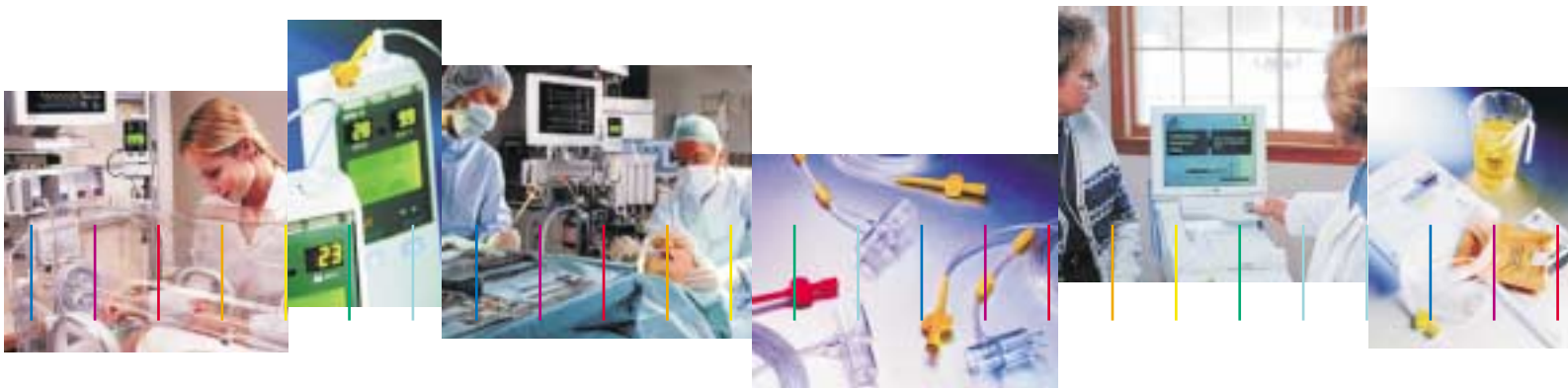


# Enabling technologies for improved medical care



Oridion Systems Ltd.  
Annual Report 2001



Oridion

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# CEO Letter to Shareholders

## Dear Oridion Shareholders,

The year 2001 has been a time in which Oridion continued taking new steps to help realize the strength of its patented Microstream® technology and to strengthen its marketing position in the medical community.

The need for our capnography technology, and its potential for growth, continues to become more evident as we witness both a rise in respiratory diseases worldwide and an increasing number of medical procedures done outside the traditional operating room. With a growing number of guidelines and standards calling for CO<sub>2</sub> monitoring, Oridion's technology provides physicians, as well as other care providers, with the means to provide safe monitoring and a valuable tool for complying with these guidelines.

The market potential for breath testing technologies continues to grow, as the market demands non-invasive, more economical and quicker point-of-care tests. There is also a growing need for patient management solutions in light of the increasing number of patients suffering from gastrointestinal functional disorders—a need made even greater by increasing evidence linking such disorders to the development of gastric cancer. Oridion's BreathID™ breath testing system, designed to enable physicians to diagnose and prescribe treatment for organ-specific medical conditions in just one office visit, directly addresses these market needs and demands. The variety of numerous breath tests—currently under different stages of development for use with the BreathID™—is anticipated to offer physicians, and particularly gastroenterologists, the ability to manage a wide range of disorders with just one device.

In both our capnography business unit and our breath testing business unit, the year 2001 saw many events and developments, as we achieved a number of key milestones and generated new opportunities for future growth.

## Capnography Business Unit

The need for the ability to easily monitor a person's respiratory status has rapidly grown in recent years. Respiratory diseases, such as asthma, are on the rise. An increasing number of surgical procedures, once done in the operating room, are now being done in less

sophisticated surroundings. In addition, more surgical procedures performed in the operating room are now being done while patients are under sedation and breathing spontaneously, without the support of mechanical devices. The rapidly growing number of these cases has given rise to an increased need for new breath sampling technologies. Tragic events this year in the US have also resulted in greater resources being allocated to US emergency medical services dealing with patient transport, 40% of which are respiratory-distress related cases.

Oridion has continued to meet these needs by launching, toward the end of this year, a number of new patented single patient use FilterLine® products, including Oridion's Smart CapnoLine™ O<sub>2</sub>. This product offers distinct advantages over other breath sampling cannulas, such as the ability to monitor CO<sub>2</sub> released from both a patient's mouth and nose while simultaneously supplying oxygen. The Smart CapnoLine™ O<sub>2</sub> not only helps offer the safest CO<sub>2</sub> monitoring available, it also helps care providers comply with increasingly strict healthcare guidelines requiring the monitoring of patients' respiration status in a growing number of medical care environments. The benefits offered by this product help make it especially helpful in procedures done under procedural sedation and while transporting patients in ambulances.

Another new addition to Oridion's line of consumable products is our new family of MAC-Line™ products. These new consumable products open new markets for Oridion as they can be used with installed bases of other companies' existing monitoring systems that do not contain Microstream® technology—especially those located in the operating room. As the number of procedures done on non-intubated patients in the operating room increases, Oridion's MAC-Line™ products provide solutions to older technologies' limitations in monitoring these non-intubated, spontaneously breathing patients.

Oridion also launched this year a new capnography monitor—the VitalCap™. This monitor enables the use of Oridion's patented Microstream® capnography with large installed bases of patient safety monitoring systems. With the VitalCap™, users of these systems are able to enjoy the benefits offered by Microstream® without having to replace their existing equipment. Many hospitals in the US have already acquired evaluation units of the VitalCap™. This has helped drive the strong interest of many hospital departments

who are considering adopting this technology as they plan their future budgets.

