company and Lehman (incorporated by reference to Exhibit 4.6 to the Form 8-K, filed on November 3, 2000). 4.29 Certificate of Amendment of the Certificate of Incorporation of the Company, dated November 1, 2000, relating to the Class B Series 5 Preferred Stock of the Company (incorporated by reference to Exhibit 4.7 to the Form 8-K, filed on November 3, 2000). 4.30 Letter Agreement, dated as of October 11, 2000, among the Company and the holders of the 14% Senior Convertible Debentures, dated April 15, 1999 and due April 15, 2002, in the principal amount of $5,000,000, issued by the Company to Gary W. Schreiner (incorporated by reference to Exhibit 4.8 to the Form 8-K, filed on November 3, 2000). 9.1 Voting Proxy dated December 13, 1995, of David Kenneth Macfarlane to Darby Simpson Macfarlane (incorporated by reference to Exhibit 2 to Schedule 13D of Darby Macfarlane and Ken Macfarlane dated February 12, 1996). 9.2 Voting Trust Agreement dated December 13, 1995, between David Kenneth Macfarlane and Darby Simpson Macfarlane (incorporated by reference to Exhibit 3 to Schedule 13D of Darby Macfarlane and Ken Macfarlane dated February 12,1996). 10.1* Form of Employment Agreement between the Company and Darby Simpson Macfarlane (incorporated by reference to Exhibit 10.1 to the Registration Statement).

Explanation of Responses:

10.2* Form of Employment Agreement between the Company and David Kenneth Macfarlane (incorporated by reference to Exhibit 10.2 to the Registration Statement). 10.3* Consulting Agreement, dated February 25, 1992, between the Company and Dr. Fred W. Billmeyer, Jr. (incorporated by reference to Exhibit 10.4 to the Registration Statement). 10.4 Form of Indemnity Agreement between the Company and its directors and officers (incorporated by reference to Exhibit 10.6 to the Registration Statement). 10.5 Know-How Agreement, dated September 3, 1992, between the Company, Darby Simpson Macfarlane and David Kenneth Macfarlane (incorporated by reference to Exhibit 10.12 to the Registration Statement). 10.6 Assignment, dated September 3, 1992 from Darby Simpson Macfarlane to the Company regarding Intellectual Property (incorporated by reference to Exhibit 10.13 to the Registration Statement). 10.7** Agreement, dated April 16, 1992, between the Company and IMS Cosmetics, Inc. (incorporated by reference to Exhibit 10.14 to the Registration Statement). 10.8 U.S. Patent No. 4,909,632 relating to Method for Selecting Personal Compatible Colors (incorporated by reference to Exhibit 10.17 to the Company's Annual Report on Form 10-KSB for the fiscal year ended December 31, 1994). 10.9 U.S. Patent No. 5,311,293 relating to Method and Instrument for Selecting Personal Compatible Colors (incorporated by reference to Exhibit 10.18 to the Company's Annual Report on Form 10-KSB for the fiscal year ended December 31, 1994). 10.10 U.S. Patent No. 5,313,267 relating to Method and Instrument for Selecting Personal Compatible Colors (incorporated by reference to Exhibit 10.19 to the Company's Annual Report on Form 10-KSB for the fiscal year ended December 31, 1994). 10.11 The Australian Patent relating to Method of Selecting Personal Compatible Color (incorporated by reference to Exhibit 10.20 to the Company's Annual Report on Form 10-KSB for the fiscal year ended December 31, 1994). 10.12 European Community Patent No. 0446512 relating to Method for Selecting Personal Compatible Colors (incorporated by reference to Exhibit 10.21 to the Company's Annual Report on Form 10-KSB for the fiscal year ended December 31, 1994). 40 Number Description of Document ------ ---------- 10.13 U.S. Patent No. 5,671,735 relating to Method and Apparatus for Detecting and Measuring Conditions Affecting Color (incorporated by reference to Exhibit 10.13 to the Amendment to the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 1998). 10.14 Assignment, dated October 30, 1992, between Darby Simpson Macfarlane and the Company relating to the Avon litigation (incorporated by reference to Exhibit 10.19 to the Registration Statement). 10.15 Know-How Assignment, dated October 30, 1992, from Pink & Peach Computer Corp. to the Company (incorporated by reference to Exhibit 10.20 to the Registration Statement). 