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INNOVATIVE MEDICAL SERVICES

Form 10KSB/A

July 23, 2003

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

Form 10-KSB/A

ANNUAL REPORT PURSUANT TO SECTION 13 or 15 (d) OF THE  
SECURITIES EXCHANGE ACT OF 1934  
For the fiscal year ended July 31, 2002

Commission file number 0-21019

INNOVATIVE MEDICAL SERVICES  
(Exact name of registrant as specified in its charter)

California  
(State or other jurisdiction of  
incorporation or organization)

33-0530289  
(I.R.S. Employer  
Identification No.)

1725 Gillespie Way, El Cajon, California 92020  
(Address of principal executive offices, including Zip Code)

(619) 596-8600  
(Registrant's Telephone Number, including area code)

Securities registered pursuant to Section 12(b) of the Act: None  
Securities registered pursuant to Section 12(g) of the Act:

Common Stock  
(Title of Class)

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

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

State issuer's revenues for its most recent fiscal year: \$2,409,700

Aggregate market value of the voting stock held by non-affiliates of the registrant: Approximately \$3,107,000 as of October 25, 2002.

Indicate the number of shares outstanding of each of the issuer's classes of common stock: 8,780,899 shares of common stock as of October 25, 2002.

Documents incorporated by reference: Certain Exhibits

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## PART I

### ITEM 1. DESCRIPTION OF BUSINESS

#### Company Overview

Innovative Medical Services began as a provider of pharmaceutical water purification products. Although our current revenues are still primarily from the pharmacy industry, we have expanded from our niche pharmacy market into other, broader markets with new products, including residential and commercial water filtration systems, health and wellness-related retail and e-commerce merchandise, silver ion bioscience technologies and boric acid based pesticide technologies.

#### Water Treatment Division

The Fillmaster(R) pharmaceutical water purification, dispensing and measuring products include the Pharmapure(R) water purification system, the FMD 550 dispenser, the patented Fillmaster 1000e computerized dispenser and the patented Scanmaster(TM) bar code reader. We also market proprietary National Sanitation Foundation certified replacement filters for the Fillmaster Systems.

Our Nutripure(R) line of water treatment and filtration systems includes the Nutripure 3000S-Series whole-house water softening systems, the Nutripure Elite reverse osmosis point-of-use systems, the Nutripure 2000 countertop water filtration system and the Nutripure Sport filtered sport bottle. We distribute our various Nutripure products in several ways, including retail sales, catalogue placement, business-to-business sales, internet promotion and in-home sales presentations.

#### E-Commerce Division

Through our subsidiary Nutripure.com, we had operated an e-commerce health website, Nutripure.com(TM), that distributed Bergen Brunswig products. We provided consumers a wide variety of vitamins, minerals, nutritional supplements, homeopathic remedies and natural products. In addition to merchandise, the site offered comprehensive health and wellness information in an easy-to-access, intuitive reference format. In December 2001 Bergen Brunswig Corporation requested we release it from its contract to provide the vitamins, minerals, nutritional supplements, homeopathic remedies and natural products sold on our Nutripure.com website. We agreed, and therefore, on January 15, 2002, Bergen Brunswig Corporation terminated the distribution license for these products. As a result, we closed our e-commerce division.

#### Bioscience Division

Our bioscience division features a patented, aqueous disinfectant called Axenohl(TM). In November 2001, we acquired the patent for Axenohl(TM). The use dilution formulation of Axenohl is called Axen(TM). The EPA registration for use of Axenohl and Axen as hard surface disinfectants has been issued, and we plan to pursue additional EPA and FDA regulatory approvals for other applications. Additional possible uses for this product include wound care, topical infection care, personal disinfecting retail products and food processing, which may require FDA approvals, as well as municipal water treatment and point-of-use/point-of-entry water treatment products, which may require additional EPA approvals.

Our bioscience division also includes a line of pesticide technologies. Branded as Innovex(TM), the product line launched in October 2001 with our EPA-approved, patent-pending RoachX(TM). Subsequently, we have developed and launched

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additional products in the Innovex product line, including and AntX75(TM) baits, two formulas of EPA-exempt non-toxic TrapX rodent lure, Pro's Choice(TM) caulk for pest control operators, and EPA approved CleanKill(TM), the Axen-based hard surface disinfectant for the pest control industry.

### History

Innovative Medical Services was incorporated in the State of California on August 24, 1992, to pursue the immediate business of manufacturing and marketing the Fillmaster and subsequently a broadly based business of delivering advanced technology, equipment and supplies to not only the pharmacy industry, but also other healthcare markets and to retail consumers.

In the past five years, Innovative Medical Services transitioned from a one-product company supplying a niche market to a multi-division company managing new products and programs. In addition to expanding the Fillmaster product line with the Fillmaster 1000e and the Scanmaster, we launched a line of residential water treatment and filtration products. Through acquisition, we have also expanded into the bioscience arena with our Axenohl antimicrobial products and our Innovex pesticide products.

In 1997, we developed and launched the now-patented Fillmaster 1000e computerized, electronic dispenser as an upgrade dispenser to the Fillmaster pharmaceutical water purification and dispensing system.

In 1997 and 1998 we developed our entry-level residential water system, Nutripure(R) NP2000CT. After 18 months of extensive market research, Innovative Medical Services completed development of this carbon countertop system and released the product in June 1998.

In October 1998, Innovative Medical Services acquired AMPROMED, Rio de Janeiro, Brazil, and certain assets of Export Company of America Inc. (EXCOA), Fort Lauderdale, FL, and established a new Nevada corporation to hold and operate the export/import operation. AMPROMED's primary business is the sale of medical, dental and veterinary disposable products. In addition to medical supplies, we plan to distribute water treatment and silver ion products to Brazil through AMPROMED. Since the acquisition, the economic conditions in the region have declined and implementation of the project has been delayed. We no longer have immediate plans to import medical and dental supplies into Brazil but we believe, however, that Ampromed is a vital part of our plan to market and sell Axenohl, RoachX and the Nutripure line of water treatment products.

In 1999 we developed and launched yet another enhancement to our Fillmaster pharmaceutical water purification and dispensing system, the Scanmaster bar code reader. Designed as an add-on upgrade to the Fillmaster 1000e computerized dispenser, the Scanmaster allows the user to scan a prescription's NDC bar code in front of the dispenser, and the Fillmaster 1000e displays the product name and required water quantity. The Fillmaster System then dispenses the prescription with one touch of a button.

In December 1999, we formed a wholly owned subsidiary, Nutripure.com, to capitalize on internet commerce opportunities focusing on health and wellness. In January 2000, we began the process to spin off Nutripure.com as a separate public company. During the intervening time, adverse market conditions for solely internet-based ventures eroded Management's confidence in the viability of a public market for Nutripure.com common stock. Therefore, in October 2000, our Board of Directors elected to retain Nutripure.com as an operating division of Innovative Medical Services in order to minimize the substantial administrative expense associated with launching and operating a public company.

Also in 1999, we began investigating marketing opportunities for a silver-ion based technology called Axenohl. The Axenohl patent was owned at the time by

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NVID International.

Early in 2000, after concluding that we wished to pursue development and marketing of the Axenohl technology, we engaged in a marketing and licensing agreement with NVID International for Axenohl for specific market segments in specific geographic areas.

In mid 1999, we launched Nutripure.com, a wholly-owned subsidiary e-commerce venture established to market vitamins, minerals, nutritional supplements, homeopathic remedies and natural products sold on our Nutripure.com website. We partnered with Bergen Brunswig as our supplier for this program.

In 2000 we launched the Nutripure Dealer program which expanded our product line to include whole-house water conditioning systems other point-of-use water treatment equipment while expanding our distribution network by offering these products to independent water treatment for sale to the public under IMS' Nutripure brand.

In 2001 we acquired the marketing rights and patent to our boric acid pesticide technologies. The first of these products developed, RoachX, launched in October 2001.

In late 2001, as part of a litigation settlement with NVID regarding the marketing rights to Axenohl, we acquired the patent to the Axenohl technology.

In December 2001 Bergen Brunswig Corporation requested we release it from its contract to provide the vitamins, minerals, nutritional supplements, homeopathic remedies and natural products sold on our Nutripure.com website. We agreed, and therefore, on January 15, 2002, Bergen Brunswig Corporation terminated the distribution license for these products. As a result, we closed our e-commerce division. The website is being held for resale.

In mid-2002 we expanded our Innovex line of pesticides to include RoachX, AntX75, two formulas of TrapX, Pro's Choice silicone caulk and CleanKill, a hard surface disinfectant for use in the pest control industry that uses Axenohl disinfecting technology.

In 2002 we relaunched the Nutripure Dealer program and changed our Nutripure.com wholly-owned subsidiary to Nutripure Corporation The corporation is now being used to operate the Nutripure Dealer program.

### Principal Products and Markets

#### WATER TREATMENT DIVISION

##### Pharmaceutical Water Treatment

Fillmaster(R) The Fillmaster dispensing apparatus, connected to the Pharmapure(R) reverse osmosis water filtration system, provides measured amounts of purified water for reconstitution of liquid oral antibiotics and certain other pharmacy applications. Pharmapure is a six-stage water purification unit featuring an electronic water purity testing module and an auxiliary faucet for dispensing purified water. Fillmaster is a calibrated volumetric measuring and dispensing apparatus. The entire system (the "Fillmaster System") integrates with the building's tap water plumbing and is closed and pressurized to prevent contamination.

The Fillmaster System saves time and money for pharmacies. According to our testing, the Fillmaster has a fill rate at least three times that of previous bottle-and-hose methods, and direct and indirect costs associated specifically with bottled water are reduced or eliminated. Pharmacy storage space can be

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reallocated to more profitable items, labor savings accompany the efficiencies, and the expense of bottled water purchases of up to \$1.25 per gallon is replaced by one annual filter change. Under optimum usage, a pharmacy reduces the cost of "purified water" to approximately \$.04 per gallon.

In addition to efficiency and cost savings, the Fillmaster System increases prescription integrity by greatly reducing the possibility of human error while dispensing prescriptions. The patented Fillmaster 1000e employs multiple microprocessors to provide accurate and even-flow dispensing. We sell Fillmaster 1000e dispensers as an upgrade to existing installations and as a component of new installations. The Scanmaster, launched in August 1999, is a pager-sized, modular upgrade to the Fillmaster 1000e. A user simply scans a prescription's NDC bar code in front of the dispenser, and the Fillmaster 1000e displays the product name and required water quantity. The Fillmaster System then dispenses the prescription with one touch of a button. The advanced technology of the Fillmaster 1000e computerized dispenser and the Scanmaster bar code reader ensures accuracy of measurement and assurance of compliance to minimize liability.

This is a finite, niche market in which our significant customers to date consist primarily of domestic retail chain pharmacies. There are approximately 72,000 pharmacies in the United States and Canada, with many thousands more worldwide. Water-mixed antibiotic prescriptions, for which the Fillmaster is primarily used, make up approximately 12.6% of a pharmacy's total prescriptions and approximately 20% of a pharmacy's gross profit. We have installed over 20,000 Fillmaster dispensers in pharmacies across the nation, including Wal-Mart, Walgreens, Albertson's/American Stores, Eckerd, Fred Meyer, Target, CVS, Kroger, Smith's Food and Drug, Longs Drugs, Rite-Aid, Drug Emporium, Fry's, Hi-School Pharmacies, H-E-B, Fleming, Giant and Snyders. Also included in the customer base are many United States Military Clinics, including Bethesda Naval Hospital; the Kaiser Foundation for Medical Care; the Mayo Clinic and several hundred Independent and Hospital Pharmacies.

**Fillmaster(R) System Filters** We also market unique and proprietary NSF certified filter replacements for the Fillmaster's Pharmapure water purification system, which require changing at intervals of approximately 12 months or sooner as indicated by the purity testing module. The filter replacements represent a significant continuing source of revenues to us.

**Customer Service Plan 2000(TM)** Innovative Medical Services offers outstanding service to its pharmacy customers with its exclusive Customer Service Plan 2000 (CSP 2000). The CSP 2000 provides an extended unlimited warranty on all Innovative Medical Services pharmacy products, regardless of age or quantity; significant discounts on maintenance item costs; free software upgrades for the Fillmaster 1000e and Scanmaster; a secure web site that allows pharmacy customers to monitor history, scheduled maintenance and account status; automatic replacement filter shipments; and simplified, annual invoicing. Motivated by the cost savings and the extended warranty coverage, most of our chain customers have entered into multi-year contracts for the CSP 2000.

### Residential Water Treatment Products

**Nutripure(R) Dealer Program** Innovative Medical Services' Nutripure Water Dealer Program offers existing independent water treatment dealers a line of residential water softening and other point-of-use water treatment equipment for sale to the public under IMS' Nutripure brand. In addition, the program provides complementary, industry-unique financing that extends credit to consumers for the purchase of water treatment equipment from participating dealers. We realize revenues from both the sale of Nutripure equipment and the financing.

The Nutripure whole-house water softening systems, like most water softening systems on the market, are typically professionally installed in a customer's

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basement or garage and require electricity. The Nutripure water softening systems, comprised of a resin tank, brine tank and controller, extract minerals from the water through an ion exchange process. Nutripure whole house systems are often installed in conjunction with Nutripure reverse osmosis systems.

We have formed alliances with independent dealer groups, finance companies and leading equipment component manufacturers to create a marketing program to sell and finance whole-house water treatment systems through existing dealers. We believe this marketing strategy provides consumers and independent dealers a name and image they can trust. The programmable systems come equipped with microprocessors and electronic water meters to monitor daily water usage and provide automatic, demand-based water conditioning. An electronic memory stores operating system information, and battery backup keeps it current if power is lost.

Innovative Medical Services' Nutripure Water Dealer Program also offers a Nutripure line of residential drinking water systems combines reverse osmosis technology with carbon filtration to improve the taste, smell, quality and safety of standard tap water. Reverse osmosis is a water treatment process that removes contaminants from water by using pressure to force the water molecules through a semi-permeable membrane. Carbon, sometimes referred to as activated carbon, is a water treatment medium commonly used for dechlorination and for reducing trace and soluble materials from water. We also market unique and proprietary filter replacements for the Nutripure residential drinking water systems that require changing every 12 months.

The Nutripure reverse osmosis filtration system is comprised of a storage tank, a faucet and a water filtration apparatus which includes a sediment filter, pre- and post-carbon filters and a reverse osmosis membrane. Nutripure requires neither professional installation nor electricity to operate. The Nutripure system filters to .001 micron and reduces heavy metals, chemicals and microorganisms, such as cryptosporidium and giardia, as well as reducing bad taste and odor from drinking water. A micron is a measurement unit equal to one millionth of a meter. Micron measurements are applied to water filtration systems to indicate the particle size at which suspended solids larger than that size will be removed.

Nutripure(R) 2000 Innovative Medical Services entered the retail venue with its Nutripure 2000 Countertop Water Filtration System. Nutripure 2000, developed specifically for mass merchandising, offers water filtration technology at competitive pricing. Nutripure's filter component is a one-micron, carbon microfilter that reduces dirt, chemicals, lead and parasites to improve the taste, quality and safety of tap water. The Nutripure 2000 requires no assembly, mounts directly to a faucet and features a 2,000-gallon capacity filter, an automatic bypass shutoff valve, an electronic monitor that reminds users when to change the filter, and an exclusive filter design that prevents leaking and contamination because water flows only through the completely sealed filter cartridge. We distribute Nutripure 2000 through retail outlets in the United States.

The filter component, manufactured by Omnipure Filter Company of Caldwell, Idaho, has been tested by Spectrum Laboratories to meet or exceed National Sanitation Foundation Standard No. 53 Health Effects and Standard No. 42 Aesthetic Effects. These tests determine if the product meets the most stringent standards set by the NSF for consumer water filtration. Spectrum Labs, Inc. is an independent laboratory in New Brighton, Minnesota. The testing on the Nutripure product was paid for by Omnipure Filter Company, Caldwell, Idaho. The test reports were submitted by Spectrum Labs, Inc. to Omnipure on April 6, 1998. We had no prior relationship with Spectrum Labs when the tests were conducted. We selected the Omnipure filter component for the Nutripure 2000 in part because it had this testing available, though there are several other similar quality filter components readily available. Other than purchase orders there is no

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written agreement between us and Omnipure.

