



# *Hitting our stride*



The Female Health Company

Annual Report 2002

Unit sales +29%

Revenue growth +26%

Market Value +288%

Dear Shareholders:

The Female Health Company (FHC) has always been a pioneer when it comes to its product and mission, and this year was no exception. While the worldwide economic downturn has most companies smarting, FHC continued to show sound health and solid progress in 2002. Recently an investor commented, "Great work, but why has it taken so long?"

The answer is that we're finally "Hitting Our Stride," the theme we've chosen for this year's annual report. As we've recently seen only too vividly, a meteoric rise in stock price does not necessarily translate into underlying financial health and sustainable growth in market value. Indeed, it has taken FHC years to develop the product, create a global market, establish credibility and confidence in the FC Female Condom (FC), and learn the systems and politics of operating in business and social environments very different from those in the United States. We are changing minds; we are influencing behavior—country by country, culture by culture, person by person. Experts in corporate change management will tell you it takes years and millions of dollars to change a single corporate culture. Imagine, then, the scope of our task.

Long ago, we committed to responding to the HIV/AIDS crisis—"to get active, to play our part, to make a difference." While never losing sight of our urgent humanitarian goals, we've also never lost sight of our commitment to investors. We have worked rigorously to meet our financial goals and to increase the value of the company—not an inconsiderable task given a social market where need is soaring and resources are painfully limited.

The good news is that although growth has taken longer than predicted, it is real. During fiscal year 2002, we increased unit sales 29%, revenues 26%, and market value 288%. We have contributed to local economies by increasing employment. We have increased our visibility exponentially by winning the coveted Queen's Award from the British government. Both Queen Elizabeth and Prime Minister Blair have formally recognized our significant mission and development.

We're now hitting our stride because we have identified and pulled together all the necessary components that support the introduction of a product such as FC into developing countries. As you will see here, growth in our business is incremental; it's a process. We've had to develop an in-depth understanding of how acceptance, use, sustainability and long-term demand for FC evolve within different cultures and countries. By sharing some experiences here, we hope to show you the complexities we're unraveling and why it's taken time to make financial headway. Our increasingly integrated understanding of FHC's unique growth process bodes well for excellent future growth.

Remember, we've had no models; there are no precedents for what FHC has done and continues to do. It has taken time to understand, and there are many players. Growth has been critically dependent upon identifying partners and forging alliances with varied sectors and many organizations—international public health agencies, e.g., Joint United Nations Programme on HIV/AIDS (UNAIDS), major donor organizations, social marketing groups and community-based, non-government organizations (NGOs). Sorting all of this out has taken years, but we're finally gaining ground—literally and figuratively—as we expand around the globe.



Typically, we've seen FC acceptance, use and demand evolve nationally in three basic phases. In Mongolia, for example, we're in Phase I—assessing acceptability and viability. In Zambia, we've progressed to Phase II—increasing awareness and implementing outreach. In Brazil, we're in Phase III, full steam ahead.

After you read the country "progress reports," you will come away with a better understanding of how the growth process takes place and why it continues to require patience and tenacity. You will also be reminded of the value and role of FC in the global struggle against HIV/AIDS. You will see why FHC can report today that we are indeed hitting our stride.

In closing, as 2002 ends, we would be remiss if we failed to address the topic of ethically based business practices. FHC was founded on leadership that embraces integrity, trust, a passion for winning, and solid business fundamentals. We believe our company and our stock have staying power because we have made these values the foundation of our growth and business practice. We renew our commitment—to those whose lives may depend upon FC; to our ministry of health and government agency customers; to our many partner agencies, foundations and companies; and to you, our investors, who are counting upon FHC to increase the value of your investment and reward your trust in us.

We are hitting our stride, but the race has only begun for the women of the world who need, want and use the FC Female Condom.

O.B. Parrish  
Chairman and Chief Executive Officer

Mary Ann Leeper, Ph.D.  
President and Chief Operating Officer



Open



## Phase I: Assessing acceptability and viability in Mongolia

**W**ith 2.4 million people, Mongolia is sparsely populated, yet it's one of the countries at highest risk for the spread of sexually transmitted infections (STIs), including HIV/AIDS. The risk profile here has increased exponentially due to major economic transition and concomitant increases in mobility and poverty. In the wake of the turmoil, more youth are living on the street, selling sex is viewed as a viable source of income, and contact with outsiders has increased, a factor which has ushered in new sexual freedom and elevated the spread of STIs.

Aware of the urgency of bringing prevention methods to women in Mongolia, FHC is now in Phase I here, assessing acceptability and viability of the FC Female Condom (FC). As always, we are not working alone. We're allied in an innovative, cross-sector collaboration—the Female Condom Coordinating Committee (FCCC)—led by the Ministry of Health and Social Welfare, the United Nations Population Fund, and Marie Stopes International (MSI).