The marketing of Oridion's products has traditionally been done via original equipment manufacturing (OEM) agreements with world leading medical device manufacturers. Our OEM partners continue to remain a key strategy in selling our monitoring devices and establishing market share. During 2001, Oridion signed a number of new OEM contracts, both with existing partners for new products and with new partners that have chosen Microstream® technology for their products. Supplies and launches of these OEM products are scheduled to begin in 2002 and 2003.

In addition to our OEM business model, this year we established a new US direct marketing sales force. This sales force, while continuing to work together with the Company's OEM partners, is responsible for signing agreements with focused distribution groups that offer Oridion the benefit of large distribution networks in previously undeveloped markets, without increased marketing costs.

## Breath Testing Business Unit

This year we began testing market potential for the BreathID™ by installing it in leading Israeli and European medical institutions. Since then, we have witnessed steady growth in the use of the BreathID™ and the purchase of consumable kits by these institutions. Oridion has started developing additional markets worldwide for the BreathID™, including Japan and additional European countries, where Oridion is currently performing clinical trials.

Study results, published in 2001 in the New England Journal of Medicine, show that 4.7% of the study group suffering from dyspepsia and infected with *H. pylori* developed gastric cancer. On a worldwide basis, the statistics of people suffering from dyspepsia and *H. pylori* are overwhelming, with 20% to 40% of the world's population estimated to suffer from dyspepsia and over 50% of the world's population estimated to be infected with *H. pylori*. Considering the significant number of people at potential risk and the very low recovery rates from gastric cancer, the need for a system that can economically, quickly and comfortably diagnose people that may be infected by *H. pylori*—

such as Oridion's BreathID™—becomes alarmingly clear.

In preparation of our US launch, Oridion achieved a major milestone this year by receiving the first of two FDA regulatory allowances—510(k) market clearance—necessary for the US launch of the BreathID™. Oridion currently awaits final FDA approval of our patented *H. pylori* breath testing kit, after which we plan to launch the BreathID™ and *H. pylori* breath test in the US.

The many advantages offered by the point-of-care BreathID™ system include increased patient comfort, less waiting time for results and lower costs—all when compared to laboratory based testing methods. The BreathID™ also offers the advantage of being based on Oridion's patented Microstream® technology. This platform technology has allowed the Company's R&D team to begin working together with world-renowned doctors on the development of new BreathID™ breath tests. With the number of tests the Company is able to potentially develop for use with the BreathID™, the advantages offered by this system can be extended to numerous medical environments.

## Looking Ahead

As part of Oridion's long term plans and to assist Oridion's future development from a strategic point of view, Oridion decided in the final part of 2001 to split its operations into two separate companies. Accordingly, and subject to obtaining necessary approvals from the relevant Israeli Authorities, Oridion BreathID Ltd.—a newly established subsidiary—will now oversee all of Oridion's breath testing activities while Oridion's capnography activities will remain with Oridion Medical 1987 Ltd. Over the long term, and by offering each company the ability to function separately, this split will assist the effective allocation of resources while helping each company's management team assess and meet constantly changing market needs. This split will also help enhance shareholder value in the form of future possible mergers, acquisitions or financing, for each of the business lines.

The year 2001 may best be summarized as a time in which we set in place many activities aimed at ensuring Oridion's growth in future years. In both Oridion's business units, we developed new products, began

# CEO Letter to Shareholders

activities in new geographic markets, and strengthened Oridion's existing marketing and sales presence in the US, Europe and Japan. In addition, Oridion signed new capnography OEM agreements and launched products that address previously unmet CO<sub>2</sub> monitoring needs in various medical environments. These activities, combined with the core quality of our Microstream® technology, help position Oridion for future growth and for accomplishing our goals of becoming a market leader in all our different fields of activities.

The many changes Oridion has experienced in the past few years—from a privately held to a publicly traded company, from a small product range to a wide variety of monitors, diagnostic devices and consumable products—have not changed its goals, originally set by Oridion's founders over one and a half decades ago: To provide improved medical care for patients worldwide.

We thank everyone who has had a part in our accomplishments and especially our dedicated employees, our long standing partners and our valued investors. We look forward to sharing many more achievements and successes together.

Sincerely,

A handwritten signature in black ink, appearing to read "Joseph Y. Yeh". The signature is fluid and cursive, with a large loop at the end.

President and CEO

# Financial Review

# 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 2001 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 BreathID™ application and is currently developing an additional breath test for use with this system. Since its inception and until the year 2000, sales of capnography devices and consumables have accounted for all of Oridion's revenues. Towards the end of year 2001, the Company's breath testing unit started generating initial revenues in Israel.

Oridion markets and distributes its capnography products through sales agreements with OEMs and private label manufacturers specializing in the patient monitoring market in the United States, Europe and Japan. In the year ended December 31, 2001, approximately 78 percent of Oridion's sales were made to large medical device companies located in the US for integration into their monitoring systems—part of which 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 breath test device completed clinical trials and the Company submitted an FDA application for US market clearance at the end of 2000. Oridion received FDA market clearance for the BreathID™ device in July 2001 and is currently awaiting FDA market approval of the consumable kit for the first BreathID™ application—Oridion's patented <sup>13</sup>C urea *H. pylori* breath test. In the second half of the year, Oridion placed three BreathID™ devices in leading hospitals in Israel to start the commercialization of the device. Initial feedback has been very positive.

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, 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, 88 percent of revenues were derived from five of Oridion's customers, as compared to 94 percent from the same five 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 annually 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 \$ 0.2 million to \$1.2 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 the 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.