Spectrum Labs' Product Testing Department conducted testing on the product for chlorine reduction in accordance with test protocol contained in NSF International Standard Number 42 "Drinking Water Treatment Units/Aesthetic Effects," Appendix B, "Chemical Unit Test Methods," Section I, "Procedure - Plumbed-In and Faucet Mounted Taste, Odor and Chlorine Reduction Units Without Reservoir," revised June 1988. The product was found to meet the requirements for compliance under Standard Number 42 for taste, odor and chlorine reduction for Class I filters.

In addition, Spectrum Labs evaluated the product for cyst and turbidity reduction and structural integrity in accordance with test protocol contained in NSF International Standard Number 53, "Drinking Water Treatment Unites/Health Effects," Section 6.12, "Mechanical Filtration Test Methods," and Section 6.6, "Structural Integrity Performance. The filter media evaluation was performed based on test protocol contained in NSF Standard Number 53, Section 6.7, "Filter Media." Influent and effluent samples were analyzed for cyst reduction using American Society for Testing and Materials Method Number F796 which is a standard particle counting method. Samples evaluated for turbidity were analyzed using EPA Method Number 180.1 which is a nephelometric method. NSF Standard Number 53, Section 6.6.1.2 protocol was used to perform the pressure evaluation for structural integrity. The product was found to meet the requirements for compliance under NSF Standard Number 53 for cyst and turbidity reduction, filter media evaluation and structural integrity performance.

Nutripure(R) 2000 Replacement Filters We also market replacement filters for the Nutripure 2000 water system. The Nutripure 2000 contains a 2,000-gallon filter that must be changed every year.

Nutripure(R) Sport Filtered Sport Bottle The Nutripure Filtered Sport Bottle, also offered as a private label or premium item, provides clean, great-tasting water for on-the-go consumers. The Nutripure Filtered Sport Bottle features a small carbon filter at the bottom end of the plastic straw so that, as the consumer drinks through the straw, the water is drawn up through the filter. An innovative alternative to buying expensive bottled water, Nutripure Sport filters an average of approximately 30 microns, reducing sediment and chlorine, and can be refilled 60 times before an inexpensive filter change is required. The Nutripure Sport program provides recurring revenue through sales of the replacement filter twin pack.

### RETAIL PRODUCTS DIVISION

Medifier(TM) We also market the Medifier, a patented universal prescription bottle label magnifier. The Medifier holds various sized prescription bottles in position under a magnifier strip that enlarges dosage and use instructions to a clearly readable size. The Medifier is marketed to Innovative Medical Services' existing sales channels, as well as through catalogue sales and promotional products distributors.

### E-COMMERCE DIVISION

Nutripure.com(R) In December 1999, we formed a wholly owned subsidiary, Nutripure.com, to capitalize on internet commerce opportunities focusing on health and wellness. In January 2000, we began the process to spin off Nutripure.com as a separate public company. During the intervening time, adverse market conditions for solely internet-based ventures eroded Management's

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confidence in the viability of a public market for Nutripure.com common stock. Therefore, in October 2000, our Board of Directors elected to retain Nutripure.com as an operating division of Innovative Medical Services in order to minimize the substantial administrative expense associated with launching and operating a public company.

In December 2001 Bergen Brunswig Corporation requested we release it from its contract to provide the vitamins, minerals, nutritional supplements, homeopathic remedies and natural products sold on our Nutripure.com website. We agreed, and therefore, on January 15, 2002, Bergen Brunswig Corporation terminated the distribution license for these products. As a result, we closed our e-commerce division.

### BIOSCIENCE DIVISION

**Silver Ion Technologies** Our bioscience division includes a silver ion technology called Axenohl(TM). Axenohl is a patented, aqueous disinfectant. The use dilution formulation of Axenohl is called Axen(TM). The EPA registration for use of Axenohl and Axen as hard surface disinfectants has been issued. The first Axen-containing product we developed was our CleanKill(TM) hard surface disinfectant for sale to the pest control industry. We intend not only to sell our own Axen-based hard surface disinfectant products, but also to sell Axen as an additive to other manufacturer's products.

The current EPA approval of Axen is based on prior testing using 12-part per million (ppm) strength. In February and March 2002, we announced the results of a battery of tests using an increased formula strength of 30-ppm to meet rigorous standards of potential product partners and to achieve the shortest possible kill times on a greater scope of microbes. The tests were performed by nationally recognized independent laboratories Nelson Laboratories of Salt Lake City, Utah and AppTec ATS, St. Paul, Minnesota, under AOAC protocol and GLP regulations in accordance with EPA regulations.

Specific Axen test results include:

- o 30-Second Kill Time ---At 30 ppm, Axen demonstrated a 30-second, 99.9999% kill of standard indicator organisms including Staphylococcus aureus ATCC 6538, Pseudomonas aeruginosa ATCC 15442 and Salmonella cholerasuis ATCC 10708. Each is regarded as ever present in nearly every person's life and is also a frequent human pathogen.
- o Residual Kill Activity --- The residual activity of Axen was tested at 0, 1, 6, and 24 hours after application to a hard surface against standard indicator organisms (Staphylococcus aureus ATCC 6538, Pseudomonas aeruginosa ATCC 15442 and Salmonella cholerasuis ATCC 10708). Quantitative residual results at 24 hours after initial application show a 99.99% reduction in all three bacteria tested.
- o Bacteria---Additional testing of Axen against Methicillin Resistant Staphylococcus aureus ATCC 700698 (MRSA), Vancomycin Resistant Enterococcus faecium ATCC 700221 (VRE) and Escherichia coli OH157 ATCC 43888 demonstrated a 99.9999% kill in 2 minutes. These specific bacteria are especially problematic in hospitals because of their resistance to antibiotics. Further, Axen showed a 99.9999% kill in 30 seconds against Listeria monocytogenes ATCC 19111. Food processing operations are challenged to keep this bacterium under control.
- o Fungus --- Axen demonstrated a 99.9999% kill in 10 minutes of the common athlete's foot fungus, Trichophyton mentagrophytes ATCC 9533. After review and approval by the EPA, this data will allow the Company to add a fungicidal claim to its hard surface disinfectant



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label.

- o Viruses --- Axen also demonstrated 99.9999% virucidal efficacy against HIV Type 1 in 30 seconds, Herpes simplex virus type 1 in one minute, and Influenza A virus ATCC VR-544, Rhinovirus type R 37 ATCC VR-1147, Strain 151-1 and Poliovirus type 2 ATCC VR-1022, Strain Lansing in 10 minutes. After review and approval by the EPA, this data will allow the Company to add these virucidal claims to its hard surface disinfectant label.

We are awaiting EPA approval of the 30-ppm formula. After receiving EPA approval, we will be able to expand the existing Axen efficacy claims as a hard surface disinfectant.

Based on the EPA toxicity categorization of antimicrobial products that ranges from Category I (high toxicity) down to Category IV, Axen, with its combination of the biocidal properties of ionic silver and citric acid, is an EPA Category IV antimicrobial for which precautionary labeling statements are normally not required. This compares with Category II warning statements for most leading brands of antimicrobial products.

We plan to pursue additional EPA and FDA regulatory approvals for other applications. Additional possible uses for this product include wound care, topical infection care, personal disinfecting retail products and food processing, which may require FDA approvals, as well as municipal water treatment and point-of-use/point-of-entry water treatment products, which may require additional EPA approvals.

In March 2001, we signed a five-year contract to provide Axenohl to Dodo & Company, a Korean cosmetics manufacturer and marketer. Under the contract, Dodo & Company would purchase approximately \$1.2 million dollars of product from us over five years. In addition to the purchase price, the contract calls for us to receive a reimbursement for research and development and a royalty on sales of the Axen-containing products. The contract requires Dodo & Company to obtain appropriate regulatory clearances in South Korea, but we have no documentation to show that this has been completed. We believe that Dodo & Company has miscalculated the royalties due to us, and we have requested that Dodo & Company reevaluate their royalty calculations. Dodo & Company has requested a renegotiation of the contract including the royalty fee calculation. During the year, Dodo & Company has continued to expand its A-Clinic Club line to include over 10 different products, all of which contain Axenohl as an active ingredient. Because of Dodo & Company's significant investment in the product line, we believe we will be able to renegotiate the contract to the satisfaction of both parties. Until this matter is resolved, however, we are unlikely to ship additional product to Dodo & Company.

On November 30, 2001, the Company acquired the patent for Axenohl, a silver ion based technology which is the basis for the Company's silver ion products. The Company previously licensed the use of this patent.

The Company purchased the patent for 700,000 shares of its common stock plus certain expenses. The Company valued the patent at \$1,540,600 based on the market price of the stock exchanged. In addition, the Company agreed to pay royalties in the amount of 5% of gross Axenohl sales until March 2018, the end of the life of the patent. There are minimum royalties due of \$1,000,000 for the period of November 2001 to July 31, 2004 and for each fiscal year thereafter. Innovative Medical Services has the right, in its sole and absolute discretion, to pay the minimum royalty in cash or in common stock at prevailing market prices. If the Company determines it does not wish to pay the minimum royalty payment, it has the option at any time to transfer the patent back to the prior owner rather than pay the minimum royalty.

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BORIC ACID BASED PESTICIDE TECHNOLOGIES Our bioscience division also includes a line of pesticide technologies. The EPA-approved, patent-pending RoachX(TM) was the first product to launch from the line. The national kickoff took place at the National Pest Management Association meeting in New Orleans, Louisiana, in October 2001. We are selling RoachX through Univar (formerly Vopak) and members of the Speckoz group of nine regional independent wholesalers.

United States Department of Agriculture testing confirms that RoachX is over 96% effective in three to four days with one application for indoor and outdoor eradication of cockroaches, and can be used near children and food preparation areas. Boric acid is a well-known and effective deterrent of cockroaches and will kill them on contact, but cockroaches do not naturally eat the repellent. Although many pesticide products contain boric acid as the listed active ingredient, we believe RoachX to be new because of the combination of boric acid, glycerin and a protein-based attractant in a colloidal suspension to create three unique results: 1) The formula protects the boric acid from water and humidity, 2) The cockroaches perceive the formulation as food and will actually eat the glycerin-encapsulated boric acid, and 3) The formula acts as a time-released pesticide, allowing the cockroach to return to the nest before it dies and then becomes a "bait station" for other roaches in the colony. We believe the product line, containing particular formulas for specific pests, is effective against cockroaches, ants, palmetto bugs, silverfish, waterbugs, ticks, fleas, lice and garden pests.

At the October 2001 trade show, we also launched Pro'sChoice(TM) caulk for pest control operators. We repackage an NSF, USDA and FDA approved food-grade silicone caulk as our Pro's Choice product. Pro's Choice does not contain any pesticide and is a convenience tool for pest control operators for "exclusion", or the filling of cracks and crevices to create a physical barrier insects cannot penetrate.

In January 2002, we formally launched CleanKill(TM), the Axen-based hard surface disinfectant for the pest control industry. CleanKill is approved by the EPA as an additional brand name of Axen.

In March 2002, we received EPA approval for our second pesticide product, AntX 75(TM). Targeted to pest control professionals, AntX 75 is available through commercial distributors in the pesticide industry. AntX 75 combines our patent-pending glycerol boric acid technology with a carbohydrate-based attractant to create a non-drying, time-released bait. The non-drying formula allows ants to feed until the bait is gone. The formula also completely masks the borate in the bait and produces a time-released effect that lengthens the kill time, giving the ants time to return to their nests before dying.

In April 2002, we launched two formulas of non-toxic TrapX rodent lure. This conveniently packaged, non-drying EPA-exempt product is available in fruit formula for roof rats and protein formula for Norway rats and squirrels and eliminates the hassles of mixing and cross contamination that are currently issues for pest management professionals. Both formulas work well for field and house mice and may be used in all types of traps. TrapX is available through commercial distributors in the pesticide industry.

### Competition

Although we have only one known competitor in our pharmaceutical water purification market, we face very strong competition in the residential water treatment markets where many large, long-established competitors currently hold most of the market share and have the capital resources available to invest in large national marketing campaigns. The market for Axenohl is highly competitive because we must work to displace traditional disinfecting technologies sold by well-known international industry leaders.

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The market is similar for our pesticide products. Although recent changes in EPA regulations may ease our ability to enter the market, ongoing strong market presence of existing pesticide companies may make it difficult to compete. On June 8, 2000, the United States EPA reclassified the Dow Chemical product Dursban (also sold as Lorsban). Over 800 products containing the organophosphate pesticide chlorpyrifos are reclassified and now may only be sold in a significantly diluted form. Sales of original, stronger formulations of such products to retailers ended February 1, 2001, and retailers must remove the products from shelves by December 31, 2001. The current formulations are also banned for commercial and agriculture professionals as of December 31, 2000. Professional pest control companies must use a 100 to 1 diluted version of the current product strength and obtain a waiver of responsibility from the home or business owner. As of June 6, 2001, the product underwent a further 10 to 1 dilution, creating a 1000 to 1 diluted treatment.

Our ProChoice caulk, a companion product to our pesticide products, is a repackaged readily available food-grade silicone caulk manufactured by General Electric. Although competition is significant because the caulk is commercially available from multiple manufacturers in standard 10-11 ounce tubes, we have repackaged it for the convenience of our customers into 4 ounce tubes that fit bait guns used by the pest control operators.

We recognize that innovative marketing methods are required in such competitive markets. We work to focus on the high quality and value price of our products in their markets.

### Patents and Intellectual Property

We own patents on the Medifier, the Fillmaster 1000e Electronic Dispenser and the Axenohl technology. In addition, we have a patent application pending for RoachX and related pesticide products. Except for the Nutripure whole-house water treatment systems, our other water treatment products are comprised of combinations of our own proprietary components, custom made components and patented, off-the-shelf components and are assembled and packaged by us. The Nutripure whole-house water treatment systems sold through the Nutripure dealer program are purchased from a variety of manufacturers as private label products for Innovative Medical Services. These manufacturers use patented key components in their products.

The Medifier patent, which expires in March 2010, protects a device for use as a magnifying implement which has a housing member designed to accommodate prescription bottles of various popular sizes therein in a fixed position. A longitudinally moveable magnifying lens slideably mounted in the housing member is utilized to magnify the print contained on an instruction label located on the side of the prescription bottle. Alternate embodiments allow different size medicine bottles to be alternately mounted in concentric fashion, or with the side of the medicine bottles facing the lens in a fixed position.

The Fillmaster 1000e patent expires in August 2017 and protects a method and apparatus for dispensing fluids in response to a user request for a specified amount of the fluid. A microprocessor opens and closes a fluid port for predetermined amounts of time to control the amount of fluid dispensed. The microprocessor monitors the elapsed time and the amount of fluid that has been dispensed since the last time the filter was serviced. In one preferred embodiment, the amount of fluid that is dispensed is measured by continuously monitoring the volume of fluid flowing through the apparatus. A pressure measurement device allows the microprocessor to monitor the fluid pressure. The microprocessor prevents fluid from being dispensed if the pressure is not within a predetermined range of tolerances. The fluid port is opened and closed by activating and deactivating a solenoid. A keypad allows the user to input the amount of fluid that is to be dispensed. A "Wait" period is imposed between the time that the user initiates the first stage and the time the user may initiate

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the second stage. The microprocessor does not open the fluid port if a "Failure" condition exists. An LCD is provided to display the amount of fluid that the user has requested. In an alternative embodiment, a bar code scanner or other input device allows the user to automatically input the amount of fluid that is to be dispensed.

On November 30, 2001, the Company acquired the patent for Axenohl, a silver ion based technology and its method of making which is the basis for the Company's silver ion products. The Company previously licensed the use of this patent.

The Company purchased the patent for 700,000 shares of its common stock plus certain expenses. The Company valued the patent at \$1,540,600 based on the market price of the stock exchanged. In addition, the Company agreed to pay royalties in the amount of 5% of gross Axenohl sales until March 2018, the end of the life of the patent. There are minimum royalties due of \$1,000,000 for the period of November 2001 to July 31, 2004 and for each fiscal year thereafter. Innovative Medical Services has the right, in its sole and absolute discretion, to pay the minimum royalty in cash or in common stock at prevailing market prices. If the Company determines it does not wish to pay the minimum royalty payment, it has the option at any time to transfer the patent back to the prior owner rather than pay the minimum royalty.

