

2002 CEO Letter to Shareholders

Dear Oridion Shareholders,

The year 2002 has been a significant period for Oridion, both in terms of the milestones achieved by the Company and the steps taken by the Company to encourage sustained growth. The growth in Oridion's revenues follows an increase in the range of the Company's capnography product offering, as a growing number of the world's leading medical device companies integrate Oridion's Microstream® capnography into their monitoring systems. This resulted in the Capnography business reaching its break-even rate in the last quarter of the year, at the same time that Oridion's Breath Testing business is starting to generate revenues.

Oridion's Microstream® capnography products and BreathID® breath testing diagnostic products are rapidly becoming well-known names in the medical community and the brand of choice for medical care providers worldwide. The growing demand for Oridion's products has resulted in an increase in sales force coverage for Oridion's products through Oridion's partners. At the same time, Oridion's R&D team remains focused on developing new products that are intended to continue to ensure Oridion's position as the forefront technological leader in both its fields.

Capnography

Oridion continued to witness in this past year a constant increase in the demand for capnography – the non-invasive monitoring of the CO₂ contained in the patient's breath. This increase is a result of a number of factors, including the growing use of sedatives administered by physicians in both hospital and non-hospital settings, and the growing number of medical industry standards requiring CO₂ monitoring – such as those recently established by ACEP (American College of Emergency Physicians) – the oldest and largest emergency medical specialty organization – that state “capnography monitoring is superior to pulse oximetry, esophageal detector and other forms of physical examination in detection of the status of a patient's ventilation.” Increasing instances of respiratory diseases, such as asthma and COPD (chronic obstructive pulmonary disease) and a rising awareness throughout the entire medical community of how vital CO₂ monitoring is to patient safety, also contributes to the demand for CO₂ monitoring.

As the use of CO₂ monitoring increases, so does the demand for Oridion's capnography products. As a result, Oridion's products can now be found in use in nearly every medical care environment, including various hospital departments, emergency medical services, out-patient clinics and surgical centers.

Oridion continues to support educational programs that clearly demonstrate the clinical value and advantages offered by Oridion's capnography products in different

medical environments, such as the rapidly growing field of procedural sedation. Due to the complications that can occur in such instances in which a patient is sedated, CO₂ monitoring can help alert care providers in detecting breathing complications, and help them to save lives. Oridion has been pleased to witness as a result of these programs a growth in sales of the new CapnoLine® family of consumable products launched last year.

The advantages offered by Oridion's products have helped make the Company's Microstream® technology the capnography of choice for many of the world's leading medical device companies. Over the past year, Oridion has been pleased to witness an increase in the number of products incorporating Microstream® capnography. This increase is a result of a number of factors, including the signing of additional agreements with world leading companies - such as Siemens Medical Solutions. Other factors include the increase of Microstream® enabled products offered by Oridion's existing OEM partners - such as Medtronic Physio Control, Philips Medical Systems, Tyco Healthcare, Datascope Corporation and others.

In Japan, Oridion has new agreements with leading Japanese Medical Device companies, such as Nihon Kohden Corporation, Fukuda Denshi Corporation and Colin Medical Instruments Corporation. These agreements follow the Japanese Shonin regulatory approval for a number of Oridion's capnography monitors and consumable products.

Oridion was also pleased to receive three new patents in 2002 from the United States Patent and Trademark Office protecting the Company's capnography technology. These new patents, together with the choice of world leading medical devices companies to integrate Oridion's products in their monitoring systems, serve as an important statement to the distinctiveness of Oridion's flagship Microstream® technology.

Breath Testing

Over 20% of the world's population is estimated to suffer from gastrointestinal (GI) functional disorders. In addition, illnesses such as diabetes are rapidly increasing in many areas of the world, particularly in countries with well developed healthcare systems. Patients suffering from these illnesses also frequently suffer GI functional disorders as a side effect of their main conditions. These disorders have an enormous impact on both the economy and quality of life of patients suffering from them. Billions of dollars are spent each year in the US alone for symptomatic relief of the symptoms related to these conditions.

The rise in GI disorders has resulted in an increase in the development of new drugs by pharmaceutical companies for treatment of these disorders. Furthermore, new therapeutic approaches are developing with the objective of providing specific treatment with minimal side effects. The terms "personalized medicine" and "integrated approach" – quickly becoming popular terms in many segments of the healthcare industry – involve a close relation between diagnosis and treatment.

To help enable the most effective and convenient diagnosis of GI disorders, Oridion has developed its multi-test BreathID® Breath Testing Platform – designed by Oridion to non-invasively diagnose a range of GI disorders with just one simple,

economical and portable device that can be used with different single-use kits for each type of test administered.

Oridion received final approval from the US Food and Drug administration (FDA) for its BreathID® system and *H. pylori* breath test. The BreathID® was also granted the CE mark in Europe. Obtaining regulatory approval is an important achievement for Oridion and enables the Company to now focus on driving its breath testing products to the medical communities in these key markets.

In its efforts to increase the platform testing ability of the BreathID®, Oridion completed development in 2002 of its new Gastric Emptying Rate (GER) breath test. This new test was designed by Oridion to non-invasively measure the transit time it takes for food to pass through the stomach. As currently available GER tests are costly, time consuming and unsafe, Oridion expects this new application to help provide gastroenterologists with valuable information and assist them in managing certain patients who suffer from GI disorders.

This past year has been significant for Oridion's breath testing business, as the Company signed its first distribution agreements and began initial sales of the BreathID® and its first two applications – Oridion's patented *H. pylori* breath test and Oridion's patented GER breath test – in a number of European countries. Following the regulatory approval of the BreathID® system and *H. pylori* breath test in the US, Oridion is preparing for their US launch.

In light of the increasing number of breath testing opportunities opening to Oridion, the Company founded this year a breath testing advisory committee. Oridion is proud to have from amongst the world's most renowned gastroenterologists serve as members on this committee – who will work with Oridion's management to help identify the most acute GI related diagnostic needs of the medical community and help shape the focus and mission of Oridion's constantly evolving breath testing business.

Corporate Developments

To capitalize on the numerous possibilities constantly opening to the Company and following the split of its business units into two separate companies in 2001, Oridion established in 2002 new US corporate headquarters in Boston, MA, and appointed two new members to its Board of Directors that each bring to Oridion over 25 years of experience in the medical device market. Toward the end of 2002, Oridion also re-listed its shares on the main segment of the Swiss Stock Exchange together with other industry leaders.

In light of the growing instances which clearly demonstrate the need for increased transparency of corporate proceedings and management activities, Oridion's management implemented in 2002 a number of steps to safeguard the Company and its shareholders. These steps, which come in addition to the Company's current internal and external auditors and audit committee, include the adoption of an audit committee charter that extends additional authority to the committee in its supervisory role of the Company's activities.

Looking Ahead

We look forward to signing additional agreements and launching new capnography products with both existing and new partners as they continue to develop and launch new patient monitoring systems. The successful degree of cooperation we continue to experience with our partners strengthens our belief that the technological advances we make translates into lives saved.

In remaining true to our belief that CO₂ monitoring should be made possible regardless of the type of patient or the type of clinical environment the patient is in, we plan to continue developing our FilterLine® and CapnoLine™ families of consumable products.

As the technological leader for capnography solutions, Oridion strives to establish the use of capnography in every type of medical procedure as the earliest possible warning sign of danger to the patient's status. Oridion expects to see its market share of the growing capnography market increase with each new solution it offers.

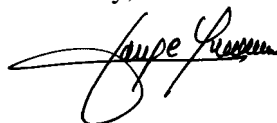
In our breath testing business, we plan to begin BreathID® sales in the US and increase sales in Europe. We bear a large degree of satisfaction from the improvement the BreathID® brings to the quality of the lives of those patients suffering from GI disorders that require diagnosis and constant follow-ups.

With two tests already developed and launched in Europe for the BreathID®, and additional tests currently under development, we plan to continue extending the platform capabilities of the BreathID® and enable its use with a growing range of GI disorders.

Due to the unparalleled platform capabilities and many other advantages offered by the BreathID®, Oridion expects the BreathID® to become a standard diagnostic and disease management system in every gastroenterologist's office worldwide.