### **Year ended December 31, 2000 compared to year ended December 31, 1999**

**Revenues.** For the year ended December 31, 2000, revenues increased by approximately \$4.3 million or 71 percent to \$10.3 million from \$6.0 million for the year ended December 31, 1999. The increase resulted from increased volume of sales of new generation capnography products to two of Oridion's existing US customers. For the year ended December 31, 2000, 76 percent of revenues were derived from Oridion's principal three customers, as compared to 87 percent from the same three principal customers in 1999. The 11 percent decline in the percentage of sales to Oridion's three principal customers reflected an increase in the number of Oridion's customers and the increase in revenues in 2000 compared with 1999. For the years ended December 31, 2000 and 1999, sales to customers in the US accounted for 78 percent and 68

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

percent of revenues, respectively, and sales to customers in Europe, principally in Germany and France, accounted for 20 percent and 30 percent. In the immediate future, Oridion believes that it will continue to depend on sales to a number of key OEMs and private label manufacturers. 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, 2000 increased by approximately \$1.9 million or 45 percent to \$6.1 million from \$4.2 million for the year ended December 31, 1999. The increase in cost of revenues resulted from the growth in sales. Gross margin increased to 41 percent for the year ended December 31, 2000 from 31 percent for the year ended December 31, 1999. The increase in gross margin resulted primarily from the continued growth in sales of consumables which generally provide higher margins and the economies of scale Oridion was able to achieve from overall growth in sales as Oridion obtained better purchase terms for materials from its existing suppliers, with which it has annually renewable supply contracts.

**Research and development expenses, net.** Research and development expenses, net, increased to \$3.1 million for the year ended December 31, 2000 compared to \$2.7 million for the year ended December 31, 1999 due to an increase in investment in research related to Oridion's breath test technology, in particular, technology miniaturization, development of consumables for use outside the operating room and the development of new breath tests to diagnose other diseases and assess organ function. Oridion funded its research and development out of working capital, including from the proceeds of Oridion's initial public offering. Research and development expenses, net,

represented 30 percent of revenues for the year ended December 31, 2000 compared to 44 percent for the year ended December 31, 1999.

**Selling and marketing expenses, net.** Selling and marketing expenses, net, for the year ended December 31, 2000 increased to \$5.9 million compared to \$3.5 million for the year ended December 31, 1999. This increase resulted primarily from costs incurred in recruiting 16 new employees for Oridion's marketing operations, mainly respiratory therapy specialists employed by Oridion who have the task of working with experts in anaesthesiology, emergency medicine and respiratory medicine, to raise awareness of the benefits of capnography and use of the installed base of Microstream® products in various clinical procedures. Selling and marketing expenses, net, represented 57 percent of revenues for the year ended December 31, 2000 compared to 58 percent for the year ended December 31, 1999.

**General and administrative expenses.** For the year ended December 31, 2000, general and administrative expenses remained unchanged at \$2.6 million. General and administrative expenses represented 25 percent of revenues for the year ended December 31, 2000 compared to 43 percent for the year ended December 31, 1999.

**Financial income, net.** For the year ended December 31, 2000, financial income, net, increased to \$1.0 million from a net financial expense of \$0.7 million for the year ended December 31, 1999. This substantial increase in income resulted from interest income received on deposits from the unused portion of the proceeds of the initial public offering, which Oridion completed in April 2000.

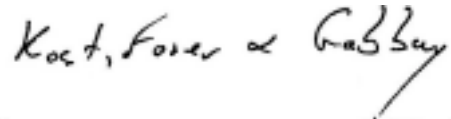
# Report of Independent Auditors

## 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, 2000 and 2001 and the related consolidated statements of operations, changes in shareholders' equity and cash flows for each of the three years in the period ended December 31, 2001. 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, 2000 and 2001, and the consolidated results of their operations and cash flows for each of the three years in the period ended December 31, 2001, in conformity with accounting principles generally accepted in the United States.



Tel-Aviv, Israel  
March 4, 2002

KOST FORER & GABBAY  
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# CONSOLIDATED BALANCE SHEETS

U.S. dollars in thousands

	<b>December 31,</b>	
	<b>2000</b>	<b>2001</b>
<b>ASSETS</b>		
<b>CURRENT ASSETS</b>		
Cash and cash equivalents	\$ 4,762	\$ 7,959
Short-term bank deposits	26,181	10,148
Marketable securities	1,224	-
Trade receivables	2,405	2,204
Other accounts receivable and prepaid expenses (Note 3)	773	596
Inventories (Note 4)	2,659	4,865
	<u>38,004</u>	<u>25,772</u>
<b>SEVERANCE PAY FUND</b>	<u>37</u>	<u>5</u>
<b>PROPERTY AND EQUIPMENT, NET (Note 5)</b>	<u>3,226</u>	<u>5,015</u>
	<u>\$ 41,267</u>	<u>\$ 30,792</u>

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

U.S. dollars in thousands

	<b>December 31,</b>	
	<b>2000</b>	<b>2001</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>CURRENT LIABILITIES</b>		
Short-term bank credit (Note 6)	\$ 166	\$ -
Trade payables	2,066	1,776
Other accounts payable and accrued expenses (Note 7)	1,992	2,141
	<u>4,224</u>	<u>3,917</u>
<b>ACCRUED SEVERANCE PAY</b>	<u>797</u>	<u>821</u>
<b>CONTINGENT LIABILITIES, CHARGES AND COMMITMENTS (Note 8)</b>		
<b>SHAREHOLDERS' EQUITY</b>		
Share capital (Note 9)		
Ordinary shares of NIS 0.01 nominal value -		
Authorized: 20,000,000 shares as of December 31, 2000 and 2001;		
Issued and outstanding: 10,124,363 shares and 10,500,421 shares as of		
December 31, 2000 and 2001, respectively;	25	25
Additional paid-in capital	72,193	73,609
Accumulated deficit	(35,972)	(47,580)
<u>Total</u> shareholders' equity	<u>36,246</u>	<u>26,054</u>
	<u>\$ 41,267</u>	<u>\$ 30,792</u>