The United States patent for Axenohl was issued on March 6, 2001, and a supplemental patent has been filed to cover the substitution of 14 other organic acids for citric acid in the formulation.

A patent application for RoachX and related products was filed in February 1998 to protect a nonaqueous form of insecticide consisting of a desiccant, preferably boric acid, with additional ingredients for binding, stability and target insect attraction.

### Manufacturing

The Fillmaster and Nutripure water systems are assembled in our manufacturing facility at our corporate offices primarily from custom manufactured components. It is our goal to perform minor manufacturing in our facility to minimize wages, equipment expense and insurance. No components of the systems have permanent or unequivocally restricted availability. Many manufacturers are available to produce the components, and a change in suppliers would result in virtually no lost production.

The original Fillmaster dispenser and the new Fillmaster 1000e dispenser are both assembled in our manufacturing facility at our corporate offices mostly from proprietary and custom parts fabricated to our specifications from injection-molded plastic and fabricated acrylic.

The Nutripure Sport bottle is also assembled in our manufacturing facility at our corporate offices from proprietary and custom components manufactured under exclusive agreements with several different manufacturers. Alternative manufacturers exist, and a change in suppliers would result in virtually no lost production. There are no plans to alter production methods.

We manufacture RoachX, AntX and TrapX in our manufacturing facility at our corporate offices and outsource some of the packaging functions. The active and inactive ingredients of these products are readily available multiple manufacturers in the US and abroad.

We purchase caulk manufactured by General Electric for our ProChoice product from a General Electric authorized distributor and repackager. This caulk is readily available through several other manufacturers.

We blend the Axenohl products in our manufacturing facility at our corporate

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offices from concentrate produced by our subsidiary, ETI-H2O. Silver, the primary active ingredient, is a readily available commodity, and the other active and inactive ingredients of Axenohl are readily available from chemical supply companies.

We purchase water softening and filtering equipment from a variety of manufacturers for the Nutripure water dealer program which they produce and label as Nutripure equipment. We resell to participating water treatment equipment dealers.

### Research and Development

Research and Development costs that have no alternative future uses are charged to operations when incurred and are included in operating expenses. The total amounts charged to Research and Development expense were \$780,500 and \$293,000 in the fiscal years ended July 31, 2002 and 2001, respectively. Our investment in Research and Development during the past year resulted in the release of 4 additions to our pesticide product line, including AntX, Pro's Choice and two formulas of TrapX. Our investment also yielded significant testing results on the new 30-ppm Axenohl formula which in turn allowed us to apply to the EPA for approval of expanded efficacy claims for our hard surface disinfectant.

### Employees

As of October 25, 2002, Innovative Medical Services employed thirty-one people, twenty-seven of whom are full-time individuals: nine employees in product assembly and shipping, six employees in sales, marketing and customer service, six employees in research and development and ten employees in management and administration. We choose to outsource more expensive, specialized functions including public relations and selected engineering projects.

### ITEM 2. PROPERTIES

Our business operates in a 13,067 square foot facility located in a light industrial/office park in El Cajon, California. This location houses all administrative, executive, sales, assembly, shipping and manufacturing functions. The space is leased from an unaffiliated third party under a sixty-five month agreement commencing on July 1, 1996. The monthly rental is \$0.74 per square foot plus \$0.15 per square foot for maintenance of common areas. There is also a fixed yearly increase of 4%. We have also signed an amendment to the lease and exercised an option to lease the building for an additional five years.

### ITEM 3. LEGAL PROCEEDINGS

The following is an update of developments in the previously disclosed litigation involving Innovative Medical Services filed in the Circuit Court of Pinellas County, Florida by Zedburn Corporation, against us for breach of contract in October 1997. The breach of contract alleged was for payment of fees for Mr. David Reitz's and Mr. Steven Durland's services of arranging a public offering of our common stock. We have filed counterclaims based upon the Racketeer Influenced and Corrupt Organization (RICO) Act against David Reitz, Zedburn Corporation, Capital Development Group, Steven Durland and other defendants. It is our position that Mr. Reitz and others perpetrated a scheme to defraud us of cash fees and securities in connection with purported services of arranging a public offering of our common stock. In October 1997, Mr. Reitz and Zedburn filed for protection under the Federal bankruptcy laws. In August 1998, Mr. Reitz voluntarily dismissed his bankruptcy and as a result thereof we have named Mr. Reitz as a defendant to our counterclaims.

We believe that the defendants had perpetrated similar schemes against other parties. We also believe we have substantially completed discovery and compiled

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compelling evidence to prove our claims.

Several of the Defendants filed Motions to Dismiss our counterclaims. A hearing on the Motions was held on October 1, 1998. Certain of the Motions were granted pending our amendment of our Counterclaim. We amended our Counterclaims in accordance with the judge's rulings. Certain Defendants filed second Motions to Dismiss the amended Counterclaims. A hearing on these latest motions was held in March 1999, before a different judge than the judge who ruled on the first motions. On April 20, 1999, orders were entered granting the Defendants' Motions to Dismiss. However these Orders did not state the basis for the Orders, nor was our legal counsel provided notice of the Orders or a copy of the new judge's correspondence offering a "formal ruling" upon request. In May 1999, we filed an Appeal of the Orders and Motions for Reconsideration based upon inconsistency of the Orders with the previous judge's rulings and the lack of notice to us. In August 2001, the Court of Appeals reversed the trial court's ruling and reinstated our claim against the defendants with the exception of Innovative Medical Services' RICO action. We intend to pursue a trial as soon as possible.

We have neither accrued a liability in our financial statements regarding this litigation nor disclosed the matter in the footnotes thereof. We have not done so because we do not believe there is any merit to Mr. Reitz's claims and that the likelihood that we will realize a loss from these matters is believed remote. In addition, we believe that in the unlikely event that we settle, the amount of any such settlement would not be material to our financial statements.

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

No matters were submitted to shareholders in the fourth quarter of the fiscal year.

#### PART II

#### ITEM 5. MARKET FOR THE REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

- (1) Market Information: Innovative Medical Services' common stock is traded on the NASDAQ SmallCap Market under the symbol "PURE".
- (2) High and Low Bid Prices: The following table sets forth high and low bid prices for each fiscal quarter, as reported by NASDAQ, for the last two fiscal years. Such quotations represent inter-dealer prices without retail mark-ups, mark-downs, or commissions and, accordingly, may not represent actual transactions.

| Quarter Ended    | Fiscal 2002 |        | Quarter Ended    | Fiscal 2001 |
|------------------|-------------|--------|------------------|-------------|
|                  | High        | Low    |                  | High        |
| July 31, 2001    | \$1.76      | \$0.47 | July 31, 2000    | \$2.68      |
| April 30, 2001   | \$2.29      | \$1.58 | April 30, 2000   | \$1.81      |
| January 31, 2001 | \$2.55      | \$1.85 | January 31, 2000 | \$4.03      |
| October 31, 2000 | \$3.47      | \$1.90 | October 31, 1999 | \$2.70      |

- (3) Security Holders: As of October 25, 2002, we had approximately 201 holders of record of our common stock. This does not include beneficial owners holding common stock in street name. The closing price per share on October 25, 2002 was \$0.40.
- (4) Dividend Plans: We have paid no common stock cash dividends and have

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no current plans to do so.

- (5) Preferred Stock: There are no shares of preferred stock presently outstanding.
- (6) Changes in Securities: During the fourth quarter of the fiscal year, we conducted a private placement of common stock and as a result, we issued 261,000 shares of common stock to seven accredited investors at a price of \$1.00 per share. With respect to the sales made, we relied on Section 4(2) of the Securities Act of 1933, as amended. No advertising or general solicitation was employed in offering the securities. The securities were offered solely to accredited or sophisticated investors who were provided all of the current public information available on Innovative Medical Services.

(7) Securities Authorized for Issuance under Equity Compensation Plans

| Plan Category   | Number of securities to<br>be issued upon<br>exercise of outstanding<br>options, warrants and<br>rights<br>(a) | Weighted-average<br>exercise price of<br>outstanding options,<br>warrants and rights<br>(b) | Number of securities<br>remaining available<br>for future issuance<br>under equity compensati<br>on plans (excluding<br>securities reflected<br>in column (a))<br>(c) |
|---|--|---|---|
| Equity<br>compensation plans<br>approved by<br>security holders     | 2,967,295  | 1.85  | 6,427,278   |
| Equity<br>compensation plans<br>not approved by<br>security holders | 1,150,000  | 1.41  | 533,000   |
| <b>Total</b>  | <b>4,117,925</b>   | <b>1.77</b>   | <b>6,960,278</b>  |

### ITEM 6. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Except for the historical information contained herein, the following discussion contains forward-looking statements that are subject to risks and uncertainties. Actual results may differ substantially from those referred to herein due to a number of factors, including but not limited to risks described in the section entitled Competition and elsewhere in this Form 10KSB. Our consolidated financial data includes Export Company of America, Inc., Ampromed Comercia Importacao e Exportacao Ltda., ETI-H2O Corporation, and Nutripure Corporation.

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### Results of Operations Fiscal 2002 vs. Fiscal 2001

During the year, we realized revenues from multiple product lines in our different divisions. In order to be more informative regarding distribution of revenues, discussion of revenues will be in terms of our water treatment segment and our and bioscience segment which includes silver ionization and pesticide divisions.

Revenues of \$3,206,500 in the fiscal year ended July 31, 2002 were 33% higher than the \$2,409,700 in revenues reported for the fiscal year ended July 31, 2001. The increase was due to increases in revenues in all of our company divisions with the addition of new products and increased market penetration of existing products. Water treatment division revenues were \$2,189,000, silver ionization division revenues were \$683,100 and pesticide division sales were \$334,400 in 2002. In 2001, water treatment division revenues were \$2,057,100, silver ionization division revenues were \$320,300 and pesticide division revenues were \$32,200.

Our water treatment division grew 6% during the year and produced the majority of our sales in 2002. We believe that the revenue mix will continue to shift toward the bioscience division products in the coming fiscal year. Although we had expected even more growth in the water treatment division with the addition of the Nutripure dealer program, we anticipate that this division will grow at a quicker pace in the coming year, especially as the water dealer program continues to expand. This market continues to be very competitive, and we expect revenues from our other commercial/retail water treatment products to continue their historic steady growth.

We believe that during fiscal year 2002, we made good progress into our new bioscience markets with the launch of several additions to the Innovex line of pesticide products and increased sales of our Axenohl silver ion technology products.

Revenues in the newly launched pesticide division rose 939% during the year. Since the formal launch of RoachX in October 2001, we have expanded the Innovex division from that one product to a more complete line of pest control products, including RoachX, AntX75, CleanKill, TrapX and Pro's Choice. We believe that during the past year we concluded the majority of the research testing and regulatory approvals for our current Innovex pesticide products; therefore, research and development expenditures for these products should decrease in the coming year. We face significant competition from larger, better capitalized companies in this market, but as we continue to gain industry acceptance of our pesticide products, we expect that revenues will continue to increase rapidly in the coming year.

During the year, revenues from our Axenohl technology rose 113%. The disinfectant market is highly competitive, and we anticipate that market acceptance of a brand new technology may be a long term achievement. In addition to competition challenges, we believe that the investment necessary to pursue research testing and regulatory approval for Axenohl products will continue to be significant. As we receive additional regulatory approvals for Axenohl, however, we expect revenues to develop quickly. For example, we are currently awaiting EPA approval on the Clean Kill 30-part per million formulation of Axen. We believe that approval is imminent, and we also believe that upon receipt of that approval, sales of Clean Kill 30 will have a significant impact on revenues in the coming year.

In March 2001, we signed a five-year contract to provide Axenohl to Dodo & Company, a Korean cosmetics manufacturer and marketer. Under the contract, Dodo & Company would purchase approximately \$1.2 million dollars of product from us over five years. In addition to the purchase price, the contract calls for us to receive a reimbursement for research and development and a royalty on sales of



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the Axen-containing products. The contract requires Dodo & Company to obtain appropriate regulatory clearances in South Korea, but we have no documentation to show that this has been completed. We believe that Dodo & Company has miscalculated the royalties due to us, and we have requested that Dodo & Company reevaluate their royalty calculations. Dodo & Company has requested a renegotiation of the contract including the royalty fee calculation. During the year, Dodo & Company has continued to expand its A-Clinic Club line to include over 10 different products, all of which contain Axenohl as an active ingredient. Because of Dodo & Company's significant investment in the product line, we believe we will be able to renegotiate the contract to the satisfaction of both parties. Until this matter is resolved, however, we are unlikely to ship additional product to Dodo & Company.

Although we think that the pesticide technologies will have the most immediate material impact on revenues in the coming year, we continue to believe that the silver ion technologies will ultimately become the largest revenue generator for Innovative Medical Services.

Gross profit for the year ended July 31, 2002 was \$1,607,900 versus \$1,047,100 in 2001. Gross profit percentage of 50% in 2002 was higher versus 43% in 2001. The increase in gross profit percentage was largely due to higher margins associated with our pesticide and silver ion technology product lines.

Loss from continuing operations for the year ended July 31, 2002 was \$2,029,100 versus net loss from continuing operations of \$1,821,300 for the same period in 2001. During the year, General and Administrative expenses increased 28% or \$443,300 from \$1,584,600 in fiscal 2001 to \$2,027,900 in fiscal 2002 because of increased costs associated with developing and marketing the water dealer program as well as the emerging silver ion and pesticide divisions. Loss from continuing operations also included expenses for start-up costs of \$47,800 for the year ended July 31, 2002 and \$230,000 for the year ended July 31, 2001. These costs were capitalized as Deferred Acquisition Costs and then written off as Abandoned Projects before the restatement described in Note 2 of the financial statements.

Selling expense decreased approximately \$32,500, or 4%, from \$781,800 in 2001 to \$749,300 in 2002 due primarily to a decrease in sales personnel. Research and Development costs increased 166%, or \$487,500, over the prior year rising from \$293,000 in 2001 to \$780,500 in 2002. This increase was the result of continued time and resources devoted to the development and testing of our emerging pesticide and silver ion technology product lines.

During the year, we incurred a loss from discontinued operations of Nutripure.com of \$193,500. For the fiscal year 2001, \$205,200 of the General and Administrative expenses have been reclassified in the prior year to Loss from Discontinued Operations as required by APB Opinion No. 30. Nutripure.com was an e-commerce website that provided consumers a wide variety of vitamins, minerals, nutritional supplements, homeopathic remedies and natural products. In December 2001, Bergen Brunswig Corporation requested we release it from its contract to provide the vitamins, minerals, nutritional supplements, homeopathic remedies and natural products sold on our Nutripure.com website. We agreed, and, therefore, on January 15, 2002, Bergen Brunswig Corporation terminated the distribution license for these products. As a result, we have closed our e-commerce division. Sales to date from the e-commerce division have not been material and closing the e-commerce division resulting in cost savings of approximately \$35,000 per quarter in maintenance and service fees, amortization and labor costs.

### Liquidity and Capital Resources Fiscal 2002 vs. 2001

From inception through July 31, 2002, we have financed our operations primarily through our initial public offering in August of 1996, by a subsequent private

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placement in March of 2000, and by other smaller private placement stock sales. We have no long-term debt and have no plans to obtain long-term financing in the next twelve months. We believe that sales from our new product lines will not provide sufficient capital resources to sustain operations and fund product development until fiscal year 2003. In the short term, we expect to raise capital through equity sales as necessary to fund future growth until we operate above the break-even point. We continually evaluate opportunities to sell additional equity or debt securities, or obtain credit facilities from lenders to strengthen our financial position. The sale of additional equity or convertible debt securities could result in additional dilution to our stockholders.