We are happy to see our plans turn into a reality. All this has been made possible by the hard work of Oridion's dedicated team of employees and your continued support of Oridion. We thank you for your belief in us and will continue to work hard in becoming and remaining leaders in our field.

Sincerely,

A handwritten signature in black ink, appearing to read "George Yariv". The signature is fluid and cursive, with a large initial "G" and "Y".

George Yariv
President and CEO
March 7th 2003

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion and analysis should be read in conjunction with the Consolidated Financial Statements of Oridion together with the Notes thereto included elsewhere in the 2002 Annual Report. The Annual Report contains certain forward-looking statements that involve risks and uncertainties. Oridion's actual performance, results and the timing of certain events could differ materially from those discussed in the forward-looking statements contained in this document as a result of certain factors as well as those included in the Annual Report.

Overview

Oridion designs, manufactures and markets proprietary medical devices and consumables that utilize its core Microstream® technology in patient safety monitoring and point-of-care diagnostic testing. Oridion's patient monitoring devices are used in capnography, the measurement of carbon dioxide contained in human breath, to determine the status and adequacy of respiratory function. In addition to its capnography products, Oridion has developed a proprietary diagnostic breath testing system – the BreathID® – designed to non-invasively diagnose certain diseases and physiological conditions in just one visit to the physician's office. Oridion has already completed development of the first two BreathID® applications and is currently developing additional breath tests for use with this system. Since Oridion's inception and until the year 2001, sales of capnography devices and consumables have accounted for all of Oridion's revenues. In mid-2002, Oridion launched its breath testing products in Europe after receiving the CE mark for sale. The first products launched were Oridion's patented multi-test BreathID® Breath Testing Platform System and the Company's patented 13C urea breath test for the detection of the *H. pylori* bacteria. The European launch followed the successful introduction of these products to leading hospitals in Israel in 2001. Toward the end of 2002, Oridion received final approval from the FDA to market its BreathID® system and 13C Urea *H. pylori* breath test in the US.

Oridion markets and distributes its capnography products through sales agreements with OEM partners and private label manufacturers specializing in the patient monitoring market in the United States, Europe and Japan. In the year ended December 31, 2002, approximately 72 percent of Oridion's sales consisted of products sold to large medical device companies intended for integration into the monitoring systems of these companies. These systems are then shipped for sale in various countries worldwide. Demand for Oridion's capnography products has often been affected by seasonal trends in hospital purchases, with sales of Oridion's products generally peaking in November and December as many hospitals follow a budget cycle based on the calendar year.

Oridion's Consolidated Financial Statements have been prepared in US Dollars in accordance with U.S. GAAP. As almost all of Oridion's sales are made in US Dollars, Oridion uses the U.S. Dollar as its functional and reporting currency.

Results of Operations

Year ended December 31, 2002 compared to year ended December 31, 2001

Revenues. For the year ended December 31, 2002, revenues increased by 35 percent to \$14.1 million compared to \$10.4 million for the year ended December 31, 2001. The increase in the sales is a result of growth in OEM capnography customer sales, new Capnography products launched, increase in Capnography consumables and the initial launch of sales for the new BreathID® application.

For the year ended December 31, 2002, 72 percent of revenues were derived from four of Oridion's customers, as compared to 80 percent from three customers in 2001. For the year ended December 31, 2002, sales to customers in the United States accounted for 70 percent and 78 percent in 2001 respectively, of revenues, and sales to customers in Europe accounted for 24 percent in 2002 and 19 percent in 2001. In the immediate future, Oridion believes that it will continue to depend on sales to a number of key OEMs and private label manufacturers. However, with the increase in sales of its capnography products in Europe and Japan, coupled with the work done by the direct sales force, Oridion believes that within time the dependence on the key OEMs will decrease. The majority of Oridion's revenues have been historically derived from sales in the United States and Europe.

Cost of revenues. Cost of revenues for the year ended December 31, 2002 increased to \$7.8 million compared to \$5.9 million for the year ended December 31, 2001. The increase is a result of an increase in sales in 2002. Gross margin increased to 44 percent for the year ended December 31, 2002 from 43 percent for the year ended December 31, 2001. The increase in the gross margin resulted from a number of factors, including, stable transfer prices for Oridion's products; continued growth in sales of consumables, which generally provide higher margins and continual improvement of efficiencies. The gross margin was slightly reduced owing to one-time start up expenses for BreathID® production.

Research and Development expenses, net. Research and development expenses, net, remained basically constant at \$3.6 million for the year ended December 31, 2002 compared to \$3.8 million for the year ended December 31, 2001. The Company continues to invest in the Capnography business – its core technology and in the development of many new Capnography products – both devices and consumables – currently in the pipeline and scheduled for launch in 2003 and beyond. In the Breath Testing business, Oridion completed development of its second Breath Test – Gastric Emptying Rate. Oridion's R&D team is continuing to develop additional applications for the BreathID® aimed at further increasing its ability to offer a wide platform for the diagnosis of a whole range of gastrointestinal disorders. With each new breath test developed, the benefits offered by the BreathID® are extended to new markets and patient groups, and new and increased business opportunities are opened for the Company. Oridion funded its research and development out of the initial public offering proceeds and subsidies received from the Chief Scientist of Israel. Research and development expenses, net, represented 26 percent of revenues for the year ended December 31, 2002 compared to 36 percent for the year ended December 31, 2001.

Selling and marketing expenses, net. Selling and marketing expenses, net, for the year ended December 31, 2002 decreased to \$9.7 million compared to \$10.8 million for the year ended December 31, 2001. In 2002, Oridion US merged three different offices into one main office in Needham Massachusetts, resulting in a reduction in overall

marketing costs. Furthermore the Breath testing business reduced a number of its marketing activities while waiting for FDA marketing clearance. Selling and marketing expenses include the activities of Oridion's Capnography US direct sales team. This team works together with Oridion's team of clinical education specialists in an effort to market Oridion's products directly to end users in various medical care environments and has already proven instrumental in helping increase the sale of Oridion's consumable capnography products. These teams have also been active in educating various segments of the medical community on the benefits of Oridion's products managing an increasing number of distributors currently selling Oridion's products and training Oridion's constantly growing number of customers on how to use Microstream® enabled products. Further selling and marketing expenses include the activities of Oridion's European and Japanese marketing teams, established in 2001, to further enhance sales of Oridion's products to the installed base of Oridion's products in these countries.

General and administrative expenses. For the year ended December 31, 2002, general and administrative expenses increased to \$2.8 million compared to \$2.4 million for the year ended December 31, 2001. General and administrative expenses represented 20 percent of revenues for the year ended December 31, 2002 compared to 23 percent for the year ended December 31, 2001.

Financial income, net. For the year ended December 31, 2002, financial income, net, decreased to \$0.2 compared to \$1.1 million for the year ended December 31, 2001. The decrease in income resulted mainly from a major reduction in the US dollar interest rates and a lower average cash balance.

Taxes. For the year ended December 31, 2002, tax benefit was \$ 0.08 million as compared to taxes payable of \$0.2 million for the year ended December 31, 2001. This is a result of a reduction in tax accruals for the US subsidiaries for 2001.

Year ended December 31, 2001 compared to year ended December 31, 2000

Revenues. For the year ended December 31, 2001, revenues remained steady at \$10.4 million compared to \$10.3 million for the year ended December 31, 2000. The main reason for the lack of sales growth was the deferral of product launches by two of Oridion's OEM customers to 2002, owing to their internal development schedules.

For the year ended December 31, 2001, 80 percent of revenues were derived from three of Oridion's customers, as compared to 88 percent from the same three customers in 2000. For both the years ended December 31, 2001 and 2000, sales to customers in the United States accounted for 78 percent of revenues, and sales to customers in Europe accounted for 19 percent in 2001 and 20 percent in 2000. In the immediate future, Oridion believes that it will continue to depend on sales to a number of key OEMs and private label manufacturers, however, with the establishment of a direct sales force in the US, which in turn manages both speciality distributors and manufacturing representatives, Oridion believes that within time the direct sales will increase significantly, which in turn will decrease the dependence on the OEMs. The majority of Oridion's revenues have been historically derived from sales in the United States and Europe.