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

# Consolidated Statements of Operations

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

	Year ended December 31,		
	1999	2000	2001
Revenues (Note 12a)	\$ 6,026	\$ 10,317	\$ 10,415
Cost of revenues	4,178	6,074	5,919
<b>Gross profit</b>	<b>1,848</b>	<b>4,243</b>	<b>4,496</b>
Operating expenses:			
Research and development, net (Note 13a)	2,668	3,132	3,763
Selling and marketing, net (Note 13b)	3,485	5,872	10,843
General and administrative	2,576	(* 2,553)	2,438
Aborted offering expenses (Note 14)	1,831	-	-
<b>Total operating expenses</b>	<b>10,560</b>	<b>11,557</b>	<b>17,044</b>
Operating loss	(8,712)	(7,314)	(12,548)
Financial income (expenses), net (Note 13c)	(651)	963	1,142
Loss before taxes on income	(9,363)	(6,351)	(11,406)
Taxes on income (Note 10)	-	(* 24)	202
<b>Net loss</b>	<b>\$ (9,363)</b>	<b>\$ (6,375)</b>	<b>\$ (11,608)</b>
<b>Basic and diluted net loss per share</b>	<b>\$ (2.12)</b>	<b>\$ (0.73)</b>	<b>\$ (1.12)</b>
<b>Weighted average number of shares used for computing basic and diluted net loss per share</b>	<b>4,417,186</b>	<b>8,700,020</b>	<b>10,378,012</b>

(\* Reclassified.

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

# Statements of Changes in Shareholders' Equity (Deficiency)

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

	Preferred shares	Ordinary shares	Share capital	Additional paid-in capital	Accumulated deficit	Total shareholders' equity (deficiency)
	(Amount of shares)					
Balance as of January 1, 1999	1,413,928	4,387,774	\$ 9	\$ 20,201	\$ (20,234)	\$ (24)
Conversion of debentures	-	39,216	*) -	167	-	167
Issuance of Preferred shares, net	198,570	-	1	1,375	-	1,376
Exercise of warrants, net	61,156	-	*) -	428	-	428
Amortization of deferred stock compensation	-	-	-	1,226	-	1,226
Stock split to be effected as a stock dividend (100%)	-	-	5	(5)	-	-
Net loss	-	-	-	-	(9,363)	(9,363)
Balance as of December 31, 1999	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)
<b>Balance as of December 31, 2001</b>	<b>-</b>	<b>10,500,421</b>	<b>\$ 25</b>	<b>\$ 73,609</b>	<b>\$ (47,580)</b>	<b>\$ 26,054</b>

\*) Represents an amount lower than \$ 1.

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

# CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. dollars in thousands

	Year ended December 31,		
	1999	2000	2001
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>			
Net loss	\$ (9,363)	\$ (6,375)	\$ (11,608)
Adjustments to reconcile net loss to net cash used in operating activities:			
Depreciation and amortization	517	811	811
Amortization of deferred stock compensation	1,226	660	115
Loss on sale of marketable securities, net	-	20	1
Accrued interest on short-term bank deposits	-	(1,018)	(148)
Marketable securities, net	-	(1,244)	1,223
Accrued severance pay, net	101	190	56
Decrease (increase) in trade receivables	5	(1,333)	201
Decrease (increase) in other accounts receivable and prepaid expenses	(398)	(150)	177
Increase in inventories	(198)	(1,335)	(2,206)
Increase (decrease) in trade payables	511	951	(290)
Increase (decrease) in other accounts payable and accrued expenses	1,766	(834)	149
Other	6	(2)	(11)
<b>Net cash used in operating activities</b>	<u>(5,827)</u>	<u>(9,659)</u>	<u>(11,530)</u>
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>			
Proceeds from the sale of property and equipment	-	2	11
Purchase of property and equipment	(554)	(1,755)	(2,600)
Investment in short-term bank deposits	-	(40,580)	(10,000)
Proceeds from sale of short-term bank deposits	-	15,417	26,181
<b>Net cash provided by (used in) investing activities</b>	<u>(554)</u>	<u>(26,916)</u>	<u>13,592</u>
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>			
Proceeds from issuance of Preferred shares, net	1,376	6,880	-
Proceeds from issuance of Ordinary shares, net	-	38,738	-
Proceeds from exercise of warrants, net	428	1,836	-
Proceeds from exercise of options, net	-	697	1,301
Proceeds from long-term loans	5,308	-	-
Proceeds from short-term loans	700	-	-
Principal payment of short-term loans	(500)	(700)	-
Principal payment of long-term loans	(36)	(6,600)	-
Short-term bank credit, net	(52)	(1,850)	(166)
<b>Net cash provided by financing activities</b>	<u>7,224</u>	<u>39,001</u>	<u>1,135</u>
Increase in cash and cash equivalents	843	2,426	3,197
Cash and cash equivalents at the beginning of the year	1,493	2,336	4,762
<b>Cash and cash equivalents at the end of the year</b>	<u>\$ 2,336</u>	<u>\$ 4,762</u>	<u>\$ 7,959</u>

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

U.S. dollars in thousands

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	Year ended December 31,		
	1999	2000	2001
(a) Significant non-cash transactions:			
Conversion of convertible debentures into share capital	<u>\$ 167</u>	<u>\$ -</u>	<u>\$ -</u>
Conversion of Preferred shares into Ordinary shares	<u>\$ -</u>	<u>\$ 7</u>	<u>\$ -</u>
(b) Supplemental disclosure of cash flows information:			
Cash paid during the year for:			
Interest	<u>\$ 452</u>	<u>\$ 419</u>	<u>\$ 72</u>
Income taxes	<u>\$ -</u>	<u>\$ 24</u>	<u>\$ 122</u>

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

# Notes to Consolidated Financial Statements

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

## NOTE 1: GENERAL

Oridion Systems Ltd. and its subsidiaries ("the Company") is a holding company which wholly-owns and controls Oridion Medical 1987 Ltd. ("Oridion") and all of its subsidiaries. All the operational activities are performed by the subsidiaries.