During the fiscal year ended July 31, 2002, our current assets to liabilities ratio decreased from 2.98 to 1.07. Current assets decreased \$620,200 from \$1,911,400 to \$1,291,200. The decrease was mainly due to a decrease in accounts receivable of \$404,100 from \$570,700 in 2001 to \$166,600 in 2002. The decrease was the result of lower sales volume in July of 2002 compared to July of 2001 and to a concentrated effort to collect outstanding receivables in a more efficient and timely manner. Inventories decreased \$115,900 from \$711,000 in fiscal 2001 to \$595,100 in fiscal 2002 which reflects a changing product mix and more efficient purchasing. Noncurrent assets increased by \$1,382,900 during the year. This change was mainly the result of the combination of purchases of patents and licenses of \$1,612,100 and the decrease of \$277,800 of deferred acquisition costs during the current year. Most of the increase in patents and licenses was for the acquisition of the Axenohl patent which was purchased for 700,000 shares of our common stock valued at \$1,540,600. The deferred acquisition costs were written off as abandoned projects during the year. Current liabilities increased \$569,300 from \$640,700 to \$1,201,000. The increase in current liabilities was the result of an increase in notes payable of \$500,000. The note payable was drawn against a \$500,000 credit line we established during the period, which was secured against our accounts receivable. The terms of the line of credit required us to maintain current accounts receivable of a minimum of \$500,000. At the end of the fiscal year, we were in technical violation with this provision. We renegotiated the line of credit in September of 2002 and extended the line of credit to \$600,000 with an interest rate of 1 1/2 % per month secured against our entire assets excluding the Axenohl patent.

Our liquidity is unaffected by the financing program offered to participating dealers in the Nutripure water dealer program. We receive funds from our lender and disperse the funds to the dealer, less a commission charged by us, upon completion of the contract. The lender disperses funds to us. We record a liability when the funds are received and relief of liability when funds are dispersed, and we do not retain liability on the credit extended.

Cash flows used from continuing operations were \$1,035,300 in fiscal year 2002 and \$1,559,000 in 2001. For fiscal year 2002 cash flows used in investing activities included \$165,200 for the purchase of machinery and equipment and \$59,100 for the cash purchase of patents and licenses. In fiscal 2001 cash flows used in investing activities included \$40,300 for the purchase of machinery and equipment and for and \$621,100 for the purchase of patents and licenses. Also, we incurred \$47,800 and \$230,000 in start-up costs during fiscal 2002 and fiscal 2001 respectively. The start-up costs of were expensed and are included in cash flows used from continuing operations. Cash flows from financing activities were \$1,216,200 in fiscal 2002 and \$1,272,400 in fiscal 2001. Financing activities for the current period included the addition of \$500,000 in notes payable from a line of credit established in September 2001. Cash flows from financing activities also included an increase of common stock of \$716,200 which included a \$400,000 private placement in which we issued 250,000 shares of common stock to eleven accredited investors at a price of \$1.60 per share. In addition, during the fourth quarter of the fiscal year, we conducted a private placement of common stock and as a result, issued 261,000 shares of common stock to seven

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accredited investors at a price of \$1.00 per share. With respect to the sales made, we relied on Section 4(2) of the Securities Act of 1933, as amended. No advertising or general solicitation was employed in offering the securities. In addition, we issued 200,000 shares of common stock for services during the fourth quarter of 2002 at \$0.50 per share. We received approximately \$68,000 from the exercise of options during the period. In the prior period, cash flows from financing activities also included the following:

1. A \$250,000 private placement in October 2000 in which we issued 94,340 shares of common stock to six investors at \$2.65 per Unit.
2. A \$250,000 private placement in January 2001 in which we issued 83,334 shares of common stock to six investors at \$3.00 per Unit. Each Unit contained one share of common stock and a warrant to acquire an additional share of common stock for \$4.00 per share up to January 28, 2003.
3. A \$225,000 private placement in April 2001 in which we issued 150,000 shares of common stock to four investors at \$1.50 per Unit. As part of this registration we also issued \$200,000 of convertible debentures at 10% interest due July 31, 2001. The holders of this debenture are entitled to convert all or any amount over \$10,000 of principal face amount and accrued interest into Units each consisting of one share of Common Stock and a Common Stock Purchase Warrant. The conversion price for each Unit shall equal 80% of the average closing bid price for the five trading days immediately preceding the receipt of Notice of Conversion. The debentures were converted to common stock on July 31, 2001.
4. In addition, approximately \$245,135 was received from exercise of outstanding stock options. The total decrease in cash and cash equivalents for 2002 was \$55,800 as compared to a decrease of \$914,200 during the same period in 2001.

### Controls and Procedures

The Company maintains disclosure controls and procedures that are designed to ensure that information required to be disclosed in the Company's Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to the Company's management, including its Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure based closely on the definition of "disclosure controls and procedures" in Rule 13a-14(c). In designing and evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

Within 90 days prior to the date of this report, the Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and the Company's Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures. Based on the foregoing, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective.

There have been no significant changes in the Company's internal controls or in other factors that could significantly affect the internal controls subsequent to the date the Company completed its evaluation.

INNOVATIVE MEDICAL SERVICES

CONSOLIDATED FINANCIAL STATEMENTS

For the Years Ended July 31, 2002 and July 31, 2001

Independent Accountants' Report

Board of Directors  
Innovative Medical Services

We have audited the accompanying consolidated balance sheets for Innovative Medical Services as of July 31, 2002 and 2001, and the related consolidated statements of operations, statement of accumulated deficits and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit 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.

The accompanying financial statements as of July 31, 2002 and 2001 and for the years then ended have been restated to correct errors as described in Note 2.

In our opinion, the consolidated financial statements, referred to above, present fairly, in all material respects, the financial position of Innovative Medical Services as of July 31, 2002 and July 31, 2001, and the results of its operations and its cash flows for the years then ended, in conformity with generally accepted accounting principles in the United States of America.

/s/ Miller and McCollom

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MILLER AND MCCOLLOM, CPAs  
4350 Wadsworth Boulevard, Suite 300  
Wheat Ridge, Colorado

October 27, 2002, except for the third paragraph above and Note 2, which is as of June 13, 2003

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CONSOLIDATED BALANCE SHEETS

|   | 2002<br>Restated<br>(Note 2) | 2001<br>Restated<br>(Note 2) |
|---|------------------------------|------------------------------|
|   | -----                        | -----                        |
| ASSETS  |                              |                              |
| Current Assets  |                              |                              |
| Cash and cash equivalents   | \$ 151,257                   | \$ 207,092                   |
| Accounts receivable, net of allowance for doubtful<br>accounts of \$ 111,000 at July 31, 2002<br>and \$115,000 at July 31, 2001                             | 166,601                      | 570,734                      |
| Due from officers and employees   | 209,437                      | 240,001                      |
| Inventories   | 595,071                      | 711,018                      |
| Prepaid expenses  | 177,445                      | 182,555                      |
|   | -----                        | -----                        |
| Total current assets  | 1,299,811                    | 1,911,399                    |
|   | -----                        | -----                        |
| Property, Plant and Equipment   |                              |                              |
| Property, plant and equipment   | 613,909                      | 903,072                      |
|   | -----                        | -----                        |
| Total property, plant and equipment   | 613,909                      | 903,072                      |
|   | -----                        | -----                        |
| Noncurrent Assets   |                              |                              |
| Deposits  | 8,955                        | 8,127                        |
| Patents and licenses  | 2,626,376                    | 1,014,282                    |
|   | -----                        | -----                        |
| Total noncurrent assets   | 2,635,330                    | 1,022,409                    |
|   | -----                        | -----                        |
| Total assets  | \$ 4,549,050                 | \$ 3,836,881                 |
|   | =====                        | =====                        |
| LIABILITIES AND STOCKHOLDERS EQUITY   |                              |                              |
| Current Liabilities   |                              |                              |
| Accounts payable  | \$ 591,031                   | \$ 543,992                   |
| Accrued liabilities   | 118,975                      | 96,691                       |
| Loans from shareholders   | 500,000                      | --                           |
|   | -----                        | -----                        |
| Total current liabilities   | 1,210,006                    | 640,683                      |
|   | -----                        | -----                        |
| Stockholders' Equity  |                              |                              |
| Class A common stock, no par value: authorized<br>50,000,000 shares, issued and outstanding<br>8,400,899 at July 31, 2002 and<br>6,954,699 at July 31, 2001 | 13,976,448                   | 11,619,665                   |
| Warrants: issued and outstanding 15,000 warrants  | 8,610                        | --                           |
| Accumulated deficit   | (10,646,014)                 | (8,423,467)                  |
|   | -----                        | -----                        |
| Total stockholders' equity  | 3,339,044                    | 3,196,198                    |

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|  |              |              |
|--|--------------|--------------|
| Total liabilities and stockholders' equity | \$ 4,549,050 | \$ 3,836,881 |
|--|--------------|--------------|

The accompanying notes are an integral part of these financial statements.

CONSOLIDATED STATEMENTS OF OPERATIONS

|  | For the Years Ended        |                            |
|--|----------------------------|----------------------------|
|  | July 31                    |                            |
|  | 2002<br>Restated<br>Note 2 | 2001<br>Restated<br>Note 2 |
| Net revenues   | \$ 3,206,448               | \$ 2,409,721               |
| Cost of sales  | 1,598,553                  | 1,362,670                  |
| Gross profit   | 1,607,895                  | 1,047,051                  |
| Selling expenses   | 749,348                    | 781,810                    |
| General and administrative expenses                                    | 2,027,875                  | 1,584,591                  |
| Research and development   | 780,510                    | 292,964                    |
| Start-up Costs   | 47,831                     | 230,000                    |
| Total operating costs  | 3,605,563                  | 2,889,365                  |
| Loss from operations   | (1,997,668)                | (1,842,314)                |
| Other income and (expense):  |                            |                            |
| Interest income  | 9,999                      | 33,738                     |
| Interest Expense   | (39,024)                   | (11,100)                   |
| Other  | (2,400)                    | (1,600)                    |
| Total other income (expense)   | (31,425)                   | 21,038                     |
| Loss from continuing operations before minority interest in subsidiary | (2,029,093)                | (1,821,276)                |

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|   |                |                |
|---|----------------|----------------|
| Minority interest in subsidiary operations    | --             | 14,972         |
| Loss from continuing operations               | (2,029,093)    | (1,806,304)    |
| Discontinued operations:                      |                |                |
| Loss from discontinued operations             | 152,405        | 205,191        |
| Loss from disposal of discontinued operations | 41,049         | --             |
| Total discontinued operations                 | 193,454        | 205,191        |
| Net loss                                      | \$ (2,222,547) | \$ (2,011,495) |
| Net loss per common share, basic and diluted  |                |                |
| Continuing operations                         | \$ (0.27)      | \$ (0.28)      |
| Discontinued operations                       | (0.02)         | (0.03)         |
| Net loss                                      | \$ (0.29)      | \$ (0.31)      |

The accompanying notes are an integral part of these financial statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS

|   | 2002<br>Restated<br>Note 2 | For t |
|---|----------------------------|-------|
| Cash flows from operating activities  |                            |       |
| Net loss  | \$ (2,222,547)             |       |
| Adjustments to reconcile net income to net cash provided by operating activities: |                            |       |
| Amortization  | 187,870                    |       |
| Depreciation  | 266,530                    |       |
| Minority interest in subsidiary operations  | -                          |       |
| Services paid for with stock  | 100,000                    |       |
| Changes in assets and liabilities:  |                            |       |
| (Increase) decrease in restricted cash  | -                          |       |

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|  |             |
|--|-------------|
| (Increase) decrease in accounts receivable                             | 404,133     |
| (Increase) decrease in due from officers and employees                 | 30,564      |
| (Increase) decrease in prepaid expense                                 | 5,110       |
| (Increase) decrease in inventory                                       | 115,947     |
| (Increase) decrease in deposits  | (827)       |
| (Increase) decrease in goodwill  | -           |
| (Increase) decrease in intangible assets                               | -           |
| Increase (decrease) in accounts payable                                | 47,039      |
| Increase (decrease) in accrued liabilities                             | 22,283      |
|  | -----       |
| Net cash provided (used) by operating activities                       | (1,035,287) |
|  | -----       |
| Cash flows from investing activities                                   |             |
| Purchase of patents and licenses                                       | (71,495)    |
| Purchase of property, plant and equipment                              | (165,236)   |
|  | -----       |
| Net cash (used) in investing activities                                | (236,731)   |
|  | -----       |
| Cash flows from financing activities                                   |             |
| Proceeds from debt obligations   | 500,000     |
| Payments on debt obligations   | -           |
| Proceeds from sale of common stock                                     | 716,183     |
|  | -----       |
| Net cash provided by financing activities                              | 1,216,183   |
|  | -----       |
| Net increase (decrease) in cash and cash equivalents                   | (55,835)    |
|  | -----       |
| Cash and cash equivalents at beginning of period                       | 207,092     |
|  | -----       |
| Cash and cash equivalents at end of period                             | \$ 151,257  |
|  | =====       |
| Supplemental disclosures of cash flow information                      |             |
| Cash paid for interest paid  | \$ 39,024   |
| Cash paid for taxes paid   | \$ 2,400    |
| Noncash investing and financing activities:                            |             |
| Value of shares issued in exchange for Silver Ion Technology patent    | \$1,540,600 |
| Value of shares issued for services                                    | \$ 100,000  |
| Value of options issued for services                                   |             |
| Value of shares issued in exchange for Nutripure.com minority interest |             |
| Value of shares issued in exchange for ETI H2O                         |             |

The accompanying notes are an integral part of these financial statements.



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## Innovative Medical Services Notes to Consolidated Financial Statements

See Independent Accountants' Report

### Note 1. Organization and Summary of Significant Accounting Policies

This summary of significant accounting policies of Innovative Medical Services is presented to assist in understanding the Company's financial statements. The financial statements and notes are representations of the Company's management who is responsible for their integrity and objectivity. These accounting policies conform to generally accepted accounting principles in the United States of America and have been consistently applied in the preparation of the financial statements. The financial statements are stated in United States of America dollars.

#### Organization and Business Activity

Innovative Medical Services was incorporated in San Diego, California on August 24, 1992 as a provider of pharmaceutical water purification products. Based on revenues, the Company's primary business is the sale and manufacture of residential and commercial water filtration systems. In addition, the Company produces, manufactures and licenses silver ion bioscience technologies (Axenohl and Axen) and produces products for the pesticide industry (Innovex).

In October of 1998, the Company formed a subsidiary, EXCOA Nevada to purchase the assets of Export Company of America, Inc. (EXCOA), a privately held Fort Lauderdale, Florida-based distributor of disposable medical, dental and veterinary supplies. The major asset of this company was its 45% interest in Ampromed Comercio Importacao E Exportacao Ltda (AMPROMED), a Rio de Janeiro-based import company that sells medical, dental and veterinary supplies and water filtration products to practitioners, retail outlets and government agencies. The Company acquired the remaining 55% interest in AMPROMED from a private individual and transferred it to EXCOA Nevada.

In December 1999, the Company incorporated NUTRIPURE.COM in the state of Nevada to pursue the creation of a health products e-commerce website. The Company discontinued operation of the website in January of 2002.

In November 2000, Innovative Medical Services acquired 100% of the stock of ETIH2O, Inc, a privately held technology corporation that developed Axenohl and is responsible for processing, and production of Axenohl and Axen. ETI-H2O is also responsible for all supervision of all research, studies, data and quality control of the Axenohl/Axen product line.

#### Basis of Presentation and Principles of Consolidation

The accompanying financial statements include the consolidated accounts of Innovative Medical Services and its subsidiaries. All inter-company balances and transactions have been eliminated.

#### Revenue Recognition

Generally, the company recognizes income based upon concluded arrangements with customers and when all events have occurred by delivery or performance. Certain income is recognized upon shipment where the sale is made f.o.b. shipping point including sales to dealers and pharmacists. Customer acceptance provisions and installation procedures accompanying delivery are minor in nature, and the Company has not experienced any material expense in satisfying warranties and

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returns.

The Company has a program of providing financing to independent dealers for equipment of other manufacturers and not the Company's products. The Company receives funds from its primary lender and disperses the funds to the dealer, less a commission charged by the Company, upon completion of the contract. The Company records the commissions earned as revenues when received.