Cost of revenues. Cost of revenues for the year ended December 31, 2001 decreased by approximately \$0.2 million or 3 percent to \$5.9 million from \$6.1 million for the year ended December 31, 2000. Gross margin increased to 43 percent for the year

ended December 31, 2001 from 41 percent for the year ended December 31, 2000. The increase in the gross margin resulted from a number of factors, including, stable transfer prices for Oridion's products, continued growth in sales of consumables, which generally provide higher margins, continual improvement of efficiencies and better purchase terms for materials from its existing suppliers, with whom the Company has annual renewable supply contracts.

Research and Development expenses, net. Research and development expenses, net, increased to \$3.8 million for the year ended December 31, 2001 compared to \$3.1 million for the year ended December 31, 2000. The increase in investment in the Capnography business relates to the miniaturization of our technology and to the development of many new Capnography products – both devices and consumables – currently in the pipeline and scheduled for launch in 2002 and beyond. In the Breath Testing business, the development of the breath test unit was completed and the Company began developing new applications for its breath testing device aimed at opening new markets for its diagnostic breath tests. Oridion funded its research and development out of the initial public offering proceeds and subsidies received from the Chief Scientist of Israel. Research and development expenses, net, represented 36 percent of revenues for the year ended December 31, 2001 compared to 30 percent for the year ended December 31, 2000.

Selling and marketing expenses, net. Selling and marketing expenses, net, for the year ended December 31, 2001 increased to \$10.8 million compared to \$5.9 million for the year ended December 31, 2000. Following the establishment of an installed base of Microstream® enabled patient safety monitors, Oridion established a direct US sales force to support its OEM partners and focus on marketing its consumable products. This will enable Oridion to continue cooperating with its OEM partners for the sale of monitors while reducing its dependence on them for marketing its consumable products. To help capitalize on the opportunities offered by the increasing number of different Oridion monitors and consumables currently available, Oridion also established this year a marketing presence in Japan and increased its marketing presence in Europe. The Company will also be working with speciality distributors and manufacturing representatives for the sale of its products in the US market.

General and administrative expenses. For the year ended December 31, 2001, general and administrative expenses decreased to \$2.4 million compared to \$2.6 million for the year ended December 31, 2000. General and administrative expenses represented 23 percent of revenues for the year ended December 31, 2001 compared to 25 percent for the year ended December 31, 2000.

Financial income, net. For the year ended December 31, 2001, financial income, net, increased by \$ 0.1 million to \$1.1 compared to \$1.0 million for the year ended December 31, 2000. This increase in income resulted from interest income received on deposits from the unused portion of the proceeds of the initial public offering. Owing to steady decrease of the US Dollar interest, financial income in the second half of the year was reduced substantially compared to the first half of the year 2001.

Taxes. For the year ended December 31, 2001 federal and state taxes in the US increased from zero to \$0.2 million. Oridion's US marketing company works on a cost plus basis with Oridion Israel, this resulted in both state and federal taxes in the US.

ORIDION SYSTEMS LTD. AND ITS SUBSIDIARIES

CONSOLIDATED FINANCIAL STATEMENTS

AS OF DECEMBER 31, 2002

IN U.S. DOLLARS

INDEX

	<u>Page</u>
Report of Independent Auditors	2
Consolidated Balance Sheets	3 - 4
Consolidated Statements of Operations	5
Statements of Changes in Shareholders' Equity (Deficiency)	6
Consolidated Statements of Cash Flows	7 - 8
Notes to Consolidated Financial Statements	9 - 27



REPORT OF INDEPENDENT AUDITORS

To the Shareholders of ORIDION SYSTEMS LTD.

We have audited the accompanying consolidated balance sheets of Oridion Systems Ltd. ("the Company") and its subsidiaries as of December 31, 2001 and 2002 and the related consolidated statements of operations, changes in shareholders' equity (deficiency) and cash flows for each of the three years in the period ended December 31, 2002. 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. 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 consolidated financial position of the Company and its subsidiaries as of December 31, 2001 and 2002, and the consolidated results of their operations and cash flows for each of the three years in the period ended December 31, 2002, in conformity with accounting principles generally accepted in the United States.

Tel-Aviv, Israel
January 30, 2003

KOST FORER & GABBAY
A Member of Ernst & Young Global

ORIDION SYSTEMS LTD. AND ITS SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

U.S. dollars in thousands

	December 31,	
	2001	2002
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	\$ 7,959	\$ 9,504
Short-term bank deposits	10,148	-
Trade receivables	2,204	3,326
Other accounts receivable and prepaid expenses (Note 3)	596	680
Inventories (Note 4)	4,865	3,252
	25,772	16,762
SEVERANCE PAY FUND	*) 854	1,018
PROPERTY AND EQUIPMENT, NET (Note 5)	5,015	4,762
	\$ 31,641	\$ 22,542

*) Reclassified.

The accompanying notes are an integral part of the consolidated financial statements.

ORIDION SYSTEMS LTD. AND ITS SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

U.S. dollars in thousands (except share data)

	December 31,	
	2001	2002
LIABILITIES AND SHAREHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Trade payables	\$ 1,776	\$ 1,763
Other accounts payable and accrued expenses (Note 6)	2,141	2,472
	3,917	4,235
ACCRUED SEVERANCE PAY	*) 1,670	1,757
COMMITMENTS AND CONTINGENT LIABILITIES (Note 7)		
SHAREHOLDERS' EQUITY (Note 8)		
Share capital:		
Ordinary shares of NIS 0.01 par value -		
Authorized: 20,000,000 shares as of December 31, 2001 and 2002;		
Issued and outstanding: 10,500,421 shares and 10,501,421 shares as		
of December 31, 2001 and 2002, respectively;	25	25
Additional paid-in capital	73,609	73,679
Accumulated deficit	(47,580)	(57,154)
Total shareholders' equity	26,054	16,550
	\$ 31,641	\$ 22,542

*) Reclassified.

The accompanying notes are an integral part of the consolidated financial statements.

ORIDION SYSTEMS LTD. AND ITS SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

U.S. dollars in thousands (except share and per share data)

	Year ended December 31,		
	2000	2001	2002
Revenues (Note 11a and b)	\$ 10,317	\$ 10,415	\$ 14,060
Cost of revenues	6,074	5,919	7,847
Gross profit	4,243	4,496	6,213
Operating expenses:			
Research and development, net (Note 12a)	3,132	3,763	3,645
Selling and marketing, net (Note 12b)	5,872	10,843	9,682
General and administrative	2,553	2,438	2,782
Total operating expenses	11,557	17,044	16,109
Operating loss	(7,314)	(12,548)	(9,896)
Financial income, net (Note 12c)	963	1,142	244
Loss before taxes on income	(6,351)	(11,406)	(9,652)
Taxes on income (tax benefit) (Note 9)	24	202	(78)
Net loss	<u>\$ (6,375)</u>	<u>\$ (11,608)</u>	<u>\$ (9,574)</u>
Basic and diluted net loss per share	<u>\$ (0.73)</u>	<u>\$ (1.12)</u>	<u>\$ (0.91)</u>
Weighted average number of shares used in computing basic and diluted net loss per share	<u>8,700,020</u>	<u>10,378,012</u>	<u>10,501,004</u>

The accompanying notes are an integral part of the consolidated financial statements.