Oridion and its subsidiaries design, manufacture and market 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, 2001, 88% of the Company's sales were to five customers, for the year ended December 31, 2000, 94% of the Company's sales were to five customers, and for the year ended December 31, 1999, 87% of the Company's sales were to four customers (See Note 12c). In addition, Oridion has developed a proprietary platform technology to diagnose the adequacy of organ function through diagnosing information found in human breath. The first application of this technology is the Company's point-of-care breath test for peptic ulcer. As of December 31, 2001, there were no significant sales from this product.

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, an exercise of options to purchase 230,000 shares held by certain employees, directors, and service providers prior to the Offering, and exercise of warrants to purchase 293,719 shares held by certain shareholders, took place.

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 on the SWX Swiss Exchange.

In December 2001, the board of directors of the Company resolved to split the breath tests activity of the Company to a new company—Oridion BreathID Ltd. which is a wholly-owned subsidiary of Oridion Systems Ltd.

## NOTE 2: SIGNIFICANT ACCOUNTING POLICIES

The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States ("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 made outside Israel in U.S. dollars, and a portion of Oridion and its subsidiaries' costs is incurred in U.S. dollars. Accordingly, the Company has determined the U.S. dollar as the currency of its primary economic environment and thus its functional and reporting currency. The Company's major wholly-owned subsidiaries, record their transactions in U.S. dollars which is their functional currency.

Transactions and balances denominated in U.S. dollars are presented at their original amounts. Non-dollar transactions and balances have been remeasured to U.S. dollars in accordance with Statement No. 52 of the Financial Accounting Standards Board ("FASB"). All transaction gains and losses from remeasurement of monetary balance sheet items denominated in non-dollar currencies are reflected in the statements of operations as financial income or expenses, as appropriate.

### c. Principles of consolidation

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

	<u>% of ownership</u>
1. Oridion Medical 1987 Ltd.	100
2. Irad Technologies Ltd. *)	100
3. Oridion Medical Inc. (through the subsidiary, Oridion Medical 1987 Ltd.)	100
4. Oridion Capnography Inc. (through the subsidiary, Oridion Medical 1987 Ltd.)	100
5. Oridion BreathID Inc. (through the subsidiary, Oridion Medical 1987 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 1987 Ltd.) *)	100
8. Oridion Capnography GmbH (through the subsidiary, Oridion Medical Europe BV)	100
9. Oridion Medical K.K. (through the subsidiary, Oridion Medical Europe BV)	100

\*) Dormant.

Intercompany transactions and balances were eliminated upon consolidation.

### d. Cash equivalents

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

# Notes to Consolidated Financial Statements

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

**e. Short-term bank deposits**

Bank deposits with maturities of more than three months but less than one year are included in short-term deposits.

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 SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities".

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. 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—by the average cost method.

Work in progress—on the basis of input of materials, labor and indirect manufacturing expenses included therein.

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

**h. Property and equipment, net**

1. Property and equipment are stated at cost, net of related investment grants and accumulated depreciation.

2. Depreciation is calculated by the straight-line method over the estimated useful lives of the assets. The annual depreciation rates are as follows:

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

The Company and its subsidiaries periodically assess the recoverability of the carrying amount of property and equipment and provide for any possible impairment loss based upon the difference between the carrying amount and fair value of such assets in accordance with SFAS

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

No. 121 "Accounting for Impairment of Long-Lived and for Long-Lived Assets to be Disposed Of". As of December 31, 2001, no impairment losses have been identified.

**i. Revenue recognition**

Revenues from sales are recognized in accordance with SAB 101 "Revenue Recognition in Financial Statements" 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 related grants, 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.

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.

**l. Provision for warranty**

The provision for warranty is calculated according to the past experience of the Company and management estimation based on a percentage of the Company's sales over 12 months prior to the date of the financial statements.

**m. Severance pay**

The Company's liability for severance pay 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.

Severance expenses for the years ended December 31, 1999, 2000 and 2001 amounted to \$ 223, \$ 182 and \$ 174, respectively.

# Notes to Consolidated Financial Statements

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

**n. Basic and diluted net loss per share**

Basic net income (loss) per share is computed based on the weighted average number of Ordinary shares outstanding during each year. Diluted net income 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 SFAS No. 128, "Earnings Per Share".

All convertible Preferred shares, outstanding stock options, convertible debentures, and 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 numbers of shares excluded from the calculations of diluted net loss per share were 2,375,762, 1,471,392 and 1,461,484 for the years ended December 31, 1999, 2000 and 2001, 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, trade receivables, short-term bank deposits and marketable securities. The majority of the Company's cash and cash equivalents and short-term deposits are invested in dollar and dollar linked investments and are deposited in major banks in Israel, Europe and in the United States. 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's marketable securities include investments in Israeli Trust Funds. Management believes that those Trust Funds are financially sound, and accordingly, minimal credit risk exists with respect to these marketable securities.

**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 25") and FASB Interpretation No. 44 "Accounting for Certain Transactions Involving Stock Compensation" ("FIN 44") in accounting for its employee stock option plans. Under APB 25, when the exercise price of the Company's share options is less than the market price of the underlying shares on the date of grant, compensation expense is recognized. The pro forma disclosures required by SFAS No. 123 "Accounting for Stock-Based Compensation" ("SFAS 123"), are provided in Note 9c.

The Company applies SFAS No. 123 and EITF 96-18 "Accounting for Equity Instruments that are Issued to Other than Employees for Acquiring, or in Conjunction with Selling, Goods or Services" 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.