Most of the Company's chain customers have entered into multi-year contracts for the Customer Service Plan 2000. The CSP 2000 provides an extended warranty on Innovative Medical Services Fillmaster pharmacy products; significant discounts on maintenance item costs; free software upgrades for the Fillmaster 1000e and Scanmaster; automatic replacement filter shipments; and simplified, annual invoicing. When the customer buys a dispenser on the Customer Service Plan 2000 they agree to pay a fixed annual fee that covers replacement filters and parts. The filters should be replaced once a year. In order to match income with related costs (and for simplicity in accounting and billing) the Company bills the customer the annual fee, and recognizes the revenue, in the same month that it ships the replacement filters to the store. This is done one year after the store is added to the Plan and each year thereafter. Future warranty costs associated with the CSP 2000 Plan are discussed in Note 18. Accounts Receivable The Company sells on terms of cash or net 30 days. Invoices not paid within stated terms are considered delinquent. The Company analyzes its accounts receivable periodically and recognizes an allowance for doubtful accounts based on estimated collectibility. Individual accounts deemed uncollectible are charged to the allowance.

### Stock-Based Compensation

The Company follows FASB Statement No. 123, 'Accounting for Stock-Based Compensation' ('FAS 123'). The provisions of FAS 123 allow companies to either expense the estimated fair value of stock options or to continue to follow the intrinsic value method set forth in APB Opinion 25, 'Accounting for Stock Issued to Employees' ('APB 25') but disclose the pro forma effects on net income (loss) had the fair value of the options been expensed. The Company has elected to continue to apply APB 25 in accounting for its stock option plans. For awards that generate compensation expense as defined under APB 25, the Company calculates the amount of expenses and recognizes the expense over the vesting period of the award.

In March 2000, the FASB issued FASB Interpretation No. 44, 'Accounting for Certain Transactions Involving Stock Compensation' ('FIN 44'), which contains rules designed to clarify the application of APB 25. FIN 44 became effective on July 1, 2000 at which time the Company adopted it. The impact of the adoption of FIN 44 was not material to the earnings or financial position of the Company.

### Research and Development

Research and development costs that have no alternative future uses are charged to operations when incurred and are included in operating expenses. The total amount charged to Research and Development expense was \$780,500 and \$293,000 in the fiscal years ended July 31, 2002 and 2001, respectively.

### Depreciation Method

The cost of property, plant and equipment is depreciated on a straight-line basis over the estimated useful lives of the related assets. The useful lives of property, plant, and equipment for purposes of computing depreciation are:

|                         |            |
|-------------------------|------------|
| Computers and equipment | 7.0 years  |
| Furniture and fixtures  | 10.0 years |

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|         |                        |
|---------|------------------------|
| Website | 3.0 years              |
| Vehicle | 5.0 years to 7.0 years |

Leasehold improvements are being depreciated over the life of the lease, which is equal to 120 months.

### Amortization of Intangible Assets

The cost of patents acquired is amortized on a straight-line basis over the remaining lives of the patents. Licenses are amortized on a straight-line basis over periods ranging from 15 to 20 years. The weighted average amortization period for all patents and licenses is 17.71 years. The estimated amortization expense over each of the next five years is \$145,700.

Amortization expense for the years ended July 31, 2002 and July 31, 2001 was \$187,900 and \$97,000, respectively.

### Long-Lived Assets

In accordance with Financial Accounting Standards Board ("FASB") Statement of Financial Accounting Standards ("SFAS") No. 121, Accounting for Impairment of Long-Lived Assets, and for Long-Lived Assets to be Disposed, the Company periodically analyzes its intangible assets and long-lived assets for potential impairment, assessing the appropriateness of lives and recoverability of unamortized balances through measurement of undiscounted operation cash flows on a basis consistent with accounting principles generally accepted in the United States of America.

### Inventory

Inventories are stated at the lower of cost or net realizable value using the average cost method. Inventories at July 31 consisted of:

|                  | 2002       | 2001       |
|------------------|------------|------------|
|                  | -----      | -----      |
| Finished Goods   | \$ 257,600 | \$ 246,400 |
| Work in Progress | 29,900     | 150,800    |
| Raw Materials    | 334,600    | 313,800    |
|                  | -----      | -----      |
|                  | \$ 622,100 | \$ 711,000 |
|                  | -----      | -----      |

### Use of Estimates

The preparation of the financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

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### Fair Value of Financial Instruments

The carrying amounts for cash equivalents, receivables, and payables approximate fair value because of the short maturity, generally less than three months, of these instruments. The carrying value of the Company's line of credit approximates fair value since the current borrowing rates available for financing are similar in terms.

### Advertising and Promotional Costs

Cost of advertising and promotion are expensed as incurred. Such costs were \$448,800 and \$276,500 for the years ended July 31, 2002 and July 31, 2001, respectively. Deferred Acquisition Costs The Company capitalizes costs incurred to evaluate and acquire other businesses and technologies. If the acquisitions are successful these costs are reclassified as a cost of the investment or expensed as loss on abandoned projects when the acquisitions are not successful. Deferred costs were zero at July 31, 2002 and \$230,000 at July 31, 2001.

### Net Income (Loss) Per Common Share

The Company adopted FASB Statement No. 128, Earnings Per Share ("SFAS 128"), which is effective for periods ending after December 15, 1997. Entities that have only common stock outstanding are required to present basic earnings per share amounts. All other entities are required to present basic and diluted per share amounts. Diluted per share amounts assume the conversion, exercise or issuance of all potential common stock instruments unless the effect is to reduce a loss or increase the income per common share from continuing operations.

Following is a reconciliation of the weighted average number of shares actually outstanding with the number of shares used in the computations of loss per common share:

|   | For the Years Ended<br>July 31, 2002 | July 31, 2001  |
|---|--------------------------------------|----------------|
|   | -----                                | -----          |
| Shares outstanding  | 8,400,899                            |                |
| Weighted average number of shares<br>actually outstanding | 7,607,146                            |                |
| Stock Options   | 3,691,250                            |                |
| Warrants  | 0                                    |                |
|   | -----                                | -----          |
| Total weighted average shares                             | 11,298,396                           | 11,298,396     |
|   | -----                                | -----          |
| Loss from continuing operations                           | (2,251,439)                          | (2,251,439)    |
| Loss from discontinued operations                         | (193,454)                            | (193,454)      |
|   | -----                                | -----          |
| Net loss  | \$ (2,444,893)                       | \$ (2,444,893) |
|   | -----                                | -----          |
| Net loss per common share, basic<br>and diluted           |                                      |                |
| Continued operations                                      | \$ (0.30)                            | \$ (0.30)      |
| Discontinued operations                                   | (0.02)                               | (0.02)         |
|   | -----                                | -----          |
| Net loss  | \$ (0.32)                            | \$ (0.32)      |
|   | =====                                | =====          |

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On August 8, 2001, all outstanding warrants expired without exercise.

### Recent Accounting Pronouncements

In July 2001, the FASB issued Statement of Financial Accounting Standards No. 141, "Business Combinations" ("SFAS 141") and Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets" ("SFAS 142"). SFAS 141 requires all business combinations to be accounted for using the purchase method of accounting and is effective for all business combinations initiated after June 30, 2001. SFAS 142 requires goodwill to be tested for impairment under certain circumstances, and written off when impaired, rather than being amortized as previous standards required. SFAS 142 is effective for fiscal years beginning after December 15, 2001. Early application is permitted for entities with fiscal years beginning after March 15, 2001 provided that the first interim period financial statements have not been previously issued. The adoption of SFAS's 141 and 142 did not have a material effect on the Company's operating results or financial condition.

### Income Taxes

The Company records deferred taxes in accordance with Statement of Financial Accounting Standards (SFAS) No. 109, "Accounting for Income Taxes." The statement requires recognition of deferred tax assets and liabilities for temporary differences between the tax bases of assets and liabilities and the amounts at which they are carried in the financial statements, based upon the enacted tax rates in effect for the year in which the differences are expected to reverse. A valuation allowance is established when necessary to reduce deferred tax assets to the amount expected to be realized.

### Other

The Company's fiscal year end is July 31.

The Company paid no cash dividends during the periods presented.

Shipping and handling costs payable by the Company are charged to cost of sales.

Certain comparative figures have been reclassified to conform to the current year presentation.

All of the Company's assets are located in the United States.

### Note 2. Restatement of Financial Statements - Start-up Costs and Warranty Liability

The accompanying financial statements have been restated to correct an error in the recording and reporting of Start-up Costs and the Warranty Liability of the Company.

The Company expended \$230,000 during the year ended July 31, 2001 and an additional \$47,831 during the July 31, 2002 fiscal year in an effort to acquire and setup a Korean corporation. The Company capitalized these costs as Deferred Acquisition costs as incurred. The Company later determined the venture was not feasible and decided not to go forward with the project. The total costs of \$277,831 were written-off as Abandoned Projects at July 31, 2002. We now believe the treatment of these costs was not correct. The accompanying financial statements now show these costs as expensed when incurred as Start-up Costs. The effect of this restatement is to increase the net loss at July 31, 2001 by \$230,000 and to decrease the net loss at July 31, 2002 by \$230,000.

In previous years the Company had not recorded a liability for its future

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warranty obligation. Because the Company has now computed and booked this liability the accompanying financial statements have been restated to include this obligation. The warranty liability was \$34,520 at July 31, 2000 and is shown in the Equity and Common Stock footnote (Note 8) as a prior period adjustment. A liability of \$33,791 at July 31, 2001 and \$41,445 at July 31, 2002 are now included in Accrued Liabilities. The income statement effect of these items was to reduce net loss at July 31, 2001 in \$729 and to increase net loss at July 31, 2002 of \$7,654.

The accompanying financial statements also include 15,000 warrants issued for \$8,310 that were omitted from the July 31, 2002 balance sheet in error.

### Note 3. Cash and Cash Equivalents

For purposes of the balance sheets and statements of cash flows, the Company considers all highly liquid investments with a maturity of three months or less when purchased to be cash equivalents. At July 31, 2002, the Company has deposits of \$30,052 in excess of FDIC insured limits. At July 31, 2001, the Company had no deposits in excess of FDIC insured limits.

### Note 4. Due from Officers and Employees (Related Parties)

At July 31, 2002, notes receivable of \$64,075 represents amounts due from officers and \$145,362 represents amounts due from employees. At July 31, 2001, notes receivable of \$66,561 represents amounts due from officers and \$173,440 represent amounts due from employees. Increases in the officer loans during the current year were \$17,644, pay-downs of these loans totaled \$20,100 in the same period. All notes receivable are due and payable within one year. The carrying value of the notes, based on the terms at which those same loans would be made currently, approximate their fair value. All notes in excess of \$10,000 have interest accrued at 6%. Advances to employees of amounts under \$10,000 are not charged interest. The total of these loans to employees of under \$10,000 was \$7,620 at July 31, 2002 and \$15,268 at July 31, 2001.

Notes receivable includes \$32,606 from terminated employees for which the Company is litigating for repayment.

### Note 5. Property, Plant and Equipment

The following is a summary of property, plant, and equipment - at cost, less accumulated depreciation:

|                                | July 31, 2002 | July 31, 2001 |
|--------------------------------|---------------|---------------|
|                                | -----         | -----         |
| Computers and equipment        | \$ 1,076,466  | \$ 1,061,197  |
| Furniture and fixtures         | 103,855       | 103,855       |
| Website                        | 207,916       | 207,916       |
| Vehicle                        | 50,985        | 50,985        |
| Leasehold improvements         | 307,606       | 307,606       |
|                                | -----         | -----         |
|                                | 1,746,828     | 1,731,559     |
| Less: accumulated depreciation |               |               |

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|                  |            |            |
|------------------|------------|------------|
| and amortization | 1,091,870  | 828,487    |
|                  | -----      | -----      |
| Total            | \$ 654,958 | \$ 903,072 |
|                  | -----      | -----      |

Depreciation expense charged to general and administrative expense for the years ended July 31, 2002 and July 31, 2001 was \$266,500 and \$193,500, respectively.

Note 6. Loans from Shareholder The details relating to debt are as follows:

|   | July 31, 2002 | July 31, 2001 |
|---|---------------|---------------|
|   | -----         | -----         |
| Line of Credit (from shareholder)                                   |               |               |
| \$500,000 line of credit, interest at 12%                           |               |               |
| Due and payable September 13, 2002                                  |               |               |
| Secured by accounts receivable                                      | \$ 500,000    | \$ -          |
| Current maturities of notes payable included in current liabilities | 500,000       | -             |
|   | -----         | -----         |
| Total long term debt  | \$ -          | \$ -          |
|   | -----         | -----         |

The terms of the line of credit required the Company to maintain current accounts receivable of a minimum of \$500,000. At the end of year, the Company was in technical violation with this provision. The Company renegotiated the line of credit in September of 2002 and extended the line of credit to \$600,000 with an interest rate of 1 1/2 % per month secured against the entire assets of the Company excluding the Axenohl patent.

Note 7. Commitments

On May 14, 1996, the Company entered into an operating lease agreement for its home office which expires (under extension) in October 2006. The lease includes a yearly increase of 4%. The rental expense recorded in general and administrative expenses for the years ended July 31, 2002 and July 31, 2001 was \$144,348 and \$133,968, respectively. Future minimum rental payments required for each of the 5 succeeding years assuming exercise of the option are as follows:

| Year Ended July 31 | Amount    |
|--------------------|-----------|
| -----              | -----     |
| 2003               | \$144,348 |
| 2004               | \$150,122 |
| 2005               | \$156,127 |
| 2006               | \$162,372 |
| 2007               | \$ 37,970 |

The Company has an employment contract with its Chief Executive Officer/President which includes a provision for him to be paid an amount equal to 3% of the Company's net income before taxes, if any.

During the year the Company acquired the patent for Axenohl, a silver ion based technology (Note 14). The Company agreed to pay royalties in the amount of 5% of

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gross Axenohl sales until March 2018, the end of the life of the patent. There are minimum royalties due of \$1,000,000 for the period of November 2001 to July 31, 2004 and for each fiscal year thereafter. Future minimum royalty payments required for each of the 5 succeeding years are as follows:

| Year Ended July 31<br>----- | Amount<br>----- |
|-----------------------------|-----------------|
| 2003                        | \$ 0            |
| 2004                        | \$1,000,000     |
| 2005                        | \$1,000,000     |
| 2006                        | \$1,000,000     |
| 2007                        | \$1,000,000     |

The maximum royalty payments cannot be estimated because they are based on future sales.

### Note 8. Equity and Common Stock

The following schedule summarizes the change in equity:

|  | Common<br>Stock<br>Shares<br>----- | Common<br>Stock<br>\$<br>----- | Warrants<br>Issued<br>----- | Warrants<br>\$<br>----- | Accumu<br>Defi<br>----- |
|--|------------------------------------|--------------------------------|-----------------------------|-------------------------|-------------------------|
| Balance, July 31, 2000                     | 5,942,903                          | \$10,018,873                   | 4,472,500                   | \$ 108,750              | \$(6,3                  |
| Prior Period<br>Adjustment<br>(See Note 2) |                                    |                                |                             |                         | (                       |
| Sale of Stock                              | 180,967                            | 431,814                        |                             |                         |                         |
| Private Placement                          | 421,314                            | 851,158                        |                             |                         |                         |
| Options Issued for<br>Services             | 64,500                             | 209,070                        |                             |                         |                         |
| Stock Dividends                            | 121,961                            |                                |                             |                         |                         |
| Acquisitions                               | 223,054                            |                                |                             |                         |                         |
| Net Loss                                   | 0                                  | 0                              | 0                           | 0                       | (2,0                    |
| Balance, July 31, 2001                     | 6,954,699                          | \$11,510,915                   | 4,472,500                   | 108,750                 | \$(8,4                  |
| Sale of Stock                              | 35,200                             | 75,183                         |                             |                         |                         |
| Private Placement                          | 511,000                            | 641,000                        |                             |                         |                         |
| Shares Issued for                          |                                    |                                |                             |                         |                         |



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|                              |           |              |             |           |             |
|------------------------------|-----------|--------------|-------------|-----------|-------------|
| Services                     | 200,000   | 100,000      |             |           |             |
| Warrants Issued for Services |           |              | 15,000      | 8,610     |             |
| Expiration of Warrants       |           | 108,750      | (4,472,500) | (108,750) |             |
| Purchase of Patents          | 700,000   | 1,540,600    |             |           |             |
| Net Loss                     | 0         | 0            | 0           | 0         | (2,000)     |
|                              | -----     | -----        | -----       | -----     | -----       |
| Balance, July 31, 2002       | 8,400,899 | \$13,976,448 | \$ 15,000   | \$ 8,610  | \$ (10,000) |
|                              | =====     | =====        | =====       | =====     | =====       |

The Company had issued Class A warrants which entitled the holder to acquire an additional common share for \$5.25 per common share beginning August 8, 1997 and expiring August 8, 2001. The Class A Warrants were redeemable by the Company for \$0.05 per warrant, at the Company's option, commencing one year after the effective date of the offering provided the closing bid price for the Company's common shares shall have averaged in excess of \$9.00 per share for thirty consecutive business days ending within five days of the date of notice of redemption.