ORIDION SYSTEMS LTD. AND ITS SUBSIDIARIES

STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY (DEFICIENCY)

U.S. dollars in thousands (except share data)

	<u>Preferred shares</u>	<u>Ordinary shares</u>	<u>Share capital</u>	<u>Additional paid-in capital</u>	<u>Accumulated deficit</u>	<u>Total shareholders' equity (deficiency)</u>
	<u>(Amount of shares)</u>					
Balance as of January 1, 2000	1,673,654	4,426,990	\$ 15	\$ 23,392	\$ (29,597)	\$ (6,190)
Issuance of Preferred shares, net	1,000,000	-	3	6,877	-	6,880
Issuance of Ordinary shares, net	-	2,500,000	7	38,731	-	38,738
Conversion of Preferred shares into Ordinary shares	(2,673,654)	2,673,654	-	-	-	-
Exercise of warrants, net	-	293,719	*) -	1,836	-	1,836
Exercise of options, net	-	230,000	*) -	697	-	697
Amortization of deferred stock compensation	-	-	-	660	-	660
Net loss	-	-	-	-	(6,375)	(6,375)
Balance as of December 31, 2000	-	10,124,363	25	72,193	(35,972)	36,246
Exercise of options, net	-	376,058	*) -	1,301	-	1,301
Amortization of deferred stock compensation	-	-	-	115	-	115
Net loss	-	-	-	-	(11,608)	(11,608)
Balance as of December 31, 2001	-	10,500,421	25	73,609	(47,580)	26,054
Exercise of options, net	-	1,000	*) -	4	-	4
Amortization of deferred stock compensation	-	-	-	66	-	66
Net loss	-	-	-	-	(9,574)	(9,574)
Balance as of December 31, 2002	-	10,501,421	\$ 25	\$ 73,679	\$ (57,154)	\$ 16,550

*) Represents an amount lower than \$ 1.

The accompanying notes are an integral part of the consolidated financial statements.

ORIDION SYSTEMS LTD. AND ITS SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. dollars in thousands

	Year ended December 31,		
	2000	2001	2002
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net loss	\$ (6,375)	\$ (11,608)	\$ (9,574)
Adjustments required to reconcile net loss to net cash used in operating activities:			
Depreciation and amortization	811	811	1,437
Amortization of deferred stock compensation	660	115	66
Accrued interest on short-term bank deposits	(1,018)	(148)	-
Marketable securities, net	(1,224)	1,224	-
Accrued severance pay, net	190	56	(77)
Decrease (increase) in trade receivables	(1,333)	201	(1,122)
Decrease (increase) in other accounts receivable and prepaid expenses	(150)	177	(84)
Decrease (increase) in inventories	(1,335)	(2,206)	1,388
Increase (decrease) in trade payables	951	(290)	(13)
Increase (decrease) in other accounts payable and accrued expenses	(834)	149	331
Gain on sale of property and equipment	(2)	(11)	(1)
Net cash used in operating activities	<u>(9,659)</u>	<u>(11,530)</u>	<u>(7,649)</u>
CASH FLOWS FROM INVESTING ACTIVITIES:			
Proceeds from the sale of property and equipment	2	11	3
Purchase of property and equipment	(1,755)	(2,600)	(961)
Investment in short-term bank deposits	(40,580)	(10,000)	-
Proceeds from sale of short-term bank deposits	15,417	26,181	10,148
Net cash provided by (used in) investing activities	<u>(26,916)</u>	<u>13,592</u>	<u>9,190</u>
CASH FLOWS FROM FINANCING ACTIVITIES:			
Proceeds from issuance of Preferred shares, net	6,880	-	-
Proceeds from issuance of Ordinary shares, net	38,738	-	-
Proceeds from exercise of warrants, net	1,836	-	-
Proceeds from exercise of options, net	697	1,301	4
Principal payment of short-term loans	(700)	-	-
Principal payment of long-term loans	(6,600)	-	-
Short-term bank credit, net	(1,850)	(166)	-
Net cash provided by financing activities	<u>39,001</u>	<u>1,135</u>	<u>4</u>
Increase in cash and cash equivalents	2,426	3,197	1,545
Cash and cash equivalents at the beginning of the year	<u>2,336</u>	<u>4,762</u>	<u>7,959</u>
Cash and cash equivalents at the end of the year	<u>\$ 4,762</u>	<u>\$ 7,959</u>	<u>\$ 9,504</u>

The accompanying notes are an integral part of the consolidated financial statements.

ORIDION SYSTEMS LTD. AND ITS SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. dollars in thousands

	Year ended December 31,		
	2000	2001	2002
(a) <u>Significant non-cash transactions:</u>			
Classification of inventory to property and equipment	\$ -	\$ -	\$ 225
Conversion of Preferred shares into Ordinary shares	\$ 7	\$ -	\$ -
(b) <u>Supplemental disclosure of cash flows information:</u>			
Cash paid during the year for:			
Interest	\$ 419	\$ 72	\$ 37
Income taxes	\$ 24	\$ 122	\$ -

The accompanying notes are an integral part of the consolidated financial statements.

ORIDION SYSTEMS LTD. AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 1:- GENERAL

Oridion Systems Ltd. and its subsidiaries ("the Company") is a holding company which wholly-owns Oridion Medical 1987 Ltd. and Oridion BreathID Ltd. (together, "Oridion") and all of their subsidiaries. Oridion designs, manufactures and markets proprietary medical devices and consumables that utilize its core Microstream[®] technology in patient safety monitoring and point-of-care diagnostic testing. Oridion's patient safety monitoring devices are used in its line of capnography products, which are utilized by its customers in the U.S., Europe and the Far East in monitoring patients under anesthesia. For the year ended December 31, 2002, 72% of the Company's sales were to four customers, for the year ended December 31, 2001, 80% of the Company's sales were to three customers and for the year ended December 31, 2000, 88% of the Company's sales were to three customers (see Note 11c). In addition, Oridion has developed a proprietary platform technology to diagnose the adequacy of organ function through diagnosing information found in human breath. The Company started its first sales of the Breath tests units in Europe during the year 2002 and received FDA marketing clearance in December 2002, to market it in the US.

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES

The consolidated financial statements are prepared according to United States generally accepted accounting principles ("US GAAP").

a. Use of estimates:

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

b. Financial statements in U.S. dollars:

A majority of Oridion and its subsidiaries' revenues is generated in U.S. dollars, and a portion of Oridion and its subsidiaries' costs is incurred in U.S. dollars. Accordingly, the Company's management has determined the U.S. dollar as the currency of its primary economic environment and thus as its functional and reporting currency.

Accordingly, monetary accounts maintained in currencies other than the dollar are remeasured into U.S. dollars in accordance with Statement of Financial Accounting Standards No. 52 "Foreign Currency Translation" ("SFAS No. 52"). All transactions gains and losses from the remeasurement of monetary balance sheet items are reflected in the statements of operations as financial income or expenses as, appropriate.

ORIDION SYSTEMS LTD. AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

c. Principles of consolidation:

The consolidated financial statements include the accounts of the Company and those of the following companies:

	% of ownershi p
1. Oridion Medical 1987 Ltd.	100
2. Oridion BreathID Ltd. *)	100
3. Irad Technologies Ltd. **)	100
4. Oridion Capnography Inc. (through the subsidiary, Oridion Medical 1987 Ltd.) ***)	100
5. Oridion BreathID Inc. (through the subsidiary, Oridion BreathID Ltd.)	100
6. Oridion Medical Europe BV (through the subsidiary, Oridion Medical 1987 Ltd.)	100
7. Oridion Spain S.L. (through the subsidiary, Oridion Medical Europe BV)**)	100
8. Oridion Capnography GmbH (through the subsidiary, Oridion Medical Europe BV)	100
9. Oridon Medical K.K. (through the subsidiary, Oridion Medical Europe BV)	100

*) In December 2001, the board of directors of the Company resolved to split the Breath Tests activity of the Company into a new company, Oridion BreathID Ltd., which is a wholly-owned subsidiary of Oridion Systems Ltd. During 2002, the Company filed a request, with the District Court, to approve the split, effective as of January 1, 2002.

***) Non-active.

****) During 2002, Oridion Capnography Inc. was merged with Oridion Medical Inc. The new company is called Oridion Capnography Inc.

Intercompany transactions and balances, including profits from intercompany sales not yet realized outside the Company, have been eliminated upon consolidation.

d. Cash equivalents:

Cash equivalents include short-term highly liquid investments that are readily convertible to cash with original maturities of three months or less.

ORIDION SYSTEMS LTD. AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

e. Short-term bank deposits:

Short-term bank deposits are deposits with maturities of more than three months but less than one year. The deposits are in U.S. dollars and bear interest at an average rate of 1.6%. The short-term bank deposits are presented at their cost, including accrued interest.

f. Marketable securities:

The Company accounts for investments in equity securities (other than those accounted for under the equity method of accounting) in accordance with Statement of Financial Accounting Standards No. 115 "Accounting for Certain Investments in Debt and Equity Securities" ("SFAS No. 115").