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

**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:

Cash and cash equivalents, short-term bank deposits, trade receivables, short-term bank credit and trade payables—The carrying amounts of these items approximate their fair value due to the short-term maturity of such instruments.

The fair value for marketable securities is based on quoted market prices.

**r. Income taxes**

The Company accounts for income taxes in accordance with SFAS No. 109 "Accounting for Income Taxes". This statement prescribes the use of the liability method whereby deferred tax asset and liability account balances are determined based on differences between financial reporting and tax based on 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. Impact of recently issued accounting standard**

In June 2001, the Financial Accounting Standards Board issued SFAS No. 141, "Business Combinations" and No. 142, "Goodwill and other Intangible Assets", effective for fiscal years beginning after December 15, 2001. Under the new rules, goodwill and intangible assets deemed to have indefinite lives will no longer be amortized but will be subject to annual impairment tests in accordance with the Statements. Other intangible assets will continue to be amortized over their useful lives. The Company expects to adopt SFAS No. 141 and SFAS No. 142 as of January 1, 2002 and it does not expect that the adoption of the Statement will have a significant impact on the Company's financial position and results of operations.

In August 2001, the Financial Accounting Standards Board issued SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets", which addresses financial accounting and reporting for the impairment or disposal of long-lived assets and superseded SFAS No. 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 Opinion No. 30, "Reporting the Results of Operations for a disposal of a segment of a business". SFAS No. 144 is effective for fiscal years beginning after December 15, 2001, with earlier application encouraged. The Company expects to adopt SFAS No. 144 as of January 1, 2002 and it has not determined the effect, if any, the adoption of SFAS No. 144 will have on the Company's financial position and results of operations.

**t. Reclassification:**

Certain prior year amounts have been reclassified in conformity with current years financial statements presentation.

# Notes to Consolidated Financial Statements

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

## NOTE 3: OTHER ACCOUNTS RECEIVABLE AND PREPAID EXPENSES

	<b>December 31,</b>	
	<b>2000</b>	<b>2001</b>
Employees	\$ 19	\$ 39
Government authorities	542	175
Prepaid expenses	117	196
Others	95	186
	<u>\$ 773</u>	<u>\$ 596</u>

## NOTE 4: INVENTORIES

Raw materials	\$ 1,917	\$ 2,596
Work in progress	346	284
Finished goods	396	1,985
	<u>\$ 2,659</u>	<u>\$ 4,865</u>

## NOTE 5: PROPERTY AND EQUIPMENT, NET

Cost:		
Leasehold improvements	\$ 1,608	\$ 2,335
Computers and related equipment	1,418	2,119
Motor vehicles	56	27
Office furniture and equipment	815	1,727
Machinery equipment and installations	1,460	1,751
	<u>5,357</u>	<u>7,959</u>
Less - accumulated depreciation	<u>2,131</u>	<u>2,944</u>
Depreciated cost	<u>\$ 3,226</u>	<u>\$ 5,015</u>

Depreciation expenses amounted to \$ 421, \$ 568 and \$ 811 for the years ended December 31, 1999, 2000 and 2001, respectively.

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

**NOTE 6: SHORT-TERM BANK CREDIT**

	<b>Interest rates</b>		<b>December 31,</b>	
	<b>2000</b>	<b>2001</b>	<b>2000</b>	<b>2001</b>
Bank credit in NIS	12.7%	8.3%	\$ 49	\$ -
Bank credit in US dollars	7.5% - 11.5%	6.5%	117	-
			<u>\$ 166</u>	<u>\$ -</u>

As of December 31, 2001, the Company has an authorized line of credit in the amount of \$ 750. The line of credit bears interest at an annual rate of 8.30% for the credit in NIS, and an annual rate of Libor +1.02% 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 11.80% for the credit in NIS and an average annual rate of Libor + 4% for the credit in dollars.

**NOTE 7: OTHER ACCOUNTS PAYABLE AND ACCRUED EXPENSES**

	<b>December 31,</b>	
	<b>2000</b>	<b>2001</b>
Royalties payable	\$ 555	\$ 402
Employees and payroll accruals	1,003	949
Accrued expenses and other liabilities	434	790
	<u>\$ 1,992</u>	<u>\$ 2,141</u>

**NOTE 8: CONTINGENT LIABILITIES, CHARGES AND COMMITMENTS**

**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).

Over the period commencing 1987 through December 31, 2001, grants received amounted to \$ 5,974, and royalties paid or accrued amounted to \$ 1,333. As of December 31, 2001 Oridion has a remaining contingent obligation of \$ 4,614.

# Notes to Consolidated Financial Statements

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

**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 the 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.

Over the period commencing 1994 through December 31, 2001 grants received amounted to \$ 488 and royalties paid or accrued amounted to \$ 332. As of December 31, 2001, the Company has a remaining contingent obligation of \$ 156.

**c. Lease commitments**

The facilities of the Company and its subsidiaries are rented under several operating leases for certain periods. Future minimum lease commitments under non-cancelable operating leases for the years ending December 31, are as follow:

2002	\$ 322
2003	322
2004	<u>322</u>
	<u>\$ 966</u>

Rent expenses for the years ended December 31, 1999, 2000 and 2001 were \$ 248, \$ 280 and \$ 326, respectively.

**NOTE 9: SHARE CAPITAL**

**a. Rights conferred by Preferred shares**

All Preferred shares had been converted into Ordinary shares on a one to one basis immediately prior to the closing of the Company's initial offering of its Ordinary shares to the public ("IPO").

**b. Issuance of share capital**

Following are the changes in the Company's share capital from January 2001:

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 - IPO shareholders, in which 4,350,000 shares were sold at CHF 46 per share.