The Company had issued Class Z warrants which entitled the holder to acquire an additional common share for \$10.00 per common share beginning August 8, 1998 and expiring August 8, 2001. The Class Z Warrants were redeemable by the Company for \$0.10 per warrant, at the Company's option, commencing one year after the effective date of the offering provided the closing bid price for the Company's common shares shall have averaged in excess of \$15.00 per share for thirty consecutive business days ending within five days of the date of notice of redemption.

The Company also has 5,000,000 shares of preferred stock authorized, no preferred stock has been issued.

On August 8, 2001 the total 3,687,500 Class A warrants and the total 785,000 Class Z warrants expired without exercise.

On October 26, 2000, Innovative Medical Services distributed a dividend of one share of Innovative Medical Services' common stock for every fifty shares held of record on November 6, 2000, with fractional shares rounded up to the nearest whole share, for a total of 121,961 shares. ARB 43 specifies that stock dividends in small percentages are to be accounted for by transferring an appropriate amount from earned surplus to permanent capital. The Company has no earned surplus, and therefore the Company did not feel this accounting was possible or appropriate. Nor could we find any basis or authority for charging the dividend to the accumulated deficit account. Therefore the Company has accounted for the dividend as a recapitalization with no dollar entries made to capital accounts since the Company has no-par stock. The amount that would have been charged to Earned Surplus and credited to Paid in Capital would have been the 121,961 shares multiplied by market price of the stock at the time (approximately \$3.00 per share) or \$356,883.

Note 9. Related Party Transactions

See Note 4.

Note 10. Stock Option Plans

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The Company has the following stock option plans (the Plans) pursuant to which options to acquire common stock have been granted.

1996 Incentive Stock Option Plan: Approved by Shareholders in April, 1996 with 1,000,000 shares authorized under this Plan. The options have a five-year term with vesting ratably over a five-year period.

1996 Directors and Officers Stock Option Plan: Adopted by the Board in April, 1996 with 1,000,000 shares authorized under this Plan. The maximum number of shares subject to options granted under this Plan to any one Director or Officer shall not exceed 200,000 shares in any 12-month period. The options have a five-year term with vesting ratably over a five-year period.

Amended 1998 Directors and Officers Stock Option Plan: Approved by Shareholders in December, 1998 with 2,000,000 shares authorized under this Plan. The maximum number of shares subject to options granted under this Plan to any one Director or Officer shall not exceed 200,000 shares in any 12-month period. The options have a five-year term with vesting ratably over a five-year period.

2001 Directors and Officers Stock Option Plan: Approved by Shareholders in January 2001 with 1,000,000 shares authorized under this Plan. The maximum number of shares subject to options granted under this Plan to any one Director or Officer shall not exceed 200,000 shares in any 12-month period. The options have a five-year term with vesting ratably over a five-year period.

2001 ETIH20 Stock Option Plan: Adopted by the Board in January 2001 with 1,000,000 shares authorized under this Plan. The options have a five-year term with vesting ratably over a five-year period.

2001 Consultants and Advisors Stock Option Plan: Adopted by the Board in January 2001 with 500,000 shares authorized under this Plan. The maximum number of shares subject to options granted under this Plan to any one participant shall not exceed 50,000 shares in any 12-month period. The options have a five-year term with vesting ratably over a five-year period.

On March 11, 2002, the Company's shareholders approved the Innovative Medical Services 2002 Employee Incentive Stock Option Plan. The purpose of the Plan is to advance the business and development of the Company and its shareholders by affording to the key employees and non-employee directors of the Company the opportunity to acquire a propriety interest in the Company by the grant of Options to acquire shares of the Company's common stock.

The Options granted are "Incentive Stock Options" within the meaning of Section 422 of the Internal Revenue Code of 1986, as amended, for certain key employees. The Plan is administered by an Administrative Committee whom shall serve a one-year term. Subject to anti-dilution provisions, the Plan may issue Options to acquire up to 4,000,000 shares to Key Employees. The exercise price for Options shall be set by the Administrative Committee but shall not be for less than the fair market value of the shares on the date the Option is granted. The period in which Options can be exercised shall be set by the Administrative Committee not to exceed five years from the date of Grant. The Plan may be terminated, modified or amended by the Board of directors upon the recommendation of the Administrative Committee. The options vest ratably over a five-year period.

On March 11, 2002, the Company's shareholders approved the Innovative Medical Services 2002- Non-Qualified Stock Option Plan. The purpose of the Plan is to advance the business and development of the Company and its shareholders by affording Eligible Plan Participants the opportunity to acquire a propriety interest in the Company by the grant of Options to acquire shares of the Company's common stock. Eligible Plan Participants include the Directors and

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Officers of the Company, consultants, advisors and other individuals deemed by the Compensation Committee to provide valuable services to the Company but who are not otherwise eligible to participate in the Employee Incentive Stock Option Plan.

The Plan is administered by an Administrative Committee whom shall serve a one-year term. The Administrative Committee is composed of the Board's Compensation/Administration Committee. Subject to anti-dilution provisions, the Plan may issue Options to acquire up to 2,000,000 shares to Eligible Plan Participants. The Company will not receive any consideration for the grant of options under the Plan and approximate market value of the shares to be reserved for the plan is \$4,000,000 based upon the average thirty trading day closing price for the Company's common stock for the period ending January 31, 2002. The exercise price for Options shall be set by the Administrative Committee but shall not be for less than the fair market value of the shares on the date the Option is granted. Fair market value shall mean the average of the closing price for ten consecutive trading days at which the Stock is listed in the Nasdaq quotation system ending on the day prior to the date an Option is granted. The period in which Options can be exercised shall be set by the Administrative Committee not to exceed five years from the date of Grant.

The Company estimates a fair value method of accounting for stock-based compensation in accordance with Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" (SFAS 123). In accordance with SFAS 123, the Company has chosen to continue to account for employee stock-based compensation utilizing the intrinsic value method. Accordingly, compensation cost for stock options is measured as the excess, if any, of the fair market price of the Company's stock at the date of grant over the amount an employee must pay to acquire the stock.

Also, in accordance with SFAS 123, the Company has provided footnote disclosure with respect to stock-based employee compensation. The cost of stock-based employee compensation is measured at the grant date based on the value of the award and is recognized over the service period. The value of the stock based award is determined using a pricing model whereby compensation cost is the excess of the fair value of the stock as determined by the model at grant date or other measurement date over the amount an employee must pay to acquire the stock.

The Company accounts for non-employee stock based compensation by recording the fair value of the stock options granted over the anticipated service period.

The effect of applying FAS 123 on the years ended July 31, 2002 and 2001 pro forma net loss as stated below is not necessarily representative of the effects on reported net loss for future years due to, among other things, the vesting period of the stock options and the fair value of additional stock options in future years. Had compensation cost for the Company's stock option plans been determined based upon the fair value at the grant date for awards under the plans consistent with the methodology prescribed under FAS 123, the Company's net loss in the years ended July 31, 2002 and 2001 would have been approximately \$2,856,400 and \$2,420,600 or \$(0.38) per share and \$(0.38) per share, respectively, on a diluted basis. Compensation cost for non-employees of \$27,300 was charged to income in the year ended July 31, 2002 and zero in the year ended July 31, 2001. The weighted average fair value of the options granted during the years ended July 31, 2002 and 2001 are estimated at \$1.13 per share and \$1.22 per share, respectively, on the date of grant using the Black-Scholes option-pricing model. The following assumptions were used for grants in 2002 and 2001; no dividend yield, volatility of 101.48% and 98.79%, respectively; a risk-free interest rate of 5.25% and 5.50%, respectively and an expected life of 2.98 years from date awarded.

A summary of stock option activity is as follows:

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|                          | Number of Shares | Weighted-Average<br>Exercise Price (\$) |
|--------------------------|------------------|---|
|                          | -----            | -----                                   |
| Balance at July 31, 2000 | 2,035,540        | 1.55                                    |
| Granted                  | 997,000          | 2.21                                    |
| Exercised                | (203,824)        | 1.78                                    |
| Forfeited                | (93,750)         | 1.50                                    |
|                          | -----            |   |
| Balance at July 31, 2001 | 2,734,966        | 1.72                                    |
|                          | =====            |   |
| Granted                  | 1,850,000        | 1.56                                    |
| Exercised                | (35,200)         | 1.93                                    |
| Forfeited                | (338,091)        | 1.63                                    |
|                          | -----            |   |
| Balance at July 31, 2002 | 4,21,675         | 1.74                                    |
|                          | =====            |   |

| Range of<br>Exercise<br>Prices | Number<br>Shares<br>Outstanding | Outstanding   |  | Number<br>Exercisable | Exercisable |
|--------------------------------|---------------------------------|---|--|-----------------------|-------------|
|                                |                                 | Weighted<br>Average<br>Remaining Life<br>(in years) | Weighted<br>Average<br>Exercise<br>Price |                       |             |
|                                |                                 |   |  |                       |             |
|                                |                                 |   |  |                       |             |
| \$0.56 to \$0.74               | 635,000                         | 3.49  | \$0.59                                   | 335,000               | \$          |
| \$1.00                         | 533,125                         | 1.81  | \$1.00                                   | 523,125               | \$          |
| \$1.31 to \$1.90               | 547,300                         | 2.39  | \$1.72                                   | 532,500               | \$          |
| \$2.00                         | 1,600,000                       | 3.25  | \$2.00                                   | 1,300,000             | \$          |
| \$2.10 to \$2.50               | 460,000                         | 4.18  | \$2.11                                   | 460,000               | \$          |
| \$2.93 to \$3.56               | 436,250                         | 2.17  | \$3.05                                   | 436,250               | \$          |
|                                | 4,211,675                       | 2.98  | \$1.74                                   | 3,586,875             | \$          |
|                                | =====                           |   |  | =====                 |             |

Note 11. Pension Plan

The Company participates in a Small SEP program under which the employer makes contributions to a SEP, which includes a salary reduction arrangement (SARSEP). Employees who participate in the SARSEP may elect to have the employer: (a) make contributions to the SEP on their behalf, or (b) pay them cash. A salary reduction arrangement may be used only in years in which the SEP meets requirements that the IRS may impose to ensure distribution of excess contributions. Annual contributions of an employer under a SEP are excluded from

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the participant's gross income. No employer contributions were made during the fiscal years ending July 31, 2001 and July 31, 2002.

### Note 12. Income Taxes

The current provisions for income taxes of \$2,400 for fiscal year ended July 31, 2002 and \$1,600 for July 31, 2001 is the minimum franchise tax paid to the State of California regardless of income or loss. The Company files federal and California consolidated tax returns with its subsidiaries.

At July 31, 2002, the Company had federal, and California tax net operating loss carryforwards of approximately \$8,968,100 and \$3,789,500 respectively. At July 31, 2001, the Company had federal, and California tax net operating loss carryforwards of approximately \$7,107,301 and \$2,766,100 respectively. The difference between the financial reporting and the federal tax loss carryforwards is primarily due to accrued expenses and valuation allowances reported in the financials but not deductible for tax purposes. The difference between federal and California tax loss carryforwards is primarily due to the limitation on California loss carryforwards. The federal tax loss carryforwards will begin expiring in the fiscal year ended July 31, 2011, unless previously utilized and will completely expire in fiscal year ended July 31, 2021. The California tax loss carryforwards will begin to expiring in fiscal year ended July 31, 2011, unless previously utilized and will completely expire in fiscal year ended July 31, 2021.

The Company has total deferred tax assets of \$3,325,700 and \$1,263,000 for the fiscal years ended July 31, 2002 and 2001, respectively. Realization of these deferred tax assets, which relate to operating loss carryforwards and timing differences, is dependant on future earnings. The timing and amount of future earnings are uncertain and therefore, the valuation allowance had been established. The increase in the valuation allowance on the deferred tax asset during the fiscal year ended July 31, 2002 was \$2,062,700.

Significant components of the Company's deferred tax assets are as follows:

|   | July 31, 2002 | July 31, 2001 |
|---|---------------|---------------|
| Net operating loss carryforward             | \$ 3,547,800  | \$ 1,222,000  |
| Depreciation and amortization               | 90,500        |               |
| Accrued expenses and calculation allowances | (342,400)     | 36,000        |
| Other                                       | 29,800        | 5,000         |
|   | 3,325,700     | 1,263,000     |
| Valuation allowance for deferred tax assets | (3,325,700)   | (1,263,000)   |
|   | \$ 0          | \$ 0          |

A reconciliation of income taxes computed using the statutory income tax compared to the effective tax rate is as follows:

|  |      |      |
|--|------|------|
|  | 2002 | 2001 |
|--|------|------|

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|  |       |       |
|--|-------|-------|
|  | ----- | ----- |
| Federal tax benefit at the expected statutory rate | 34 %  | 34 %  |
| State income tax, net of federal tax benefit       | 9     | 9     |
| Valuation allowance                                | (43)  | (43)  |
|  | ----- | ----- |
| Income tax benefit - effective rate                | 0 %   | 0 %   |
|  | ===== | ===== |

Note 13. Risks and Uncertainties

The Company faces competitive risks for its Axenohl and pesticide products because the products displace traditional technologies sold by better capitalized and established companies.

A significant part of the Company's revenues are from pharmaceutical water products.

Note 14. Business Segment and Sales Concentrations

In accordance with the provisions of SFAS No. 131, certain information is disclosed based on the way management organizes financial information for making operating decisions and assessing performance. In determining operating segments, the Company reviewed the current management structure reporting to the chief operating decision-maker ('CODM') and analyzed the reporting the CODM receives to allocate resources and measure performance.

The Company's business activities are divided, managed and conducted in two basic business segments, the Water Treatment segment and the Bioscience segment. These two segments were determined by management based upon the inherent differences in the end use of the products, the inherent differences in the value added processes made by the Company, the differences in the regulatory requirements and the inherent differences in the strategies required to successfully market finished products. The Water Treatment segment includes Commercial Water and Residential Retail products and the Nutripure Water Dealer program. Bioscience includes Axenohl (Silver Ion Technology) and the Innovex line of pest control products.