Management determines the appropriate classification of its investments in marketable equity securities at the time of purchase and reevaluates such determinations at each balance sheet date. The Company classified its marketable securities as trading.

The Company's trading securities are carried at their fair value based upon the quoted market price of those investments at each balance sheet date. Net realized and unrealized gains and losses on these securities are included in financial expenses (income), net.

g. Inventories:

Inventories are stated at the lower of cost or market value. Cost is determined as follows:

Raw materials and packing materials - by the average cost method.

Work in progress- represents the cost of manufacturing, subcontractors work, with the addition of allocable indirect manufacturing costs.

Finished goods - on the basis of direct manufacturing costs with the addition of allocable indirect manufacturing costs.

h. Property and equipment:

1. Property and equipment are stated at cost, net of investment grants received and accumulated depreciation. Depreciation is calculated by the straight-line method over the estimated useful lives of the assets. The annual depreciation rates are as follows:

	<u>%</u>
Computers and related equipment	20-33 (mostly 33)
Motor vehicles	15 - 20
Office furniture and equipment	6 - 10
Machinery equipment and installations	10
Diagnostic equipment	20
Leasehold improvements	Over the term of the lease

ORIDION SYSTEMS LTD. AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

2. The Company's long-lived assets are reviewed for impairment in accordance with Statement of Financial Accounting Standards No. 144 "Accounting for the Impairment or Disposal of Long-lived Assets" ("SFAS No. 144"), whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to the future undiscounted cash flows expected to be generated by the assets. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. Assets to be disposed of are reported at the lower of the carrying amount or fair value less selling costs. As of December 31, 2002, no impairment losses have been identified.

- i. Revenue recognition:

The Company generates revenues mainly from selling its products through OEM partners and its distributors, both of whom are considered end users.

Revenues from product sales are recognized in accordance with Staff Accounting Bulletin No. 101, "Revenue Recognition in Financial Statements" ("SAB 101"), when persuasive evidence of an agreement exists, delivery of the product has occurred, no significant obligations with regard to implementation remain, the fee is fixed or determinable, and collectibility is probable.

- j. Research and development costs:

Research and development costs, net of grants received, are charged to the statement of operations as incurred.

- k. Royalty-bearing grants:

Royalty-bearing grants from the Government of Israel for funding approved research and development projects are recognized at the time the Company is entitled to such grants, on the basis of the costs incurred and included as a deduction of research and development costs. Research and development grants amounted to \$ 1,075, \$ 550 and \$ 424 in 2000, 2001 and 2002, respectively. Total royalties accrued or paid amounted to \$ 361, \$ 390 and \$ 493 in 2000, 2001 and 2002, respectively and were recorded as part of cost of goods sold.

The Company also received royalty-bearing grants from the Fund for Encouragement of Marketing Activity. These grants are recognized at the time the Company is entitled to such grants on the basis of the costs incurred and included as a deduction of sales and marketing expenses.

ORIDION SYSTEMS LTD. AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

l. Provision for warranty:

The Company offers a warranty of 15-18 months on all of its products, excluding consumables. The specific terms and conditions of those warranties vary depending upon the product sold and country in which the product is sold. The Company estimates the costs that may be incurred under its basic limited warranty and records a liability in the amount of such costs at the time product revenue is recognized. Factors that affect the Company's warranty liability include the number of sold units, historical and anticipated rates of warranty claims, and cost per claim. The Company periodically assesses the adequacy of its recorded warranty liabilities and adjusts the amounts as necessary.

Changes in the Company's product liability during 2002, are as follows:

Balance at the beginning of the year	\$ 52
Warranties issued during the year	60
Settlements made during the year	<u>(42)</u>
Balance at the end of the year	<u>\$ 70</u>

m. Severance pay:

The Company's liability for severance pay of its Israeli employees is calculated pursuant to Israeli severance pay law based on the most recent salary of the employees multiplied by the number of years of employment as of the balance sheet date. Employees are entitled to one month's salary for each year of employment or a portion thereof. The Company's liability for all of its employees, is fully provided by monthly deposits with severance pay funds, insurance policies and by an accrual.

The deposited funds include profits accumulated up to the balance sheet date. The deposited funds may be withdrawn only upon complying with the Israeli severance pay law or labor agreements. The value of the deposited funds is based on the cash surrendered value of these policies, and includes immaterial profits.

The U.S. subsidiaries sponsor a retirement savings plan, which covers some of its employees. The Company's matching contribution to the plan was approximately \$ 24, \$ 46 and \$ 46 for the year 2000, 2001 and 2002, respectively.

Severance expenses for the years ended December 31, 2000, 2001 and 2002 amounted to \$ 182, \$ 174 and \$ 66, respectively.

ORIDION SYSTEMS LTD. AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

- n. Basic and diluted net loss per share:

Basic net loss per share is computed based on the weighted average number of Ordinary shares outstanding during each year. Diluted net loss per share is computed based on the weighted average number of Ordinary shares outstanding during each year, plus dilutive potential Ordinary shares considered outstanding during the year, in accordance with Statement of Financial Accounting Standards No. 128 "Earnings Per Share" ("SFAS No. 128").

All convertible Preferred shares, outstanding stock options, convertible debentures, and outstanding warrants have been excluded from the calculation of the diluted net loss per Ordinary share because all of these securities are anti-dilutive for all periods presented. The total weighted average number of options outstanding as of December 31, 2000, 2001 and 2002 were 1,383,800, 1,300,175 and 1,655,713, respectively.

- o. Concentrations of credit risk:

Financial instruments that potentially subject the Company to concentrations of credit risk consist principally of cash and cash equivalents, short-term bank deposits and trade receivables.

Cash and cash equivalents and short-term bank deposits are invested in US \$ with major banks in Israel, Europe and the United States. Such deposits in the United States may be in excess of insured limits and are not insured in other jurisdictions. Management believes that the financial institutions that hold the Company's investments are financially sound and, accordingly, minimal credit risk exists with respect to these investments.

The trade receivables of the Company are mainly derived from sales to customers located primarily in the U.S. and Europe. The Company performs ongoing credit evaluations of its customers and to date has not experienced any material losses. An allowance for doubtful accounts was not determined since the Company has no collection difficulties.

The Company has no off-balance sheet concentration of credit risk, such as foreign exchange contracts, option contracts or other foreign hedging arrangements.

ORIDION SYSTEMS LTD. AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

- p. Accounting for stock-based compensation:

The Company has elected to follow Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB No. 25") and FASB Interpretation No. 44, "Accounting for Certain Transactions Involving Stock Compensation" ("FIN No. 44"), in accounting for its employee stock option plans. Under APB No. 25, when the exercise price of the Company's stock options is less than the market price of the underlying shares on the date of grant, compensation expense is recognized.

The Company applies Statement of Financial Accounting Standards No. 123 "Accounting for Stock-Based Compensation" ("SFAS No. 123") and Emerging Issues Task Force No. 96-18 "Accounting for Equity Instruments that are Issued to Other than Employees for Acquiring, or in Conjunction with Selling, Goods or Services" ("EITF 96-18"), with respect to options issued to non-employees. SFAS No. 123 requires use of an option valuation model to measure the fair value of the options at the grant date.

- q. Fair value of financial instruments:

The following methods and assumptions were used by the Company in estimating its fair value disclosures for financial instruments:

The carrying amounts of cash and cash equivalents, short-term bank deposits, trade receivables other accounts receivable, trade payables and other accounts payable approximate their fair value due to the short-term maturity of such instruments.

- r. Income taxes:

The Company accounts for income taxes in accordance with Statement of Financial Accounting Standards No. 109, "Accounting for Income Taxes" ("SFAS No. 109"). This statement prescribes the use of the liability method whereby deferred tax assets and liability account balances are determined based on differences between financial reporting and tax bases of assets and liabilities and are measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse. The Company provides a valuation allowance, if necessary, to reduce deferred tax assets to their estimated realizable value.