10.16 1992 Stock Option Plan (incorporated by reference to Exhibit 10.1 to the Registration Statement on Form 8-A (File No. 333-51697)). 10.17 Consulting Agreement dated January 6, 1995, between the Company and Janssen-Meyers Associates, L.P. (incorporated by reference to Exhibit 10.27 to the Company's Annual Report on Form 10-KSB for the fiscal year ended December 31, 1994). 10.18 Warrant Agreement dated January 6, 1995, between the Company and Janssen-Meyers Associates, L.P. (incorporated by reference to Exhibit 10.28 to the Company's Annual Report on Form 10-KSB for the fiscal year ended December 31, 1994). 10.19 Warrant Agreement dated March 13, 1995, between the Company and Janssen-Meyers Associates, L.P. (incorporated by reference to Exhibit 10.29 to the Company's Annual Report on Form 10-KSB for the fiscal year ended December 31, 1994). 10.20 Manufacturing Agreement, dated November 3, 1998, between the Company and a third party manufacturer (incorporated by reference as Exhibit 10.1 to the Form 8-K dated November 12, 1998). 10.21 Rights Agreement, dated January 11, 1999, between the Company and Continental Stock Transfer & Trust Company (incorporated by reference as Exhibit 1 to the Form 8-A dated January 5, 1999). 10.22 Subscription Agreement, dated April 15, 1999 (incorporated by reference to Exhibit 4.2 to the Form 8-K dated April 30, 1999). 10.23 Form of 14% Convertible Debentures Due April 15, 2002 (incorporated by reference to Exhibit 4.3 to the Form 8-K dated April 30, 1999). 10.24 Preferred Stock Purchase Agreement, dated as of June 11, 1999, by and between the Company and LB I Group Inc. (incorporated by reference to Exhibit 4.1 to the Form 8-K, filed on July 1, 1999). 10.25 Warrant Agreement, dated as of February 11, 1999, by and between the Company and LB I Group Inc. (incorporated by reference to Exhibit 4.2 to the Form 8-K, filed on July 1, 1999). 10.26 Preferred Stock Purchase Agreement, dated as of February 11, 2000, by and between the Company and LB I Group Inc. (incorporated by reference to Exhibit 4.7 hereof). 10.27 Warrant Agreement, dated as of February 11, 2000, by and between the Company and LB I Group Inc. (incorporated by reference to Exhibit 4.8 hereof). 10.28 Consent and Waiver, dated June 8, 1999, made by Gary W. Schreiner in favor of the Company (incorporated by reference to Exhibit 10.23 to the Form 10-K/A filed on January 21, 2000). 10.29 License Agreement, dated September 1, 1998, between the Company and Nordstrom., Inc. (incorporated by reference to Exhibit 10.24 to the Form 10-K/A filed on January 21, 2000). 10.30 Agreement, dated December 13, 1996, between the Company and

Gordon Laboratories, Inc. (incorporated by reference to Exhibit 10.25 to the Form 10-K/A filed on January 21, 2000). 10.31 Agreement, dated as of June 7, 1999, between the Company and Datex-Ohmeda, Inc. (incorporated by reference to Exhibit 10.1 to the Form 8- K/A filed on January 28, 2000). 21 Subsidiaries of the Company (incorporated by reference to Exhibit 21 to the Company's Post Effective Amendment No. 1 on Form SB-1 to the Registration Statement filed on January 11, 1994). 23+ Consent of Independent Accountants. ---------- * Management contract or compensatory plan or arrangement required to be filed as an exhibit. ** Portions subject to confidential treatment. + Filed herewith. 41 SIGNATURES In accordance with Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized. CHROMATICS COLOR SCIENCES INTERNATIONAL, INC. By: /s/ Brian T. Fitzpatrick Date: April 23, 2002 --- ---------- Brian T. Fitzpatrick, Acting Chief Executive Officer By: /s/ Darby S. Macfarlane Date: April 23, 2002 --- ---------- Darby S. Macfarlane, Chairperson of the Board, Chief Technology Officer; Treasurer; Director In accordance with the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated. By: /s/ Darby S. Macfarlane Date: April 23, 2002 --- ---------- Darby S. Macfarlane, Chairperson of the Board, Chief Technology Officer; Treasurer; Director By: /s/ Brian T. Fitzpatrick Date: April 23, 2002 --- ---------- Brian T. Fitzpatrick, Acting Chief Executive Officer By: /s/ David K. Macfarlane Date: April 23, 2002 --- ---------- David K. Macfarlane, Vice President, Research & Development; Director By: /s/ Leslie Foglesong Date: April 23, 2002 --- ---------- Leslie Foglesong, Secretary; Assistant Treasurer; Director By: /s/ Edmund Vimond Date: April 23, 2002 --- ---------- Edmund Vimond, Director By: /s/ Edward Mahoney Date: April 23, 2002 --- ---------- Edward Mahoney, Director 42 CHROMATICS COLOR SCIENCES INTERNATIONAL, INC. AND SUBSIDIARIES INDEX TO CONSOLIDATED FINANCIAL STATEMENTS Contents Page ------ Independent Auditors' Reports..... 