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

**c. Issuance of options to employees and service providers**

As of December 31, 2001 the Company has three stock option plans: one stock option plan outside Israel, which is an incentive-restricted stock option plan ("the U.S. Plan"), which was adopted by the Board of Directors of the Company during 1995 and 2000, and two share 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 generally become exercisable after two to five years. All the options have a maximum term of 7 years.

As of December 31, 2001, 2,630,442 options had been made available for purchase of which the outstanding allocated amount is 1,461,484. An additional 606,058 options have been exercised to date.

The following table is a summary of the activity for the Company's share options:

	Year ended December 31,					
	1999		2000		2001	
	Number of options	Weighted average exercise price	Number of options	Weighted average exercise price	Number of options	Weighted average exercise price
Outstanding - beginning of the year	780,442	\$ 3.40	1,425,942	\$ 3.90	1,471,392	\$ 8.80
Granted	645,500	\$ 4.50	355,200	\$ 23.90	599,800	\$ 3.69
Exercised	-	-	(230,000)	\$ 3.00	(376,058)	\$ 3.54
Forfeited	-	-	(79,750)	\$ 4.40	(233,650)	\$ 30.68
Outstanding - end of the year	<u>1,425,942</u>	<u>\$ 3.90</u>	<u>1,471,392</u>	<u>\$ 8.80</u>	<u>1,461,484</u>	<u>\$ 4.54</u>
Options exercisable	<u>508,250</u>	<u>\$ 3.88</u>	<u>810,817</u>	<u>\$ 4.23</u>	<u>634,396</u>	<u>\$ 4.93</u>

The options outstanding as of December 31, 2001 have been separated into ranges of exercise price, as follows:

Exercise price	Options Outstanding as of December 31, 2001	Weighted average contractual life	Options exercisable at December 31, 2001	Weighted average exercise price of exercisable Options
\$ 2.50	45,845	2.42	45,845	\$ 2.50
\$ 3.24	491,750	6.73	34,870	\$ 3.24
\$ 3.69	94,050	6.76	5,428	\$ 3.69
\$ 4.50	756,039	4.27	516,419	\$ 4.50
\$ 17.74	73,800	5.27	31,834	\$ 17.74
	<u>1,461,484</u>	<u>5.25</u>	<u>634,396</u>	<u>\$ 4.93</u>

# Notes to Consolidated Financial Statements

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

Where the Company has recorded deferred stock compensation for options issued with an exercise price below the fair value of the Ordinary shares, the deferred stock compensation is amortized and recorded as compensation expense ratably over the vesting period of the options.

Pro-forma information regarding net loss and net loss per share is required by SFAS No. 123 (for grants issued after December 1994), and has been determined as if the Company had accounted for its employee stock options under the fair value method of that Statement. The fair value for these options was estimated at the date of grant, using the Black-Scholes Option Valuation Model, with the following weighted-average assumptions for 1999, 2000 and 2001: risk-free interest rate of 5% for 1999 and 2000 and 6% for 2001, dividend yields of 0%, volatility factors of the expected market price of the Company's shares are 0% for 1999, 56% for 2000 and 86% for 2001, and a weighted-average expected life of the option of four years.

The weighted-average fair value, of the options granted for the years ended December 31, 1999, 2000 and 2001 were:

	<b>For exercise price on the grant date that:</b>					
	<b>Equals market price</b>			<b>Is less than market price</b>		
	<b>Year ended December 31,</b>			<b>Year ended December 31,</b>		
	<b>1999</b>	<b>2000</b>	<b>2001</b>	<b>1999</b>	<b>2000</b>	<b>2001</b>
Weighted average exercise prices	\$ -	\$ 28.7	\$ 3.3	\$ 3.9	\$ 8.8	\$ -
Weighted average fair value on grant date	\$ -	\$ 8.0	\$ 1.9	\$ 3.2	\$ 8.1	\$ -

For purposes of pro-forma disclosure, the estimated fair value of the options is amortized as an expense over the options' vesting period. The Company's pro-forma information is as follows:

	<b>Year ended December 31,</b>		
	<b>1999</b>	<b>2000</b>	<b>2001</b>
Net loss, as reported	\$ (9,363)	\$ (6,375)	\$ (11,608)
Pro-forma net loss	\$ (10,245)	\$ (6,625)	\$ (12,893)
Pro-forma basic and diluted net loss per share	\$ (2.32)	\$ (0.76)	\$ (1.24)

- d. The outstanding options granted to service providers as of December 31, 2001 amounted to 121,750.

Where the Company has recorded deferred stock compensation for options issued to service providers, the deferred stock compensation is calculated in accordance with the Black-Scholes Option Valuation Model above mentioned, and recorded as compensation expenses ratably over the vesting period of the options.

e. **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.

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

**NOTE 10: INCOME TAXES**

**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. 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, 2001, 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, 2001, Oridion has complied with the provisions of the law.

During 1998, Oridion received an additional approval for other investments under the "alternative benefits". According to the approval, the scope of the approved investment totals \$ 1,225 and the date of implementation is until November 8, 2000. During the reported period, 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 \$ 6,510 during the period between August 2001 to August 2003.

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%.

# Notes to Consolidated Financial Statements

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

**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 2, the financial statements are presented in U.S. dollars. The differences between the annual change in the CPI and in the NIS/dollar exchange rate causes a 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 this difference between the reporting currency and the tax bases of assets and liabilities.

**d. Carryforward losses**

As of December 31, 2001, Oridion had approximately \$ 33,580 of Israeli net operating loss carryforwards. The Israeli loss carryforwards have 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.