- s. Reclassification:

Certain amounts from prior years referring to amortization of other assets, have been reclassified to conform with current year's presentation.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 2:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

- t. Impact of recently issued accounting standard:

In April 2002, the FASB issued SFAS No. 145, "Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections," which rescinds SFAS No. 4, "Reporting Gains and Losses from Extinguishment of Debt" and an amendment of that Statement, and SFAS No. 64, "Extinguishments of Debt Made to Satisfy Sinking-Fund Requirements". SFAS No. 145 also rescinds SFAS No. 44, "Accounting for Intangible Assets for Motor Carriers". SFAS No.145 amends SFAS No. 13, "Accounting for Leases", to eliminate an inconsistency between the required accounting for sale-leaseback transactions and the required accounting for certain lease modifications that have economic effects that are similar to sale-leaseback transactions. SFAS No.145 also amends other existing authoritative pronouncements to make various technical corrections, clarify meanings, or describe their applicability under changed conditions. SFAS No.145 is effective for fiscal years beginning after May 15, 2002. The Company does not expect the adoption of SFAS No.145 will have a material impact on its results of operations or financial position.

In June 2002, the FASB issues SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities", which addresses significant issue regarding the recognition, measurement, and reporting of costs associated with exit and disposal activities, including restructuring activities. SFAS No.146 requires that costs associated with exit or disposal activities be recognized when they are incurred rather than at the date of a commitment to an exit or disposal plan. SFAS No.146 is effective for all exit or disposal activities initiated after December 31, 2002. The Company does not expect the adoption of SFAS No. 146 to have a material impact on our results of operations or financial position.

In November 2002, the FASB issued FASB Interpretation No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, an interpretation of FASB Statements No.5, 57,and 107 and Rescission of FASB Interpretation No.34" ("FIN No.45"). FIN No. 45 elaborates on the disclosures to be made by a guarantor in its interim and annual financial statements about its obligations under certain guarantees that it has issued. It also clarifies that a guarantor is required to recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee. FIN No.45 does not prescribe a specific approach for subsequently measuring the guarantor's recognized liability over the term of the related guarantee. It also incorporates, without change, the guidance in FASB Interpretation No. 34, "Disclosure of Indirect Guarantees of Indebtedness of Others", which is being superseded. The disclosure provisions of FIN No.45 are effective for financial statements of interim or annual periods that end after December 15, 2002 and the provisions for initial recognition and measurement are effective on a prospective basis for guarantees that are issued or modified after December 31, 2002, irrespective of a guarantor's year-end. The Company does not expect the adoption of FIN No.45 to have a material impact on its results of operations or financial position.

ORIDION SYSTEMS LTD. AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 3:- OTHER ACCOUNTS RECEIVABLE AND PREPAID EXPENSES

	December 31,	
	2001	2002
Employees	\$ 39	\$ 6
Government authorities	175	268
Prepaid expenses	196	187
Other	186	219
	\$ 596	\$ 680

NOTE 4:- INVENTORIES

Raw materials and packing materials	\$ 2,596	\$ 1,400
Work in progress	284	328
Finished goods	1,985	1,524
	\$ 4,865	\$ 3,252

NOTE 5:- PROPERTY AND EQUIPMENT, NET

Cost:		
Computers and related equipment	\$ 2,119	\$ 2,450
Motor vehicles	27	64
Office furniture and equipment	1,727	1,960
Machinery equipment and installations	1,751	1,762
Diagnostic equipment	-	225
Leasehold improvements	2,335	2,684
	7,959	9,145
Less - accumulated depreciation	2,944	4,383
Depreciated cost	\$ 5,015	\$ 4,762

Depreciation expenses amounted to \$ 568, \$ 811 and \$ 1,437 for the years ended December 31, 2000, 2001 and 2002, respectively.

ORIDION SYSTEMS LTD. AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 6:- OTHER ACCOUNTS PAYABLE AND ACCRUED EXPENSES

	December 31,	
	2001	2002
Royalties payable	\$ 402	\$ 408
Employees and payroll accruals	949	1,150
Accrued expenses and other liabilities	790	914
	\$ 2,141	\$ 2,472

NOTE 7:- COMMITMENTS AND CONTINGENT LIABILITIES

a. Royalties to the Chief Scientist:

Oridion is committed to pay royalties at the rate of 3.5% to the Government of Israel, on sales proceeds from products in which the Government participates in the research and development by way of grants. The commitment is determined on a product-by-product basis, in an amount not to exceed the total of the grants received (linked to the U.S. dollar and bears interest at the rate of LIBOR).

Over the period commencing 1987 through December 31, 2002, grants received amounted to \$ 6,493, and royalties paid or accrued amounted to \$ 1,783. As of December 31, 2002, Oridion has a remaining contingent obligation of \$ 4,710.

b. Royalties to the Fund for the Encouragement of Marketing Activities:

The Israeli Government, through the Fund for the Encouragement of Marketing Activities, awarded Oridion grants for participation in expenses for overseas marketing. Oridion is committed to pay royalties at the rate of 4% of the increase in export sales, up to the amount of the grants received (linked to the U.S. dollar and bearing interest at the rate of LIBOR).

Over the period commencing 1994 through December 31, 2002, grants received amounted to \$ 488. Through December 31, 2002, Oridion has paid or accrued royalties in the amount of \$ 394. As of December 31, 2002, the Company has a remaining contingent obligation of \$ 94.

c. Lease commitments:

The facilities of the Company are rented under several operating lease agreements, which expire on various dates, the latest of which is in 2004. Future minimum lease commitments under non-cancelable operating leases as of December 31, 2002, are as follows:

2003	\$	327
2004		327
	\$	654

Rent expenses for the years ended December 31, 2000, 2001 and 2002 were \$ 280, \$ 326 and \$ 332, respectively.

ORIDION SYSTEMS LTD. AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 7:- COMMITMENTS AND CONTINGENT LIABILITIES (Cont.)

- d. As of December 31, 2002, the Company has an authorized line of credit in the amount of \$ 463. The line of credit bears interest at an annual rate of 11.30% for the credit in NIS, and an annual rate of Libor +2% for the credit in dollars. For overdrawn amounts in excess of the Company's authorized line of credit, the Company is subject to an annual interest rate of 17% for the credit in NIS and an average annual rate of Libor + 9% for the credit in dollars.

As of December 31, 2002, the Company has not utilized the line of credit.

- e. The Company received a claim letter from Yissum Research Development Company of the Hebrew University of Jerusalem Limited. In the opinion of the Company's management and Company's legal counsel, there is no substance to such claims.

NOTE 8:- SHAREHOLDERS' EQUITY

- a. Rights of Ordinary shares:

The Ordinary shares confer upon the holders the right to receive notice to participate and vote in general meetings of the Company and the right to receive dividends, if declared.

- b. Issuance of share capital:

During February 2000, the Company raised \$ 6,880, net from shareholders in exchange for the issuance of 1,000,000 Preferred shares of NIS 0.01 par value each. According to EITF 98-5, there was no beneficial conversion feature.

On April 10, 2000, the Company effected an IPO on the SWX Swiss Exchange. The Company completed the issuance of 2,500,000 Ordinary shares at the Price of CHF 29 per share. In addition, prior to the Offering, an exercise of options to purchase 230,000 shares held by certain employees, directors, and service providers, and exercise of warrants to purchase 293,719 shares held by certain shareholders, took place.

All Preferred shares had been converted into Ordinary shares on a one to one basis immediately prior to the closing of the Company's IPO.

Immediately following the closing of the Offering, the Company had a total of 10,124,363 shares issued and outstanding, all of which are registered in the SWX Swiss Exchange.

During February 2001, the Company conducted a secondary public offering on the SWX New Market of the SWX Swiss Exchange ("SWX New Market"). The offering consisted entirely of secondary shares sold by pre-initial public offering ("IPO") shareholders, in which 4,350,000 shares were sold at CHF 46 per share.