44 Consolidated financial statements: Balance Sheets..... 46 Statements of Operations..... 47 Statements of Changes in Stockholders' Equity (Deficit)..... 48 Statements of Cash Flows..... 49 Notes to Consolidated Financial Statements..... 50 43 INDEPENDENT ACCOUNTANTS' REPORT To the Board of Directors and Stockholders of Chromatics Color Sciences International, Inc. We have audited the consolidated balance sheet of Chromatics Color Sciences International, Inc. and subsidiaries as of December 31, 2000, and the related consolidated statements of operations, changes in stockholders' equity (deficit) and cash flows for each of the two years in the period ended December 31, 2000. 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 auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes 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 consolidated financial statements referred to above present fairly, in all material respects, the financial position of Chromatics Color Sciences International, Inc. and subsidiaries as of December 31, 2000, and the results of their operations and their cash flows for each of the two years in the period ended December 31, 2000 in conformity with accounting principles generally accepted in the United States of America. The accompanying consolidated financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note 2 to the consolidated financial statements, the Company has incurred recurring losses for the last several years, including $19,496,000 in 2000, and has experienced significant problems and delays exploiting its primary technology (medical equipment). These matters raise substantial doubt about the Company's ability to continue as a going concern. Management's plans in regard to these matters are also described in Note 2. The financial statements do not include any adjustments that might result from the outcome of this uncertainty. BDO Seidman, LLP New York, New York April 13, 2001, except for Note 3, which is July 3, 2001 44 Independent Auditors' Report To the Board of Directors and Shareholders of Chromatics Color Sciences International, Inc. We have audited the accompanying consolidated balance sheet of Chromatics Color Sciences International, Inc. and subsidiaries as of December 31, 2001, and the related consolidated

statements of operations, changes in shareholders' equity (deficit) 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 audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes 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 audit provides a reasonable basis for our opinion. In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Chromatics Color Sciences International, Inc. and subsidiaries as of December 31, 2001 and the consolidated results of their operations and their consolidated 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 2 to the consolidated financial statements, the Company has incurred recurring net losses, cash outflows from operating activities and has a negative working capital position and a capital deficiency. These matters raise substantial doubt about the Company's ability to continue as a going concern. Management's plans in regard to these matters are also described in Note 2. The financial statements do not include any adjustments that might result from the outcome of this uncertainty. Richard A. Eisner, LLP New York, New York April 17, 2002 45 Chromatics Color Sciences International, Inc. Consolidated Balance Sheets December 31, 2001 2000 ---------- ---------- ASSETS Current assets: Cash and cash equivalents $ 55,000 $ 1,379,000 Accounts receivable 4,000 73,000 Inventories 350,000 747,000 Prepaid expenses and other current assets 38,000 297,000 ---------- ---------- Total current assets 447,000 2,496,000 Property and equipment, net 155,000 244,000 Software development costs, net 261,000 Patent