**e. Non-Israeli subsidiaries**

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

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

	<b>Year ended December 31,</b>		
	<b>1999</b>	<b>2000</b>	<b>2001</b>
Domestic	\$ (9,444)	\$ (6,551)	\$ (6,394)
Foreign	81	*) 200	(5,012)
	<u>\$ (9,363)</u>	<u>\$*) (6,351)</u>	<u>\$ (11,406)</u>

\*) Reclassified

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

**NOTE 11: TRANSACTIONS AND BALANCES WITH RELATED PARTIES**

	<u>Year ended December 31,</u>		
	<u>1999</u>	<u>2000</u>	<u>2001</u>
<b>a. Expenses</b>			
Directors fees to shareholders	<u>\$ 40</u>	<u>\$ 10</u>	<u>\$ 30</u>
Salaries and wages to related parties	<u>\$ 832</u>	<u>\$ 1,137</u>	<u>\$ 1,021</u>
<b>b. Balances with related parties</b>			
Credit balance	<u>\$ 507</u>	<u>\$ -</u>	<u>\$ -</u>
Debit balance	<u>\$ 109</u>	<u>\$ -</u>	<u>\$ -</u>

**NOTE 12: SEGMENT, CUSTOMERS AND GEOGRAPHIC INFORMATION**

**a. The Company has two reportable segments: Capnography and Breath Test.**

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 *H. Pylori* and future applications.

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

	<u>Year ended December 31, 1999</u>		
	<u>Capnography</u>	<u>Breath Test</u>	<u>Total</u>
Revenues from external customers	\$ 6,026	\$ -	\$ 6,026
Interest expenses	391	260	651
Depreciation and amortization	1,134	513	1,647
Segment loss	4,763	4,600	9,363
Segment assets	5,070	2,603	7,673
Expenditures for segment assets	443	111	554
	<u>Year ended December 31, 2000</u>		
	<u>Capnography</u>	<u>Breath Test</u>	<u>Total</u>
Revenues from external customers	\$ 10,317	\$ -	\$ 10,317
Interest expenses	578	385	963
Depreciation and amortization	835	393	1,228
Segment loss	3,261	3,114	6,375
Segment assets	27,237	14,030	41,267
Expenditures for segment assets	1,229	526	1,755

# Notes to Consolidated Financial Statements

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

	Year ended December 31, 2001		
	Capnography	Breath Test	Total
Revenues from external customers	\$ 10,384	\$ 31	\$ 10,415
Interest income	802	340	1,142
Depreciation and amortization	740	186	926
Segment loss	6,155	5,453	11,608
Segment assets	20,328	10,471	30,799
Expenditures for segment assets	2,130	470	2,600

## b. Geographic information

	Year ended December 31,					
	1999		2000		2001	
	Long-lived assets	Total revenues	Long-lived assets	Total revenues	Long-lived assets	Total revenues
The Company attributes revenues based on the end customers location as follows:						
Israel	\$ 2,241	\$ -	\$ 3,102	\$ 24	\$ 4,633	\$ 43
United States	41	4,095	124	8,091	370	8,108
Europe	-	1,826	-	2,036	8	1,997
Far East	-	5	-	12	4	243
Other	-	100	-	154	-	24
	<u>\$ 2,282</u>	<u>\$ 6,026</u>	<u>\$ 3,226</u>	<u>\$ 10,317</u>	<u>\$ 5,015</u>	<u>\$ 10,415</u>

## c. Major customers

	Year ended December 31,		
	1999	2000	2001
	% of total sales		
Customer A	<u>33%</u>	<u>23%</u>	<u>23%</u>
Customer B	<u>34%</u>	<u>41%</u>	<u>37%</u>
Customer C	<u>7%</u>	<u>13%</u>	<u>14%</u>
Customer D	<u>13%</u>	<u>11%</u>	<u>6%</u>
Customer E	<u>-</u>	<u>6%</u>	<u>9%</u>

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

**NOTE 13: SELECTED STATEMENTS OF OPERATIONS DATA**

	<b>Year ended December 31,</b>		
	<b>1999</b>	<b>2000</b>	<b>2001</b>
<b>a. Research and development expenses, net</b>			
Research and development expenses	\$ *)2,928	\$ 4,207	\$ 4,313
Less - participation of the Government of Israel	260	1,075	550
	<u>\$ 2,668</u>	<u>\$ 3,132</u>	<u>\$ 3,763</u>
<b>b. Selling and marketing expenses, net:</b>			
Selling and marketing	\$ *)3,485	\$ 5,885	\$ 10,843
Less: participation from Government funds	-	13	-
	<u>\$ 3,485</u>	<u>\$ 5,872</u>	<u>\$ 10,843</u>

\*) Reclassified.

	<b>Year ended December 31,</b>		
	<b>1999</b>	<b>2000</b>	<b>2001</b>
<b>c. Financial income (expenses), net</b>			
<b>Financial expenses:</b>			
Financial expenses in respect of convertible debentures	\$ (7)	\$ -	\$ -
Financial expenses in respect of long-term loans	(535)	(419)	-
Foreign currency translation differences	(47)	(130)	-
Others	(90)	(107)	(84)
	<u>(679)</u>	<u>(656)</u>	<u>(84)</u>
<b>Financial income:</b>			
Foreign currency translation differences	-	-	166
Others	28	1,619	1,060
	<u>28</u>	<u>1,619</u>	<u>1,226</u>
	<u>\$ (651)</u>	<u>\$ 963</u>	<u>\$ 1,142</u>

# Notes to Consolidated Financial Statements

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

## **NOTE 14: ABORTED OFFERING EXPENSES**

The Company intended to conduct an Initial Public Offering ("IPO") on the Neuer Market, a segment of the Frankfurt Stock Exchange, during September 1999. During September 1999, the Board of Directors decided to cancel the issuance of its planned format. The Company included the expenses involved with the aborted IPO in the amount of \$ 1,831 in the statement of operations in the item of aborted offering expenses.

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