ORIDION SYSTEMS LTD. AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 8:- SHAREHOLDERS' EQUITY (Cont.)

c. Issuance of options:

As of December 31, 2002, the Company has three stock option plans: a stock option plan outside Israel, which is an incentive-restricted stock option plan ("the U.S. Plan"), approved by the Board of Directors of the Company during 1995 and 2000, and two stock option plans ("the Israeli Plans") which were approved During 1995 and 2000 (the U.S. Plan and the Israeli Plans together: "the Plans"). Under the terms of the Plans, options may be granted to officers, directors, employees and consultants of the Company and generally become exercisable after two to five years. All the options have a maximum term of 7 years. Any options, which are cancelled or forfeited before expiration, become available for future grants.

Pursuant to the Plans 2,023,384 options are reserved for issuance. As of December 31, 2002, an aggregate amount of 239,863 options are still available for future grant.

A summary of the Company's share option activity (excluding options to consultants) under the plans is as follows:

	Year ended December 31,					
	2000		2001		2002	
	Number of options	Weighted average exercise price	Number of options	Weighted average exercise price	Number of options	Weighted average exercise price
Outstanding at the beginning of the year	1,225,942	\$ 4.06	1,350,642	\$ 9.20	1,346,734	\$ 4.59
Granted	294,200	\$ 27.85	577,800	\$ 3.69	343,850	\$ 3.31
Exercised	(89,750)	\$ 3.78	(348,058)	\$ 3.46	(1,000)	\$ 4.50
Forfeited	(79,750)	\$ 4.40	(68,650)	\$ 21.57	(67,313)	\$ 6.05
Cancelled	-	\$ -	(165,000)	\$ 34.47	-	\$ -
Outstanding at the end of the year	<u>1,350,642</u>	<u>\$ 9.20</u>	<u>1,346,734</u>	<u>\$ 4.59</u>	<u>1,622,271</u>	<u>\$ 4.31</u>
Options exercisable	<u>735,817</u>	<u>\$ 4.20</u>	<u>551,207</u>	<u>\$ 5.07</u>	<u>892,307</u>	<u>\$ 4.74</u>

The options outstanding as of December 31, 2002 have been separated into ranges of exercise price, as follows:

<u>Exercise price</u>	<u>Options outstanding as of December 31, 2002</u>	<u>Weighted average remaining contractual life Years</u>	<u>Options exercisable at December 31, 2002</u>
\$ 1.78	88,000	6.69	6,811
\$ 2.50	38,095	2.20	35,514
\$ 3.24	476,250	5.73	158,507
\$ 3.69	64,550	5.76	18,787
\$ 3.79	165,000	6.22	32,209
\$ 3.91	63,850	6.45	8,790
\$ 4.50	665,476	3.20	590,086
\$ 17.74	61,050	4.27	41,603
	<u>1,622,271</u>		<u>892,307</u>

ORIDION SYSTEMS LTD. AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 8:- SHAREHOLDERS' EQUITY (Cont.)

Where the Company has recorded deferred stock compensation for options issued with an exercise price below the fair market value of the Ordinary shares, the deferred stock compensation has been amortized and recorded as compensation expense ratably over the vesting period of the options. Compensation expense of approximately \$ 660, \$ 115 and \$ 66 were recognized during the years ended December 31, 2000, 2001 and 2002, respectively.

Under SFAS No. 123, "Accounting for Stock-Based Compensation"("SFAS No. 123"), pro forma information regarding net loss and loss per share is required for grants issued after December 1994, and has been determined as if the Company had accounted for its employee share options under the fair value method of SFAS No. 123. The fair value for these options were estimated at the grant date using a Black-Scholes option pricing model with the following weighted-average assumptions for 2000, 2001 and 2002: risk-free interest rates of 5%, 6% and 2% respectively, dividend yields of 0% for each year, expect volatility of 0.56, 0.86 and 0.74 respectively and a weighted-average expected life of the options of 4 years.

The weighted-average fair value of the options granted for the years ended December 31, 2000, 2001 and 2002 were:

	For exercise price on the grant date that:					
	Equals market price			Less than market price		
	Year ended			Year ended		
	December 31,			December 31,		
	2000	2001	2002	2000	2001	2002
Weighted average exercise prices	<u>\$ 28.7</u>	<u>\$ 3.3</u>	<u>\$ 3.1</u>	<u>\$ 8.8</u>	<u>\$ -</u>	<u>\$ -</u>
Weighted average fair value on grant date	<u>\$ 8.0</u>	<u>\$ 1.9</u>	<u>\$ 1.1</u>	<u>\$ 8.1</u>	<u>\$ -</u>	<u>\$ -</u>

Pro-forma information under SFAS No. 123 is as follows:

	Year ended December 31,		
	2000	2001	2002
Net loss, as reported	<u>\$ (6,375)</u>	<u>\$ (11,608)</u>	<u>\$ (9,574)</u>
Pro-forma net loss	<u>\$ (6,625)</u>	<u>\$ (12,893)</u>	<u>\$ (10,071)</u>
Pro-forma basic and diluted net loss per share	<u>\$ (0.76)</u>	<u>\$ (1.24)</u>	<u>\$ (0.96)</u>

ORIDION SYSTEMS LTD. AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 8:- SHAREHOLDERS' EQUITY (Cont.)

Cancellation and grant within 6 months and a day:

In September 2001, the Company adopted a new voluntary stock option exchange program, under which certain employees had the opportunity to cancel outstanding Stock Options. At such time which is not less than six months and one day from the date of cancellation of such Stock Options, the Company shall grant 1 new option for every cancelled 1 option to those employees who are employed by the Company at such time. Each new option will have the same vesting commencement date and vesting schedule as the option for which it was exchanged. The exercise price of the new options will be based on the fair market value of the Company's Ordinary shares at the time of the grant thereof. A total of 165,000 options were cancelled in connection with the option exchange program.

In March 2002, as part of the option exchange program, the Company granted 165,000 options to said employees.

The Company's outstanding options to consultants as of December 31, 2002, are as follows:

<u>Issuance date</u>	<u>Options for ordinary shares</u>	<u>Exercise price per share</u>	<u>Options exercisable</u>	<u>Exercisable through</u>
May 1997	19,750	\$ 2.50	19,750	May 2004
November 1998	1,000	\$ 4.50	1,000	November 2005
June 1999	20,000	\$ 4.50	15,000	June 2006
February 2000	51,000	\$ 4.50	50,159	February 2007
July 2000	1,000	\$ 17.74	500	July 2007
October 2001	22,000	\$ 3.69	22,000	October 2008
September 2002	46,500	\$ 1.78	-	September 2009
	<u>161,250</u>		<u>108,409</u>	

The Company had accounted for its options to consultants under the fair value method as SFAS No. 123 and EITF 96-18. Those options vest primarily over 7 years. The fair value for these options was estimated using Black-Scholes option-pricing model with the following weighted-average assumptions for 2000, 2001 and 2002: risk-free interest rates of 5%, 6% and 2% respectively, dividend yields of 0% for each year, expected volatility of 0.56, 0.86 and 0.74 respectively and a weighted-average contractual life of the options of 7 years.

d. Dividends:

In the event that cash dividends are declared in the future, such dividends will be paid in NIS. The Company does not intend to pay cash dividends in the foreseeable future.

ORIDION SYSTEMS LTD. AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 9:- TAXES ON INCOME

- a. Tax benefits under the Law for the Encouragement of Capital Investments, 1959 ("the law"):

According to the law, one of Oridion's production facilities has been granted an "Approved Enterprise" status.

Pursuant to the aforementioned law, Oridion has elected the "alternative benefits" - waiver of Government grants in return for tax exemption (the first program). Income derived from the "Approved Enterprise" will be tax-exempt for a period of ten years, commencing with the first taxable year.

The tax-exempt income attributable to the "Approved Enterprise" can be distributed to shareholders without subjecting the Company to income taxes only upon the complete liquidation of the Company. If these retained tax-exempt profits are distributed in a manner other than in the complete liquidation of the Company, they would be taxed at the corporate tax rate applicable to such profits, as if the Company had not elected the alternative system of benefits (currently, 25% for an "Approved Enterprise"). Through December 31, 2002, Oridion does not have any tax-exempt income.