costs, net 581,000 Net assets of Gordon 1,000,000 Deferred financing costs 710,000 Other assets 332,000 ---------- ---------- $ 1,312,000 $ 4,914,000 ========== ========== LIABILITIES Current liabilities: Accounts payable and accrued expenses: Attorneys and accountants $ 1,031,000 $ 459,000 Consultants 469,000 141,000 Trade 276,000 261,000 Severance payable 725,000 Due to related parties 274,000 Notes payable 1,449,000 Notes payable - officer/stockholder 250,000 Advance from investor 25,000 ---------- ---------- Total current liabilities 4,499,000 861,000 ---------- ---------- Amount payable for purchase of Gordon 653,000 ---------- ---------- 4,499,000 1,514,000 ---------- ---------- COMMITMENTS AND OTHER MATTERS REDEEMABLE PREFERRED STOCK: Class A - authorized 1,400,000 shares, $.01 par value; issued and outstanding 1,380,000 shares (redemption $.01 per share) 14,000 ---------- ---------- STOCKHOLDERS' EQUITY (DEFICIT) Preferred stock 11,804,000 11,511,000 Common stock; authorized 550,000,000 shares, $.001 par value; issued and outstanding 20,989,550 and 19,033,308 shares 21,000 19,000 Additional paid-in capital 46,984,000 45,934,000 Accumulated deficit (61,996,000) (54,078,000) ---------- ---------- (3,187,000) 3,386,000 ---------- ---------- $ 1,312,000 $ 4,914,000 ========== ========== See notes to consolidated financial statements 46 Chromatics Color Sciences International, Inc. Consolidated Statements of Operations Year Ended December 31, 2001 2000 1999 ---------- ---------- ---------- Revenues: Sales $ 8,000 $ 80,000 $ 1,103,000 ---------- ---------- ---------- Cost and expenses: Cost of sales 1,000 760,000 898,000 Sales, marketing and trade show costs 285,000 2,047,000 2,512,000 Medical regulatory expenses 304,000 840,000 1,323,000 Research and development 745,000 1,257,000 996,000 Patent application costs 47,000 256,000 134,000 Severence expense 795,000 Impairment charges 1,338,000 1,508,000 General and administrative: Compensation - Officers, employees and consultants 1,389,000 2,390,000 2,089,000 Legal fees 340,000 702,000 794,000 Accounting fees 92,000 158,000 79,000 Rent and storage 335,000 339,000 297,000 Insurance 221,000 315,000 223,000 Repairs and maintenance 56,000 158,000 118,000 Depreciation and amortization 404,000 729,000 495,000 Taxes 67,000 74,000 55,000 Stock administrative fees 85,000 131,000 172,000 Public relations 42,000 212,000 193,000 Other 230,000 423,000 421,000 ---------- ---------- ---------- 6,776,000 12,299,000 10,799,000 ---------- ---------- ---------- (6,768,000) (12,219,000) (9,696,000) ---------- ---------- ---------- Other income (expense): Interest income 3,000 133,000 201,000 Interest expense and financing costs (662,000) (1,437,000) (3,313,000) ---------- ---------- ---------- (659,000) (1,304,000) (3,112,000) ---------- ---------- ---------- Loss from continuing operations (7,427,000) (13,523,000) (12,808,000) Loss from discontinued operations (Note 3) (1,250,000) (5,973,000) Gain on disposal of

Gordon 759,000 ---------- ---------- ---------- Net loss $ (7,918,000) $ (19,496,000) $ (12,808,000) ========== ========== ========== Net loss to common stockholders: Loss from continuing operations $ (7,427,000) $ (13,523,000) $ (12,808,000) Deemed dividend on Class B, Series 2 and 3 convertible preferred stock 293,000 3,900,000 1,558,000 ---------- ---------- ---------- Loss from continuing operations to common stockholders (7,720,000) (17,423,000) 14,366,000) Loss from discontinued operations (Note 3) (1,250,000) (5,973,000) Gain on disposal of Gordon 759,000 ---------- ---------- ---------- Net loss to common stockholders $ (8,211,000) $ (23,396,000) $ (14,366,000) ========== ========== ========== Weighted average number of common shares Outstanding - basic and diluted 19,880,869 16,746,354 15,498,300 ========== ========== ========== Basic and diluted loss per share: Loss from continuing operations $ (0.39) $ (1.04) $ (0.93) Discontinued operations (0.02) (0.36) ---------- ---------- ---------- Net loss to common stockholders $ (0.41) $ (1.40) $ (0.93) ========== ========== ========== See notes to consolidated financial statements 47 Chromatics Color Sciences International, Inc. Consolidated Statements of Changes in Stockholders' Equity (Deficit) Common