Segment information is presented in accordance with SFAS 131, Disclosures about Segments of an Enterprise and Related Information. This standard is based on a management approach, which requires segmentation based upon the Company's internal organization and disclosure of revenue and operating income based upon internal accounting methods. The Company's financial reporting systems present various data for management to run the business, including internal profit and loss statements prepared on a basis not consistent with U.S. generally accepted accounting principles. Reconciling amounts consist of unallocated general and administrative expenses.

|                            | Water<br>Treatment | Biosciences | Reconciling<br>Amounts |
|----------------------------|--------------------|-------------|------------------------|
|                            | -----              | -----       | -----                  |
| 2001                       |                    |             |                        |
| -----                      |                    |             |                        |
| Revenues                   |                    |             |                        |
| Commercial Water Treatment |                    |             |                        |
| -----                      |                    |             |                        |

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|   |             |              |                |
|---|-------------|--------------|----------------|
| Fillmaster Products                     | \$1,224,200 |              |                |
| -----                                   |             |              |                |
| Replacement Filters (Includes CSP 2000) | 474,700     |              |                |
| -----                                   |             |              |                |
| Residential Water Treatment             | 190,800     |              |                |
| -----                                   |             |              |                |
| Water Dealer Program                    | 167,400     |              |                |
| -----                                   |             |              |                |
| Silver Ionization                       |             | \$320,300    |                |
| -----                                   |             |              |                |
| Pesticide                               |             | 32,300       | -              |
| -----                                   |             |              |                |
| Total Revenues                          | \$2,057,100 | \$352,600    | \$ 0           |
| -----                                   | =====       | =====        | =====          |
| Operating Income/(Loss)                 | \$ 210,600  | \$ (360,600) | \$ (1,861,500) |
| -----                                   | -----       | -----        | -----          |
| Segment Assets                          | \$1,127,500 | \$789,900    |                |
| -----                                   | -----       | -----        |                |

|   | Water<br>Treatment | Biosciences  | Reconciling<br>Amounts |
|---|--------------------|--------------|------------------------|
|   | -----              | -----        | -----                  |
| 2002                                    |                    |              |                        |
| ----                                    |                    |              |                        |
| Revenues                                |                    |              |                        |
| Commercial Water Treatment              |                    |              |                        |
| -----                                   |                    |              |                        |
| Fillmaster Products                     | \$1,161,800        |              |                        |
| -----                                   |                    |              |                        |
| Replacement Filters (Includes CSP 2000) | 524,000            |              |                        |
| -----                                   |                    |              |                        |
| Residential Water Treatment             | 106,400            |              |                        |
| -----                                   |                    |              |                        |
| Water Dealer Program                    | 396,700            |              |                        |
| -----                                   |                    |              |                        |
| Silver Ionization                       |                    | \$683,100    |                        |
| -----                                   |                    |              |                        |
| Pesticide                               | -                  | 334,400      | -                      |
| -----                                   |                    |              |                        |
| Total Revenues                          | \$2,188,900        | \$1,017,500  | \$ 0                   |
| -----                                   | =====              | =====        | =====                  |
| Operating Income/(Loss)                 | \$ 186,100         | \$ (717,300) | \$ (1,691,300)         |
| -----                                   | -----              | -----        | -----                  |
| Segment Assets                          | \$ 790,200         | \$2,450,100  |                        |
| -----                                   | -----              | -----        |                        |

Significant customers primarily consisted of domestic retail chain pharmacies.

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Sales concentrations to major chain stores were approximately \$1,107,200 and export sales were \$584,600 for the year ended July 31, 2002. Sales concentrations to major chain stores were approximately \$1,294,600 and export sales were \$390,100 for the year ended July 31, 2001. No customer accounted for more than 10% of consolidated sales.

### Note 15. Patent Acquisition

On November 30, 2001, the Company acquired the patent for Axenohl, a silver ion based technology which is the basis for the Company's silver ion products. The Company previously licensed the use of this patent.

The Company purchased the patent for 700,000 shares of its common stock plus certain expenses. The Company valued the patent at \$1,540,600 based on the market price of the stock exchanged. In addition, the Company agreed to pay royalties in the amount of 5% of gross Axenohl sales until March 2018, the end of the life of the patent. There are minimum royalties due of \$1,000,000 for the period of November 2001 to July 31, 2004 and for each fiscal year thereafter. Innovative Medical Services has the right, in its sole and absolute discretion, to pay the minimum royalty in cash or in common stock at prevailing market prices. If the Company determines it does not wish to pay the minimum royalty payment, it has the option at any time to transfer the patent back to the prior owner rather than pay the minimum royalty.

### Note 16. Business Combinations

In November 2000, Innovative Medical Services acquired 100% of the stock of ETIH20, Inc., a Florida corporation, for 56,381 shares of IMS stock valued at \$140,953 based on market value of the stock exchanged (\$2.50 per share). The transaction was recorded using the purchase method of accounting. Assets and liabilities were recorded based on fair value and no goodwill was recorded in the transaction. The Company merged ETI-H20 with a newly formed Nevada corporation of similar name and dissolved the Florida corporation. ETI-H20, a privately held technology corporation, developed Axenohl and is responsible for processing, and production of Axenohl and Axen. ETI-H20 is also responsible for all supervision of all research, studies, data and quality control of the Axenohl/Axen product line. The results of operations for ETI-H20 are included in the consolidated financial statements since the date of acquisition. The acquired entity was a startup company, if results of operations were included in prior periods and shown as though the companies had been combined at the beginning of the period, it would not be materially different from the consolidated financial statements of Innovative Medical Services.

The assets acquired and liabilities assumed are as follows:

#### Assets:

|                                 |    |         |
|---------------------------------|----|---------|
| Notes Receivable                | \$ | 33,655  |
| Inventories                     |    | 32,077  |
| Equipment                       |    | 16,932  |
| Licensing & Distribution Rights |    | 118,324 |
|                                 |    | -----   |
| Total Assets                    |    | 200,988 |
|                                 |    | -----   |
| Liabilities                     | \$ | 60,035  |
|                                 |    | -----   |



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### Note 17. Discontinued Operations

In December 1999, the Company formed NUTRIPURE.COM as a wholly owned subsidiary to operate an e-commerce health website, composed primarily of Bergen Brunswig products. On January 15, 2002, Bergen Brunswig Corporation terminated the distribution license for these products. As a result, we closed our e-commerce division. The Nutripure subsidiary now is holding the website for resale, which is its only remaining asset. Assets of the subsidiary were zero at July 31, 2002 and at \$187,600 July 31, 2001. Revenues from discontinued operations were \$1,800 in 2002 and \$7,000 in 2001. No income tax expense was allocated to discontinued operations because of the uncertainty of realizing net operating loss carryforwards.

### Note 18. Subsequent Events

On August 30, 2002, 60,000 shares of common stock were issued in exchange for a 1 year agreement for EPA regulatory consulting. On September 18, 2002, 120,000 shares were issued in exchange for a 1-year consulting agreement to facilitate the identification and facilitation of sponsored research relationships and outlicensing opportunities for the Company. On September 18, 2002, 65,000 shares were issued in exchange for a 1-year marketing and business development consulting agreement. On September 18, 2002, options on 135,000 shares were exercised.

ITEM 8. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE None.

### PART III

#### ITEM 9. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

The executive officers and directors Innovative Medical Services and their ages are as follows:

| Name                 | Age | Position                           |
|----------------------|-----|------------------------------------|
| Michael L. Krall     | 50  | President, CEO, Chairman, Director |
| Gary Brownell, CPA   | 54  | Treasurer CFO, Director            |
| Gene Auerbach        | 58  | Chief Operating Officer            |
| Donna Singer         | 32  | Executive Vice President, Director |
| Dennis Atchley, Esq. | 50  | Secretary                          |
| Greg Barnhill        | 49  | Director                           |
| Dennis Brovarone     | 47  | Director                           |
| Patrick Galuska      | 43  | Director                           |
| Eugene Peiser, PD    | 71  | Director                           |

The Directors serve until their successors are elected by the shareholders. Vacancies on the Board of Directors may be filled by appointment of the majority of the continuing directors. The executive officers serve at the discretion of the Board of Directors except as subject to the employment agreement with Mr. Krall.

#### Business Experience

DENNIS B. ATCHLEY, ESQ. Mr. Atchley is the Secretary of Innovative Medical Services and currently practices as a sole practitioner in Carlsbad, California

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handling corporate and business related litigation matters. A 1973 graduate of Loyola Marymount University in Los Angeles and a 1976 graduate of California Western School of Law in San Diego, California, Mr. Atchley is a member of the California Bar, the San Diego County Bar Association, and the Association of Business Trial Lawyers.

GENE AUERBACH Mr. Auerbach is the Chief Operating Officer of Innovative Medical Services. Prior to joining the Company in June 2002, Mr. Auerbach served as Senior Vice President, Global Supply Chain for Estee Lauder Companies (NYSE: EL) in New York City. Previously, he served as Senior Vice President for Development and International Development at AutoZone (NYSE: AZO) in Memphis, Tennessee. Prior to joining AutoZone, Mr. Auerbach gained significant international experience as Regional Director, Asia for Dairy Farm International (Jardines), where he played a key role in the executive management of 1400 retail stores in eight countries, including supermarkets, drug stores, convenience stores and restaurants. Before joining Dairy Farm International, Mr. Auerbach held the position of Senior Vice President at Costco (NasdaqNM: COST) and, prior thereto, Executive Vice President for Price Club. Before joining Price Club/Costco, Mr. Auerbach served 22 years in the US Navy where he was, and still is, the youngest officer ever selected for Captain (06) in the history of the Navy Supply Corps. Mr. Auerbach holds a BA degree in Business Administration from University of Washington and an MBA degree from Wharton School of Finance and Commerce.

GREGORY H. BARNHILL Mr. Barnhill is Managing Director of North American Equity Sales at Deutsche Bank Securities, Inc., Baltimore, MD. He joined the firm in 1975, following his graduation from Brown University with an AB degree in economics.

DENNIS BROVARONE Mr. Brovarone has been practicing corporate and securities law since 1986 and as a sole practitioner since 1990. He was elected to the Company's Board of Directors in April 1996. From December 1997 to April 2001, Mr. Brovarone served as the President and Chairman of the Board of Directors of Ethika Corporation, a publicly held, Mississippi corporation investment holding company with its office in Littleton, Colorado. From January 1995 to March 1998, Mr. Brovarone served as President (Chairman) of the Board of Directors of The Community Involved Charter School, a four year old K-12 public school located in Lakewood, Colorado, operating under an independent charter and serving approximately 350 students in an individualized, experiential learning environment. Prior to 1990, Mr. Brovarone served as in-house counsel to R.B. Marich, Inc., a Denver, Colorado based brokerage firm. Mr. Brovarone lives and works in Littleton, Colorado.

GARY W. BROWNELL Mr. Brownell is a Certified Public Accountant in a private partnership practice. He is the partner in charge of taxes and municipal audits for his firm. Mr. Brownell graduated from San Diego State University in 1973 with a Bachelor of Science degree in accounting. He received his Certified Public Accountant designation in 1983. Mr. Brownell has been a partner in Brownell and Duffy since 1985.

PATRICK GALUSKA Mr. Galuska is a consulting petroleum engineer in Denver, Colorado. His practice focuses mainly on the acquisition and exploitation of underdeveloped oil and gas assets in the Rocky Mountain area. He is a Registered Professional Engineer and is a member of the Society of Petroleum Engineers. Mr. Galuska earned his BS degree in petroleum engineering from the University of Wyoming and received his MBA degree in Finance from the University of Denver. Mr. Galuska resides in Littleton, Colorado with his wife and two children.

MICHAEL L. KRALL Mr. Krall is the President, CEO and Chairman of the Board of Directors of Innovative Medical Services, a position he has held since 1993. He is responsible for the strategic planning, product development, and day-to-day operations of IMS. Previously, Mr. Krall was the President and CEO of Bettis-Krall Construction, Inc. a successful building-development company of

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custom homes and commercial property in San Diego County, California. He has also held numerous positions in general management in the hospitality industry. Mr. Krall attended Pepperdine University (economics, statistics, mechanical engineering). He previously served 4 years in the United States Marine Corps and was elected, by general election, to a 4 year term on the Valle de Oro Planning Board. Mr. Krall lives in El Cajon, California with his wife, Connie, and two children.

EUGENE S. PEISER, DOCTOR OF PHARMACY Dr. Peiser has been an independent consultant to FDA regulated industries since 1974 and a Member of the Board of Innovative Medical Services since 1994. He graduated from the University of Tennessee College of Pharmacy with a Bachelor of Science in Pharmacy in 1951 and has received his Doctorate of Pharmacy. Dr. Peiser's consultancy advises on a wide variety of subjects, including compliance with the Prescription Drug Marketing Act and other government compliance matters, employee training and drug repackaging. Dr. Peiser furnishes expert witness services and has provided approved Pharmaceutical Continuing Education to several thousand attendees at his seminars. Dr. Peiser is a Founding Director of the Association of Drug Repackagers; is appointed as a Registered Arbitrator by the American Registry of Arbitrators; and is President of the Southwest Chapter of the Association of Military Surgeons. Dr. Peiser lives and works in Palm Harbor, FL.

DONNA SINGER Ms. Singer is the Executive Vice President of Innovative Medical Services. From 1996-1998, Ms. Singer served as Vice President of Operations for the Company. Ms. Singer is responsible for company operations, corporate communications, investor relations and marketing. Previously, Ms. Singer served as the investor relations executive at Western Garnet International, a Toronto Stock Exchange mining company. Ms. Singer graduated from Gonzaga University with a Bachelor of Arts degree and lives in El Cajon, California.

### Committees: Meetings of the Board

We have a Compensation/Administration Committee and an Audit Committee. The Compensation/Administration Committee and the Audit Committee were formed in 1995. Messrs. Barnhill, Brovarone, Galuska and Peiser comprise the Compensation/Administration Committee and Messrs. Barnhill, Brownell, Galuska and Peiser are the Audit Committee. The Compensation/Administration Committee recommends to the Board the compensation of executive officers and will serve as the Administrative Committee for the Company's Stock Option Plans. The Audit Committee serves as a liaison between the Board and the Company's auditor. The Compensation/Administration Committee met once during the fiscal year ended July 31, 2002, and the Audit Committee met once during the fiscal year ended July 31, 2002.

Our Board of Directors held five meetings during the fiscal year ended July 31, 2002, at which time all the then Directors were present or consented in writing to the action taken at such meetings. No incumbent Director attended fewer than 100% of said meetings.

### Compliance with Section 16(a) of Securities Exchange Act of 1934

To our knowledge, during the fiscal year ended July 31, 2002, our Directors and Officers complied with all applicable Section 16(a) filing requirements except that Dennis Brovarone, a director, failed to timely report one transaction. This statement is based solely on a review of the copies of such reports furnished to us by our Directors and Officers and their written representations that such reports accurately reflect all reportable transactions.

### Family Relationships

There is no family relationship between any Director, executive or person nominated or chosen by Innovative Medical Services to become a Director or

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executive officer.

### Transactions with Management

Innovative Medical Services did not enter into any transactions with Management during the fiscal year ended July 31, 2002.

### ITEM 10. EXECUTIVE COMPENSATION

#### Summary Compensation Table

The following table shows for the fiscal year ending July 31, 2002, the compensation awarded or paid by the Company to its Chief Executive Officer and any of the executive officers of the Company whose total salary and bonus exceeded \$100,000 during such year (The "Named Executive Officers"):

| SUMMARY COMPENSATION TABLE     |      |                     |                                      |   |                                     |  |
|--------------------------------|------|---------------------|--------------------------------------|---|-------------------------------------|--|
| Name and Principle Position    | Year | Annual Compensation |                                      | Long Term Compensation                            |                                     |  |
|                                |      | Salary<br>(S)       | Other Annual<br>Compensation<br>(\$) | Awards<br>Securities<br>Underlying<br>Options (#) | Payouts<br>All Other Compen<br>(\$) |  |
| Michael L. Krall President/CEO | 2002 | 144,000             | 0                                    | 150,000 Common                                    | 0                                   |  |
| Michael L. Krall President/CEO | 2001 | 144,000             | 0                                    | 50,000 Common                                     | 0                                   |  |
| Michael L. Krall President/CEO | 2000 | 144,000             | 0                                    | 50,000 Common                                     | 0                                   |  |

No other executive officer earned more than \$100,000 during the current fiscal year.

| Option Grants in Last Fiscal Year |  |   |  |                    |
|-----------------------------------|--|---|--|--------------------|
| Individual Grants                 |  |   |  |                    |
| Name                              | Number of<br>Common Shares<br>Underlying<br>Options Granted<br>(#) | % of Total Options Granted to<br>Employees in Fiscal Year |  | Exercise<br>(\$/Sh |
| Michael L. Krall President/CEO    | 50,000   | 7.0   |  | 2.1                |
| Michael L. Krall President/CEO    | 100,000  | 14.0  |  | 2.0                |

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Aggregated Option Exercises in Last Fiscal Year and Fiscal Year End

Option/Values

The following table sets forth the number and value of the unexercised options held by each of the Named Executive Officers at July 31, 2002.

| Aggregate Option Exercises in Last Fiscal Year and FY-End Option Values |                                       |                                     |   |                                     |
|---|---------------------------------------|-------------------------------------|---|-------------------------------------|
| Name  | Shares<br>Acquired on<br>Exercise (#) | Value<br>Realized at<br>FY-End (\$) | Number of Securities Underlying<br>Unexercised Options at FY-End (#)<br>Exercisable/Unexercisable | Value of Unex<br>Option<br>Exercisa |
| Michael L. Krall<br>President/CEO                                       | 0                                     | 0                                   | 681,250 Common Shares/Exercisable   | 40,000/                             |

- (1) Option value based on the difference between the exercise price of unexercised options and the average closing price of \$0.72 for the 30 trading days ending July 31, 2002.