The period of tax benefits detailed above is subject to limits of the earlier of 12 years from commencement of production or 14 years from receiving the approval. Hence, it will expire in the year 2010.

The aforementioned benefits are conditional upon the fulfillment of the terms and regulations prescribed by law, and the approvals according to which the investments are to be carried out. Non-compliance with the terms may result in the cancellation of the benefits, in whole, or in part, and the refund of the benefit amounts in addition to accrued interest. As of December 31, 2002, management believes that Oridion has complied with the provisions of the law.

During 1998, Oridion received an additional approval for other investments under the "alternative benefits" (the second program). According to the approval, the scope of the approved investment totals \$ 1,225 and the date of implementation is until November 8, 2000. During 2001, a request for approval of the third program was submitted to the investment center. In the framework of the third program Oridion committed to invest \$ 5,010 during the period between August 2001 and August 2003, of which \$ 2,227 were invested as of December 31, 2002.

Due to the accumulated losses, the utilization of the above benefits has not yet commenced.

Should the Company derive income from sources other than the "Approved Enterprise" during the relevant period of benefits, such income will be taxable at the regular corporate tax rate of 36%.

ORIDION SYSTEMS LTD. AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 9:- TAXES ON INCOME (Cont.)

- b. Tax benefits under the Law for the Encouragement of Industry (Taxation), 1969:

Oridion is an "industrial company" under the above law and, as such, is entitled to certain tax benefits, mainly accelerated depreciation of machinery and equipment.

- c. Measurement of results for tax purposes under the Income Tax Law (Inflationary Adjustments), 1985:

Results for tax purposes are measured in real terms of earnings in NIS, after certain adjustments for increases in the CPI (Israel Consumer Price Index). As explained in Note 2b, the financial statements are measured in U.S. dollars. The differences between the annual change in the CPI and in the NIS/dollar exchange rate causes a further difference between taxable income and the income before taxes shown in the financial statements. In accordance with paragraph 9(f) of SFAS No. 109, the Company has not provided deferred income taxes on the difference between the functional currency and the tax bases of assets and liabilities.

- d. Carryforward losses:

As of December 31, 2002, Oridion had approximately \$ 37,560 of Israeli net operating loss carryforward. According to the Israeli Income Tax law, once the split of Oridion BreathID, as described in Note 2c, becomes effective, the utilization of these carryforward losses during the five years commencing with the split date is limited to the lower of 20% of said carryforward losses or 50% of the taxable income. The Israeli loss carryforward has no expiration date. Oridion expects that during the period in which these tax losses are utilized, its income would be substantially tax-exempt. Accordingly, there will be no tax benefit available from such losses, and no deferred income taxes have been included in these financial statements. The Company and its subsidiaries have provided valuation allowances in respect of deferred tax assets resulting from tax loss carryforward.

- e. Non-Israeli subsidiaries:

Non Israeli subsidiaries are taxed under the tax laws in their countries of domicile.

Through December 31, 2002, the U.S. subsidiaries had U.S. federal net operating loss carryforward of approximately \$ 6,265 that can be carried forward and offset against taxable income for 20 years and expire from 2021 to 2022.

- f. Income (loss) before taxes is comprised as follows:

	Year ended December 31,		
	2000	2001	2002
Domestic	\$ (6,551)	\$ (6,394)	\$ (4,008)
Foreign	200	(5,012)	(5,644)
	\$ (6,351)	\$ (11,406)	\$ (9,652)

ORIDION SYSTEMS LTD. AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 10:- RELATED PARTIES TRANSACTIONS

	Year ended December 31,		
	2000	2001	2002
General and administrative expenses:			
Directors fees	\$ 10	\$ 30	\$ 44
Salaries to related parties	\$ 1,137	\$ 1,021	\$ 1,075

NOTE 11:- SEGMENTS, CUSTOMERS AND GEOGRAPHIC INFORMATION

- a. The Company has two reportable segments: Capnography and Breath Test. The data is presented in accordance with Statement of Financial Accounting Standards No. 131 "Disclosure About Segments of an Enterprise and Related Information" ("SFAS No. 131").

Capnography - is the business of supplying portable capnography monitors and patented monitoring technology and accessories, under Original Equipment Manufacture Agreements and Private Label Agreements.

Breath Test - is the business of developing and supplying patented breath testing equipment for the diagnosis of different organs in the human body.

The following data presents the revenues, expenditures and other operating data of the Company's operating segments:

	Year ended December 31, 2000		
	Capnography	Breath Test	Total
Revenues from sales to unaffiliated customers	\$ 10,317	\$ -	\$ 10,317
Financial income	\$ 578	\$ 385	\$ 963
Depreciation and amortization	\$ 386	\$ 182	\$ 568
Segment loss	\$ 3,261	\$ 3,114	\$ 6,375
Segment assets	\$ *) 27,737	\$ *) 14,287	\$ *) 42,024
Capital expenditures	\$ 1,229	\$ 526	\$ 1,755

*) Reclassified.

ORIDION SYSTEMS LTD. AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 11:- SEGMENTS, CUSTOMERS AND GEOGRAPHIC INFORMATION (Cont.)

	Year ended December 31, 2001		
	Capnography	Breath Test	Total
Revenues from sales to unaffiliated customers	\$ 10,384	\$ 31	\$ 10,415
Financial income	\$ 802	\$ 340	\$ 1,142
Depreciation	\$ 649	\$ 162	\$ 811
Segment loss	\$ 6,155	\$ 5,453	\$ 11,608
Segment assets	\$ *) 20,881	\$ *) 10,760	\$ *) 31,641
Capital expenditures	\$ 2,130	\$ 470	\$ 2,600

	Year ended December 31, 2002		
	Capnography	Breath Test	Total
Revenues from sales to unaffiliated customers	\$ 13,794	\$ 266	\$ 14,060
Financial income	\$ 240	\$ 4	\$ 244
Depreciation	\$ 1,182	\$ 255	\$ 1,437
Segment loss	\$ 4,591	\$ 4,983	\$ 9,574
Segment assets	\$ 16,230	\$ 6,312	\$ 22,542
Capital expenditures	\$ 918	\$ 43	\$ 961

*) Reclassified.

b. Geographic information:

	Year ended December 31,					
	2000		2001		2002	
	Long-lived assets	Total revenues	Long-lived assets	Total revenues	Long-lived assets	Total revenues
The Company attributes revenues based on the customer's location as follows:						
Israel	\$ 3,102	\$ 24	\$ 4,633	\$ 43	\$ 4,422	\$ 289
United States	124	8,091	370	8,108	326	9,801
Europe	-	2,036	8	1,997	6	3,313
Other	-	166	4	267	8	657
	\$ 3,226	\$ 10,317	\$ 5,015	\$ 10,415	\$ 4,762	\$ 14,060

ORIDION SYSTEMS LTD. AND ITS SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands

NOTE 11:- SEGMENTS, CUSTOMERS AND GEOGRAPHIC INFORMATION (Cont.)

c. Major customers:

	Year ended December 31,		
	2000	2001	2002
	% of total revenues		
Customer A	34	29	22
Customer B	41	37	26
Customer C	13	14	11
Customer D	6	9	13

NOTE 12:- SELECTED STATEMENTS OF OPERATIONS DATA

	Year ended December 31,		
	2000	2001	2002
a. Research and development expenses, net:			
Research and development expenses	\$ 4,207	\$ 4,313	\$ 4,069
Less - participation of the Government of Israel	1,075	550	424
	\$ 3,132	\$ 3,763	\$ 3,645
b. Selling and marketing expenses, net:			
Selling and marketing	\$ 5,885	\$ 10,843	\$ 9,682
Less: participation from Government funds	13	-	-
	\$ 5,872	\$ 10,843	\$ 9,682
c. Financial income, net:			
Financial expenses:			
Financial expenses in respect of long-term loans	\$ (419)	\$ -	\$ -
Foreign currency translation differences	(130)	-	-
Others	(107)	(84)	(46)
	(656)	(84)	(46)
Financial income:			
Foreign currency translation differences	-	166	73
Interest on short-term bank deposits	1,619	1,060	217
	1,619	1,226	290
	\$ 963	\$ 1,142	\$ 244