Stock Preferred Additional Stock Number of Paid-in Accumulated Amount Shares Amount Capital Deficit ---------- ---------- ---------- ---------- ---------- Balance - January 1, 1999 15,452,442 $ 15,000 $ 28,327,000 $ (21,774,000) Net loss for the year ended December 31, 1999 (12,808,000) Exercise of stock options and warrants 86,675 377,000 Original issue discount of senior convertible debentures (below market conversion price) 3,575,000 Original issue discount on Class B convertible preferred stock (warrants and below market conversion price) 2,357,000 Deemed dividend on Class B convertible preferred stock (1,558,000) Compensation cost relating to options granted to consultants 984,000 ---------- ---------- ---------- ---------- ---------- Balance - December 31, 1999 15,539,117 $ 15,000 34,062,000 (34,582,000) Net loss for the year ended December 31, 2000 (19,496,000) Conversion of debentures to preferred stock $6,079,000 Issuance of preferred stock for cash 5,025,000 Reclassification of redeemable preferred stock 2,263,000 Exercise of stock options and warrants 162,880 377,000 Conversion of convertible preferred stock into common stock (1,856,000) 1,889,563 2,000 3,017,000 Original issue discount on convertible preferred stock (warrants and below market conversion price) 3,858,000 Deemed dividend on Class B convertible preferred stock (3,900,000) Issuance of common stock for purchase of Gordon stock 721,231 1,000 4,536,000 Issuance of common stock for cash 720,517 1,000 3,294,000 Compensation cost relating to options granted to consultants 690,000 ---------- ---------- ---------- ---------- ---------- Balance - December 31, 2000 11,511,000 19,033,308 19,000 45,934,000 (54,078,000) Net loss for the year ended December 31, 2001 (7,918,000) Issuance of common stock for purchase of Gordon stock 22,894 144,000 Issuance of common stock - adjustable warrant 1,933,348 2,000 (2,000) Warrants issued in connection with notes payable 1,181,000 Deemed dividend on Class B convertible preferred stock 293,000 (293,000) Compensation cost relating to options granted to terminated employees 20,000 ---------- ---------- ---------- ---------- ---------- Balance - December 31, 2001 $11,804,000 20,989,550 $ 21,000 $ 46,984,000 $ (61,996,000) ========== ========== ========== ========== ========== See notes to consolidated financial statements 48 Chromatics Color Sciences International, Inc. Consolidated Statements of Cash Flows Year Ended December 31, 2001 2000 1999 Cash flows from operating activities: Loss from continuing operations $ (7,427,000) $ (13,523,000) $(12,808,000) Discontinued operations (491,000) (5,973,000) Adjustments to reconcile loss to net cash used in operating activities: Impairment charge and net change in net assets of discontinued operations 1,829,000 7,517,000 Depreciation and amortization 404,000 729,000 494,000 Compensation cost relating to options granted to consultants and terminated employees 20,000 690,000 984,000 Interest and financing costs 596,000 851,000 2,741,000 Writeoff of accounts receivable 71,000 Changes in operating assets and liabilities: Accounts receivable (2,000) 769,000 (750,000) Inventories 59,000 (308,000) (293,000) Prepaid expenses and other assets 241,000 (230,000) (97,000) Accrued interest on convertible debentures 583,000 496,000 Accounts payable and accrued expenses 1,901,000 107,000 (223,000) ---------- ---------- ---------- Net cash used in operating activities (2,799,000) (8,788,000) (9,456,000) ---------- ---------- ---------- Cash flows from investing activities: Software development costs (81,000) Capitalized patent costs (167,000) (337,000) (553,000) Purchase of fixed assets (6,000) (78,000) (91,000) ---------- ---------- ---------- Net cash used in investing activities (173,000) (415,000) (725,000) ---------- ---------- ---------- Cash flows from financing activities: Net proceeds from the issuance of stock 3,672,000 377,000 Proceeds from senior convertible debentures 5,000,000 Advance from investor 25,000 Payments of amounts to related party (1,360,000) (62,000) Net proceeds from notes payable and warrants 1,623,000 Net proceeds from the issuance of preferred stock and warrants 5,480,000 3,727,000