The FCCC followed the strategic planning process outlined in *The Female Condom: A Guide for Planning and Programming*, published by UNAIDS and WHO. This strategic framework forms the core of FHC's technical assistance to field programs. The overall goal is to accelerate program launches and expansion by applying our "best practice" international experience within a local context.

A study protocol was developed to explore FC acceptability in Mongolia.

Through strategic-planning workshops, target groups with high-risk behavior were identified; e.g., sex workers, STI clinic clients, adolescents and migrant laborers. Such initial efforts—to identify potential targets and approaches to reach them with both messages and FC—represent a critical investment in creating an efficient, cost-effective strategy.

Making use of FHC's Resource Center, the FCCC produced local-language packets with FC instructions and answers to frequently asked questions. In addition to providing a training curriculum, FHC also facilitated a "train the trainers" program for health providers and community-based distributors.

Another key partner in pilot design and implementation was MSI. MSI expertise contributed to resolving issues related to FC pricing, packaging, promotion and distribution.

Collecting essential information early will form the core of a national FC social marketing program to complement its public-sector introduction.

The FC program in Mongolia illustrates the Phase I strategic process outlined in the *Guide for Planning and Programming*:

- ▶ Conduct extensive strategic planning;
- ▶ Involve/inform all stakeholders;
- ▶ Conduct targeted product launch;
- ▶ Involve relevant community groups, e.g., NGOs, CBOs;
- ▶ Research initial acceptability to identify potential challenges/opportunities, guide expansion;
- ▶ Adapt communication for local context;
- ▶ Build local expertise/training capacity.

**Phase I means gathering facts up front and leveraging what we know. We've learned that solid groundwork is the first step toward hitting our stride in any country. ■**



## Phase II: Building on success in Zambia

**A**t the epicenter of Africa's HIV/AIDS epidemic, Zambia exemplifies the crisis. Already 20% of Zambian adults are HIV-infected, but the more ominous threat is that condom use remains limited and inconsistent. Men, for example, still pay sex workers a premium for sex without a condom, and, predominantly, men still determine condom use.

Rooted in reality, the Zambia National AIDS Program has committed to top priorities: (1) educating men; (2) helping women to empower themselves; and (3) making FC available.

A Zambian NGO, the Society for Family Health (SFH), launched FC under the brand name "Care" in late 1997. Initial distribution was limited to pharmacies, drug stores and beauty salons in the capital, Lusaka. Women were the primary pilot target, and female peers offered FC educational programming at retail outlets, workplaces, bars and nightclubs.

As Care was introduced, SFH monitored purchasing and use trends and conducted extensive research. They found that FC is likely to be most important for persons who are unable or unwilling to use the male condom. They also found that although barriers exist to initial FC use, face-to-face communication and counseling helped overcome obstacles, such as uncertainty about insertion. They further found that men are more willing to use FC with a spouse or regular partner and that FC may therefore be

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*Introduction of FC is not just about using the product; it's about helping change social and sexual dynamics.*



particularly useful for protection against HIV and unwanted pregnancy among married women—an often overlooked high-risk group.

Armed with marketing research, mounting support from donor agencies, and increasing demand from Zambian women, SFH is expanding its FC social marketing program nationally. It is broadening the message, detailing the educational component and including men in its outreach.



Another highlight is the recent involvement of Zambia's First Lady Maureen Mwanawasa, which has added considerable momentum to the SFH program. During the International AIDS Conference in July 2002, Mrs. Mwanawasa and her counterparts throughout Africa established the Organization of African First Ladies against HIV/AIDS. Upon returning to Zambia, Mrs. Mwanawasa made affordable access to FC a top priority by convening a strategic-planning meeting for stakeholders. FHC participated in this meeting and is working with the First Lady, SFH and other partners to ensure rapid and effective expansion of the project.

**Phase II means monitoring results, fine-tuning the program and turning up the volume by teaming with visible, committed partners to expand the message and build on solid progress. Hitting our stride wouldn't be possible without committed partners who help set and build the pace. ■**

## Phase III: Going national in Brazil

**I**n the 1990s, the United Nations predicted that Brazil would have 1.2 million people infected with HIV by 2000. By that date, however, fewer than half that number, 597,000, were HIV-infected. The numbers tell the story—some 600,000 HIV infections were averted through effective behavior-change campaigns and lower levels of mother-to-child transmission.

With AIDS still an enormous challenge, the Brazilian Government works in partnership with many organizations and continues to innovate in its response. Although condom use has increased greatly in Brazil over the past decade—e.g., in 2000, the Brazilian Ministry of Health (MOH) distributed 200 million condoms—it felt an urgent need for much wider use of both male and female condoms.