### Employment Agreements and Executive Compensation

In April 1996, the Board of Directors approved a five-year employment agreement for Michael Krall, its President. Mr. Krall receives a salary of \$144,000 per year, an amount equal to 3% of Innovative Medical Services' net income before taxes, if any, plus other benefits. The Board of Directors has extended Mr. Krall's employment agreement for an additional year.

### Compensation of Directors

Directors are entitled to receive \$300 plus reimbursement for all out-of-pocket expenses incurred for attendance at Board of Directors meetings.

### Other Arrangements

**1996 Directors And Officers Stock Option Plan:** On April 17, 1996, the Company's Board of Directors approved a Directors and Officers Stock Option Plan. The purpose of the Plan is to advance the business and development of the Company and its shareholders by affording to the Directors and Officers of the Company who are ineligible to participate in the above Incentive Stock Option Plan, the opportunity to acquire a propriety interest in the Company by the grant of Options to acquire shares of the Company's common stock. The Plan is administered by the entire Board of Directors. The Plan became effective on April 17, 1996 by the Board of Directors, was not subject to Shareholder approval and shall terminate on April 17, 2006. Subject to anti-dilution provisions, the Plan may issue Options to acquire up to 1,000,000 shares to Directors and Officers. The maximum number of shares subject to Options granted to any one Director or Officer shall not exceed 200,000 shares in any 12-month period. The exercise price for Options shall be set by the Board of Directors but shall not be for less than eighty-five (85%) of the fair market value per share on the date of grant. The period in which Options can be exercised shall be set by the Board of Directors not to exceed five years from the date of Grant. The Plan may be terminated, modified or amended by the Board of Directors.

The Innovative Medical Services 1998 Directors And Officers Stock Option Plan:

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On December 19, 1998, the Company's Shareholders approved the Amended Innovative Medical Services 1998 Officers and Directors Stock Option Plan. The purpose of the Plan is to advance the business and development of the Company and its shareholders by affording to the Directors and Officers of the Company the opportunity to acquire a propriety interest in the Company by the grant of Options to acquire shares of the Company's common stock.

The Innovative Medical Services 2001 Directors And Officers Stock Option Plan: On January 8, 2001, the Company's Shareholders approved the Innovative Medical Services 2001 Officers and Directors Stock Option Plan. The purpose of the Plan is to advance the business and development of the Company and its shareholders by affording to the Directors and Officers of the Company the opportunity to acquire a propriety interest in the Company by the grant of Options to acquire shares of the Company's common stock.

The Innovative Medical Services 2002 Non-Qualified Stock Option Plan: On March 11, 2002, the Company's Shareholders approved the Innovative Medical Services 2002- Non-Qualified Stock Option Plan. The purpose of the Plan is to advance the business and development of the Company and its shareholders by affording Eligible Plan Participants the opportunity to acquire a propriety interest in the Company by the grant of Options to acquire shares of the Company's common stock. Eligible Plan Participants include the Directors and Officers of the Company, consultants, advisors and other individuals deemed by the Compensation Committee to provide valuable services to the Company but who are not otherwise eligible to participate in the Employee Incentive Stock Option Plan.

The Options granted are not "Incentive Stock Options" within the meaning of Section 422 of the Internal Revenue Code of 1986, as amended. The issuance of such non-qualified options pursuant to this Plan is not expected to be a taxable event for the recipient until such time that the recipient elects to exercise the option whereupon the recipient is expected to recognize income to the extent the market price of the shares exceeds the exercise price of the option on the date of exercise.

The Plans are administered by an Administrative Committee whom shall serve a one year term. The Administrative Committee is composed of the Board's Compensation/Administration Committee. Subject to anti-dilution provisions, each Plan may issue Options to acquire up to 2,000,000 shares to Directors and Officers. The exercise price for Options shall be set by the Administrative Committee but shall not be for less than the fair market value of the shares on the date the Option is granted. Fair market value shall mean the average of the closing price for ten consecutive trading days at which the Stock is listed in the NASDAQ quotation system ending on the day prior to the date an Option is granted. The period in which Options can be exercised shall be set by the Administrative Committee not to exceed five years from the date of Grant. Options granted to new executive officers or directors shall vest one year from date of appointment or election. Shares issuable under options granted to continuing officers or directors are immediately exercisable and vest upon exercise. The maximum number of shares subject to Options granted to any one Director or Officer shall not exceed 200,000 shares in any 12-month period.

The Executive Officers and Directors of the Company are eligible to participate in the Plans. The Administrative Committee first granted the Executive Officers and Directors an option to purchase 100,000 shares of common stock at \$1.00 per share in 1998. The Administrative Committee shall grant to individuals newly appointed as Executive Officers or as Directors, an option to purchase 100,000 shares of common stock at fair market value. Upon each subsequent anniversary thereof, each such Officer and Director will receive an option to purchase 50,000 shares of common stock at fair market value. The Plans also give the Administrative Committee discretion to award additional options. The aggregate number and kind of shares within the Plans and the rights under outstanding Options granted hereunder, both as to the number of shares and Option price,

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will be adjusted accordingly in the event of a reverse split in the outstanding shares of the Common Stock of the Company.

The Board may at any time terminate the Plans. The approval of the majority of shareholders is required to increase the total number of shares subject to the Plans, change the manner of determining the option price or to withdraw the administration of the Plans from the Administrative Committee.

### Termination of Employment and Change of Control Arrangement

There is no compensatory plan or arrangement with respect to any individual named above which results or will result from the resignation, retirement or any other termination of employment with the Company, or from a change in the control of the Company.

ITEM 11. Security Ownership of Certain Beneficial Owners and of Management  
The following table sets forth the number of shares of the Company's Common Stock beneficially owned as of July 31, 2002 by individual directors and executive officers and by all directors and executive officers of the Company as a group. Based upon a review of the Company's shareholders list as of October 25, 2002, there is one other registered holder of five percent or more of the Company's Common Stock. As of October 25, 2002 there were 8,780,899 shares outstanding.

| Name and Address of<br>Beneficial Owner                         | Title                   | Common Stock<br>Ownership | Perc<br>O |
|---|-------------------------|---------------------------|-----------|
| Dennis Atchley<br>1725 Gillespie Way<br>El Cajon, CA 92020      | Secretary               | 193,860 (1)               |           |
| Gene Auerbach<br>1725 Gillespie Way<br>El Cajon, CA 92020       | Chief Operating Officer | 125,000 (2)               |           |
| Gregory Barnhill<br>10801 Stevenson Road<br>Stevenson, MD 21153 | Director                | 225,000 (3)               |           |
| Dennis Brovarone<br>18 Mountain Laurel<br>Littleton, CO 80127   | Director                | 456,483 (4)               |           |
| Gary Brownell<br>1725 Gillespie Way<br>El Cajon, CA 92020       | Treasurer, CFO/Director | 400,321 (5)               |           |
| Patrick Galuska<br>8137 S. Downing St.<br>Littleton, CO 80122   | Director                | 370,690 (6)               |           |
| Michael L. Krall<br>1725 Gillespie Way<br>El Cajon, CA 92020    | President, CEO/Chairman | 1,303,560 (7)             |           |

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|   |          |             |
|---|----------|-------------|
| Eugene Peiser<br>1725 Gillespie Way<br>El Cajon, CA 92020 | Director | 426,136 (8) |
|---|----------|-------------|

|  |                        |             |
|--|------------------------|-------------|
| Donna Singer<br>1725 Gillespie Way<br>El Cajon, CA 92020 | Executive VP, Director | 353,356 (9) |
|--|------------------------|-------------|

### Directors and Officers as a Group

|                 |                |
|-----------------|----------------|
| (9 individuals) | 3,854,406 (10) |
|-----------------|----------------|

|   |  |              |
|---|--|--------------|
| Charles Siddle<br>5364 N. 31st Place<br>Phoenix, AZ 85016 |  | 475,000 (11) |
|---|--|--------------|

- (1) Includes presently exercisable options to acquire up to 150,000 shares.
- (2) Includes presently exercisable options to acquire up to 100,000 shares.
- (3) Includes presently exercisable options to acquire up to 200,000 shares.
- (4) Includes presently exercisable options to acquire up to 385,000 shares.
- (5) Includes presently exercisable options to acquire up to 350,000 shares.
- (6) Includes presently exercisable options to acquire up to 300,000 shares.
- (7) Includes presently exercisable options to acquire up to 681,250 shares.
- (8) Includes presently exercisable options to acquire up to 350,000 shares.
- (9) Includes presently exercisable options to acquire up to 325,000 shares.
- (10) Includes presently exercisable options held by all of the above officers and directors to acquire up to 2,814,250 shares.
- (11) Includes 350,000 shares owned by Colt Communications LLC; 50,000 shares owned by Colt Communications Money Purchase Pension Plan; 25,000 shares owned by Siddle Family Trust and 50,000 shares owned by SPS LLC - all of which are affiliates of Charles Siddle.
- (12) Percentage ownership is based only on shares outstanding and does not include exercisable options held by Directors and Officers.

### ITEM 12. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

At July 31, 2001, notes receivable included \$66,561 which represented amounts due from officers of Innovative Medical Services. This amount includes personal loans authorized by the Board of Directors of \$18,379 to Michael L. Krall, President and CEO and \$48,182 to Gary Brownell, Chief Financial Officer. Interest accrues at 6% per annum.

Mr. Krall's loan increased during fiscal year 2002 by \$13,817 to \$32,196 and was subsequently paid down during the year by \$8,100 to \$24,096. On July 31, 2002, the accrued interest was added to the loan balance, bringing the year-end balance to \$25,723.

Mr. Brownell's loan was paid down during fiscal year 2002 by \$12,000 to \$36,182. On July 31, 2002, the accrued interest was added to the loan balance, bringing the year-end balance to \$38,352.

As of October 25, 2002, Mr. Krall has made additional pay-downs on his loan, bringing the current balance to \$17,623.

As of October 25, 2002, Mr. Brownell has made additional pay-downs on his loan, bringing the current balance to \$26,352.

### ITEM 13. EXHIBITS.



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The following Exhibits are filed as part of this registration statement pursuant to Item 601 of Regulation S-B:

- 3.1 (1) -- Articles of Incorporation, Articles of Amendment and Bylaws
  - 3.1.1 -- Articles of Amendment dated March 11, 2002
  - 4.1 (1) -- Form of Class A Warrant
  - 4.2 (1) -- Form of Class Z Warrant
  - 4.3 (1) -- Form of Common Stock Certificate
  - 4.4 (1) -- Warrant Agreement
  - 4.5 (2) -- March 2000 Warrant
  - 4.6 (3) -- January 2001 Warrant
  - 4.7 (4) -- Convertible Debenture
  - 4.8 (5) -- Convertible Debenture Purchase Agreement
  - 4.9 (6) -- Convertible Debenture Warrant
  - 10.1 (1) -- Employment Contract/Michael L. Krall
  - 10.2 (7) -- Manufacturing, Licensing and Distribution Agreement dated March 26, 2001
  - 10.3 (8) -- Axenohl License Agreement
  - 10.4 (9) -- Weaver - Roach X Assignment
  - 10.5 (9) -- Dodo Agreement [Confidential treatment requested for certain omitted information filed separately.]
  - 10.6 (8) -- Promissory Note of Michael Krall
  - 10.7 (8) -- Promissory Note of Gary Brownell
  - 10.8 (9) -- Nutripure Dealer Agreement
  - 10.9 (9) -- Sales Finance Agreement
  - 10.10 (10) -- ETIH2O, Inc., Acquisition Agreement
  - 10.11 (11) -- NVID Litigation Settlement Agreement
  - 10.12 (12) -- Addendum #1 to NVID Settlement Agreement
  - 11 -- Statement re: Computation of Earnings
  - 21 -- Subsidiaries of the Registrant
- 
- (1) Incorporated by reference from Form SB-2 registration statement, SEC File # 333-00434 effective August 8, 1996
  - (2) Incorporated by reference from S-3 registration statement, SEC File #333-36248 effective on May 17, 2000
  - (3) Incorporated by reference from S-3 registration statement, SEC File #333-55758 effective on February 26, 2001
  - (4) Incorporated by reference from S-3 registration statement, SEC File #333-61664 filed on May 25, 2001
  - (5) Incorporated by reference from pre-effective amendment no. 1 to S-3 registration statement, SEC File #333-61664 filed on July 10, 2001
  - (6) Incorporated by reference from pre-effective amendment no. 2 to S-3 registration statement, SEC File #333-61664 filed on August 13, 2001
  - (7) Incorporated by reference from Current Report on Form 8-K filed on May 24, 2001 as amended on October 19, 2001
  - (8) Incorporated by reference from the Amended Annual Report on Form 10KSB for the fiscal year ended July 31, 2000 filed on October 19, 2001
  - (9) Incorporated by reference from Amended Form 10QSB for the nine month period ended April 30, 2001 filed on October 19, 2001
  - (10) Incorporated by reference from the Amended Annual Report on Form 10KSB for

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the fiscal year ended July 31, 2001 filed on November 13, 2001

(11) Incorporated by reference from Current Report on Form 8-K filed on December 6, 2001

(12) Incorporated by reference from Amended Current Report on Form 8-K filed on December 7, 2001

B. Reports on Form 8-K: No Reports on Form 8-K were filed during the fourth quarter of the fiscal year.

### SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

INNOVATIVE MEDICAL SERVICES

DATE

/s/ MICHAEL L. KRALL

July 23, 2003

-----  
Michael L. Krall, Chairman/President/CEO

Pursuant to the requirements of the Securities Exchange Act of 1934, this report is signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

| NAME  | TITLE                                | DATE                   |
|---|--------------------------------------|------------------------|
| /s/ GREGORY BARNHILL<br>-----<br>Gregory Barnhill | Director                             | July 23, 2003<br>----- |
| /s/ DENNIS BROVARONE<br>-----<br>Dennis Brovarone | Director                             | July 23, 2003<br>----- |
| /s/ GARY BROWNELL<br>-----<br>Gary Brownell       | Chief Financial Officer and Director | July 23, 2003<br>----- |
| /s/ PATRICK GALUSKA<br>-----<br>Patrick Galuska   | Director                             | July 23, 2003<br>----- |
| /s/ MICHAEL L. KRALL<br>-----<br>Michael L. Krall | President/CEO and Director           | July 23, 2003<br>----- |

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/s/ EUGENE PEISER

Director

July 23, 20

-----  
Eugene Peiser

/s/ DONNA SINGER

Executive Vice President and Director

July 23, 20

-----  
Donna Singer

CERTIFICATIONS

I, Michael L. Krall, certify that:

1. I have reviewed this annual report on Form 10-KSB of Innovative Medical Services;
2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this annual report;
3. Based on my knowledge, the financial statements, and other financial information included in this annual report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this annual report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and have:
  - a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this annual report is being prepared;
  - b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this annual report (the "Evaluation Date"); and
  - c) presented in this annual report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
  - a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and

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- b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

6. The registrant's other certifying officers and I have indicated in this annual report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: July 23, 2003

/s/ Michael L. Krall

-----  
Michael L. Krall  
President/CEO

### CERTIFICATIONS

I, Gary Brownell, certify that:

1. I have reviewed this annual report on Form 10-KSB of Innovative Medical Services;
2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this annual report;
3. Based on my knowledge, the financial statements, and other financial information included in this annual report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this annual report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and have:
  - a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this annual report is being prepared;
  - b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this annual report (the "Evaluation Date"); and
  - c) presented in this annual report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of

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registrant's board of directors (or persons performing the equivalent functions):

- a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
- b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

6. The registrant's other certifying officers and I have indicated in this annual report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: July 23, 2003

/s/ Gary Brownell

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Gary Brownell  
Chief Financial Officer