---------- ---------- ---------- Net cash provided by financing activities 1,648,000 7,792,000 9,042,000 ---------- ---------- ---------- Net decrease in cash and cash equivalents (1,324,000) (1,411,000) (1,139,000) Cash and cash equivalents - January 1 1,379,000 2,790,000 3,929,000 ---------- ---------- ---------- Cash and cash equivalents - December 31 $ 55,000 $ 1,379,000 $ 2,790,000 ========== ========== ========== Supplemental disclosure cash flow information: Interest paid $ 89,000 Reclassification of ColorMate Units $ 1,820,000 Supplemental disclosure of noncash financing information: Issuance of debt to pay accrued expenses $ 300,000 Reduction of liability resulting from Gordon purchase price adjustment $ 509,000 Issuance of stock for amount payable for purchase of Gordon $ 144,000 $ 5,189,000 Deemed dividends $ 293,000 $ 3,900,000 $ 1,558,000 Conversion of preferred stock into common $ 3,019,000 See notes to consolidated financial statements 49 Chromatics Color Sciences International, Inc. Notes to consolidated financial statements December 31, 2001 NOTE 1 - Nature of Business and Summary of Significant Accounting Policies Since its formation in 1984, Chromatics Color Sciences International, Inc. (the "Company") has been principally engaged in color science technology research and development and licensing activities, seeking mass market applications for its proprietary technology and instrumentation. [a] Estimates and Uncertainties The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates. Significant estimates relate primarily to inventory valuation and recoverability of the Company's tangible and intangible assets. [b] Principles of Consolidation The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. All intercompany balances and transactions have been eliminated in consolidation. [c] Patent Application Costs The Company began capitalizing certain patent application costs, commencing January 1, 1998, and had been amortizing such costs over the remaining patent lives, generally 10 to 15 years. Accumulated amortization as of December 31, 2000 was $268,000. The Company assesses the continuing carrying value of these assets when events and circumstances warrant and, in 2001 and 2000, recorded impairment charges of $647,000 and $581,000, respectively (see Note 18). [d] Revenue Recognition The Company records revenue from the sale of ColorMate TLc-BiliTest Systems and TLc-Lensette Calibration Standards at the time of shipment at the minimum transfer price provided in the distribution agreement. The agreement provides for additional amounts from the distributor equal to a defined percentage of the distributor's sales price of these products. The Company records revenue from the additional amounts upon receipt from the distributor. Sales of cosmetic products are recorded when the products are shipped. Shipping charges are included in sales. Shipping and handling costs are included in cost of sales. [e] Inventories Inventories are stated at the lower of first-in, first-out cost or market. 50 NOTE 1 - Nature of Business and Summary of Significant Accounting Policies (continued) [f] Property and Equipment and Depreciation Property and equipment are stated at cost. Depreciation is computed using principally the straight-line method over estimated useful lives of 5 to 7 years. The Company continually evaluates the life and carrying amount of such equipment in light of current conditions and, in 2000, wrote off the net book value of certain equipment totaling $258,000 (see Note 18). [g] Software Development Costs Once technological feasibility was established, the costs of developing software to be marketed as part of a product were capitalized. Capitalization ceased in 1999 when the products became available for sale. The costs were amortized on the basis of estimated future revenues with annual minimum charges, which is similar to the straight-line basis over the estimated remaining useful life (three years). Accumulated amortization of software development costs at December 31, 2000 was $366,000. Based on management's assessment of the carrying amount of the asset, an impairment charge of $53,000 was recorded in 2001 (see Note 18). [h] Long-Lived Assets Long-lived assets, such as intangible assets and property and equipment, are