In 1998, MOH funded an FC acceptability study, contracting with researchers from the Population Studies Center at the University of Campinas and purchasing 100,000 FCs. Researchers designed and implemented a pilot that not only established FC acceptability, but also explored how best to introduce FC in different social contexts. In this way, programming could move continuously from trial to ongoing use, thereby maximizing the positive impact on public health.

Their study, published in 2000, has been the basis for FC program expansion in Brazil. With the purchase of 8 million FCs over the past three years, the Brazilian program has expanded to deliver FC throughout the country, using an increasing number of NGOs to reach target segments.

The MOH also works closely with *DKT do Brasil*—the country's leading marketer and supplier of male condoms—to facilitate FC accessibility and promote use. *DKT do Brasil* markets FC under the brand name "Reality" and distributes an additional 500,000 units annually.

National expansion has been guided by monitoring and research. One study explored FC acceptance and use among HIV-infected women. High rates of FC use (87%), acceptability (68%) and continuation (78%) were observed, with a reduction in the proportion of unprotected sexual acts from 14% to 6%. The study concluded that adding FC to contraceptive options, with appropriate counseling, was able to reduce unprotected sex among HIV-infected women.

Similar research has sharpened the focus on adolescents, drug users, partners of drug users, and sex workers and their



clients. As FC is more widely distributed and integrated into community programs, the MOH reports that the introduction of FC has not only helped women gain awareness of their vulnerability to disease, but also aided them in empowering themselves to negotiate safer sex with partners. Introduction of FC is not just about using the product; it's about helping change social and sexual dynamics.

For both the MOH and *DKT do Brasil*, FC is now mainstreamed. Here, in this Phase III setting, FC is no longer novel; it's a fundamental part of the overall prevention strategy.

**Phase III means moving the prevention and eradication of HIV/AIDs from the realm of "if" to the reality of "when." After years of starting from scratch, learning from experience, and collaborating with partners united in purpose, we are hitting our stride...but, as we know only too well, the race has only begun. ■**



# Financial Highlights

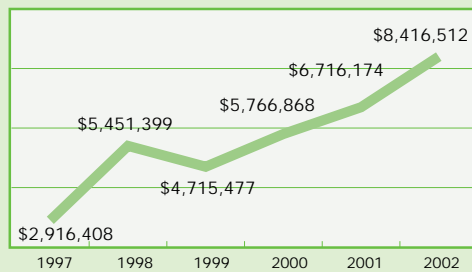
The selected financial data from continuing operations for the three years ending September 30, 2002, are derived from the audited Consolidated Financial Statements. The information here should be read in conjunction with "Management's Discussion and Analysis," the Consolidated Financial Statements, and related notes, all of which are included in the financial report to follow.

	Adjusted 2002	2002	Adjusted 2001	2001	2000
Net Revenues	\$ 8,417	\$ 8,417	\$ 6,716	\$ 6,716	\$ 5,767
Net Income (Loss)	(359) *	(3,481)	(1,047) *	(1,171)	(3,690)
Net Income (Loss) per Common Share	(0.02) *	(0.21)	(0.07)	(0.07)	(0.30)
Selling, General and Administrative Expenses	3,065	3,065	2,539	2,539	2,582 **
Common Shares Outstanding	18,042	18,042	15,693	15,693	13,804
Preferred Shares Outstanding	66	66	660	660	660

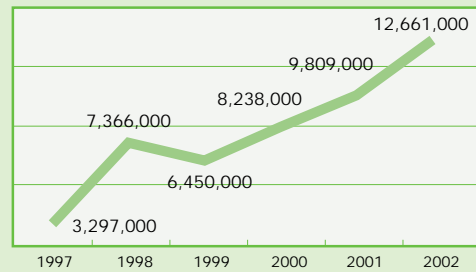
Years ended September 30

*In thousands, except per-share data*

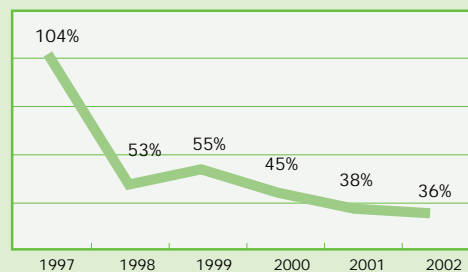
Net Revenues



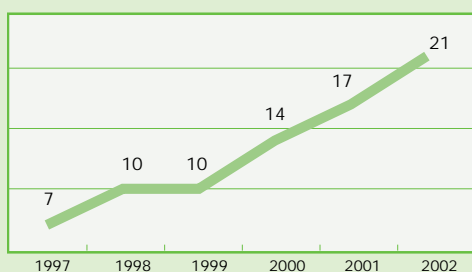
Unit Sales



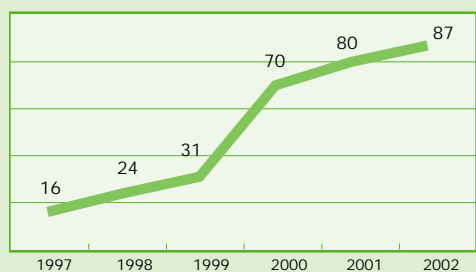
Selling, General and Administrative Expenses  
as a Percent of Sales\*\*



Commercial Markets



Public Sector Markets



\* Excludes non-cash costs incurred in 2001 and 2002 relating to out of court settlement fees and stock compensation.