evaluated for impairment when events or changes in circumstances indicate that the carrying amount of the assets may not be recoverable through the estimated undiscounted future cash flows from the use of these assets. When any such impairment exists, the related assets will be written down to fair value. In 2001 and 2000 (see note 18), the Company recorded impairment losses relating to these assets. [i] Cash Equivalents The Company considers certificates of deposit, money market funds and all other highly liquid debt instruments purchased with an original maturity of three months or less to be cash equivalents. [j] Financial Instruments Financial instruments include cash and equivalents, accounts receivable, accounts payable and long-term debt. The amounts reported for financial instruments are considered to be reasonable approximations of their fair values. The fair value estimates presented herein were based on market information available to management as of

December 31, 2001. 51 NOTE 1 - Nature of Business and Summary of Significant Accounting Policies (continued) [k] Concentration of Credit Risk/Major Customers, Supplier and Manufacturer The Company generated principally all of its revenues from one customer in 1999 and 2000 (see Note 6). The Company is dependent upon one supplier for a major part of its ColorMate TLc-BiliTest System and another to manufacture the ColorMate TLc-BiliTest System. The loss of either of these relationships would materially adversely affect the Company. [l] Loss Per Share The Company follows Statement of Financial Accounting Standards ("SFAS") No. 128, "Earnings Per Share," ("EPS") which requires a presentation of basic EPS and diluted EPS. Basic EPS excludes dilution and is computed by dividing loss to common stockholders by the weighted-average number of common shares outstanding for the period. Diluted EPS includes the effect, if dilutive, from the potential exercise or conversion of securities, which would result in the issuance of incremental shares of common stock. Such potential shares have been excluded from EPS in 2001, 2000 and 1999 as their effect would be anti-dilutive. Securities and the related number of common shares not included in the diluted computation for the year ended December 31, 2001 that would potentially dilute basic earnings per share, if any in the future, are as follows: Preferred stock 109,071,000 Warrants 35,940,000 Options 3,271,000 Advances from investor - see Note 14(b) 833,000 ---------- 149,115,000 ---------- The conversion price of the Series 4 convertible preferred stock is equal to the lower of $0.82 and 92% of the average of the three lowest consecutive closing bid prices during the 22 trading days preceding conversion. Included in the above table are 106,435,000 shares issuable upon the conversion of the outstanding Series 4 shares, reflecting the conversion terms most beneficial to the investor and a conversion price that would have been $0.0153 at December 31, 2001. Not included in the above table are the warrants issued in connection with the Gordon disposal or the Adjustable Warrant issued in connection with the sale of Common stock because the number that will vest is not determinable (see Note 14[b]).The maximum number of potential common shares from the warrants issued in the Gordon disposal is 16,000,000. The number of commmon shares issuable from the Adjustable Warrant would have been 108,129,000 on December 31, 2001. In addition, the Company issued 19,533,000 warrants with notes payable subsequent to December 31, 2001. [m] Stock-Based Compensation SFAS No. 123, "Accounting for Stock-Based Compensation," encourages, but does not require, companies to record compensation cost at fair value for stock-based employee compensation plans. The Company has chosen to continue to account for stock-based compensation for employees using the intrinsic value method prescribed in Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," and related Interpretations. Accordingly, compensation cost for options granted by the Company is measured as the excess, if any, of the quoted market price of the Company's stock at the date of the grant over the amount an employee must pay to acquire the stock. The fair value of option grants is discussed in Note 14. 52 NOTE 1 - Nature of Business and Summary of Significant Accounting Policies (continued) [n] Income Taxes Deferred tax assets and liabilities reflect the net tax effects of temporary differences between the carrying amount of assets and liabilities for financial reporting purposes and the amounts for income tax purposes. A valuation allowance is provided for the net deferred tax assets if it is more likely than not that some or all of the deferred tax assets will not be realized. [o] Research and Development Research and development costs are expensed as they are incurred. [p] Recent Accounting Standards In November 2000, the Emerging Issues Task Force ("EITF") issued consensus number 00-27 which requires the remeasurement of the original issue discount on preferred stock with characteristics similar to the convertible preferred stock issued by the Company earlier in 2000 and in 1999. The adoption of this EITF resulted in an additional imputed dividend of $2,325,000 (relating to additional charges for the below market conversion price of the preferred stock), which was recorded in the fourth quarter of 2000. In July 2001, the Financial Accounting Standards Board ("FASB") issued SFAS No. 141, "Business Combinations", which supersedes APB Opinion No. 16, "Business Combinations". SFAS 141 eliminates the pooling-of-interests method of accounting for business combinations and modifies the application of the purchase accounting method. The elimination of the pooling-of-interests method is effective for transactions initiated after June 30, 2001. The remaining provisions of SFAS 141 are effective for transactions accounted for using the purchase method that are completed after June 30, 2001. The Company believes that SFAS 141 will not have a material effect on its financial statements. In July 2001, the FASB also issued SFAS No. 142, "Goodwill and Intangible Assets", which supersedes APB Opinion No. 17, "Intangible Assets". SFAS 142 eliminates the current requirement to amortize goodwill and indefinite-lived intangible assets, addresses the amortization of intangible assets with a defined life and addresses the impairment testing and recognition for goodwill and intangible assets. SFAS 142 applies to goodwill and intangible assets arising from transactions completed before and after the Statement's effective date. SFAS 142 is effective for fiscal 2002. The Company will adopt SFAS 142 in

fiscal 2002. The Company believes that SFAS 142 will not have a material effect on its financial statements. In June 2001, the FASB issued SFAS No. 143, "Accounting for Asset Retirement Obligations". This statement addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated retirement costs. SFAS 143 is effective for fiscal years beginning after June 15, 2002. The Company believes that SFAS 143 will not have a material effect on its financial statements. 53 NOTE 1 - Nature of Business and Summary of Significant Accounting Policies (continued) [p] Recent Accounting Standards (continued) In August 2001, the FASB issued SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets". This statement addresses financial accounting and reporting for the impairment or disposal of long-lived assets and supersedes SFAS 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of", and the accounting and reporting provisions of APB No. 30, "Reporting the Results of Operations for a Disposal of a Segment of a Business." SFAS 144 is effective for fiscal years beginning after December 15, 2001, with earlier application encouraged. The Company has not yet determined the impact the adoption of SFAS 144 will have on its financial statements. NOTE 2 - Basis of Presentation The Company's consolidated financial statements have been presented on the basis that it is a going concern, which contemplates the realization of assets and the satisfaction of liabilities in the normal course of business. The Company has sustained net losses for the past several years, including $7,918,000 in 2001, $19,496,000 in 2000 and $12,808,000 in 1999, has incurred recurring cash outflows from operating activities, and has experienced significant problems and delays exploiting its primary technology (medical equipment). At December 31, 20