\*\* Certain non-operating income/expense items were reclassified as selling, general and administrative expenses to be consistent with their classification in 2001 and 2002. The reclassifications account for the change in the selling, general and administrative expenses as a percent of sales between the current and prior annual reports for the years 1997 through 2000.

## Overview

Over the past few years, the Company completed significant aspects of the development and commercialization of The Female Condom. These initiatives have resulted in the attainment of proprietary manufacturing technology and product design patents, necessary regulatory approvals, and the development of significant manufacturing capacity. These steps, taken as part of the Company's plan to develop and sell a product with global commercial and humanitarian value, have required the expenditure of significant amounts of capital and resulted in significant operating losses including the period 1996 through the present.

The Company has begun the process of developing the commercial market for The Female Condom around the world. As part of this plan, the Company has completed a number of distribution agreements and is pursuing other arrangements for the marketing and sale of The Female Condom. Management believes that as the number of markets in which The Female Condom is sold increases, sales will grow and, at certain levels, the Company will become profitable. However, there can be no assurance that such level of sales will be achieved in the near term or at all.

## Results of Operations

*Fiscal Year Ended September 30, 2002, ("2002") Compared to Fiscal Year Ended September 30, 2001, ("2001")*

The Company had net revenues of \$8.4 million and a net loss attributable to common stockholders of \$(3.6) million or \$(0.22) per share in 2002 compared to net revenues of \$6.7 million and a net loss attributable to common stockholders of \$(1.3) million or \$(0.09) per share in 2001. During 2002, the Company recorded non-cash charges of \$3.1 million consisting of an out of court settlement of a dispute (\$1,258,210) and stock compensation (\$1,863,956) primarily related to accounting for stock options under variable plan accounting guidance. During 2001, the Company recorded non-cash charges of \$123,758 consisting of stock compensation primarily for consulting services. Excluding these non-cash charges in both fiscal years, the net loss attributable to common stockholders in 2002 would be \$(491,001) or \$(0.03) per share compared to a net loss attributable to common stockholders in 2001 which would be \$(1,180,498) or \$(0.08) per share.

Gross profit increased \$1,251,127, or 54%, to \$3,561,191 for 2002 from \$2,310,064 for 2001. The increase was a result of improved net revenues combined with a less than proportionate increase in cost of products sold.

Net revenues increased \$1.7 million, or 25%, in 2002 over the prior year. The higher net revenues resulted from increased unit sales shipped to global public sector customers.

Cost of products sold increased \$449,211, or 10%, to \$4,855,321 for 2002 from \$4,406,110 for 2001. The increase was not in proportion with the sales increase due to a reduction of fixed costs per unit which resulted from the increased unit sales. Costs of products sold as a percentage of sales decreased from 66% in 2001 to 58% in 2002.

Advertising and promotional expenditures decreased \$85,323 to \$43,832 from \$129,155 for the same period in the prior year. The decline resulted from a reduction in advertising costs between these periods and reflects the Company's strategy as a manufacturer.

Selling, general and administrative expenses increased \$525,646, or 21%, from \$2.5 million in 2001 to \$3.1 million in 2002. The increase was not in proportion with the sales increase due to the primarily fixed nature of the selling, general and administrative costs. As a percentage of net revenues, selling, general and administrative expenses decreased from 38% in 2001 to 36% in 2002.

The Company's operating loss increased \$(2,187,604) from \$(481,886) in 2001 to \$(2,669,490) in 2002 as a result of the increase in operating expenses. Operating expenses increased \$3,438,731 from \$2,791,950 in 2001 to \$6,230,681 in 2002. \$2,998,408, or 87%, of this increase represents the change in non-cash costs pertaining to out of court settlement costs and stock compensation expenses incurred during 2002 compared to 2001. Excluding the non-cash charges for the out of court settlement and stock compensation, the Company would have recorded operating income of \$452,676 in 2002 compared to an operating loss of \$(358,128) in 2001.

Net interest and non-operating expenses increased \$122,302, or 18%, to \$811,672 for 2002 compared to \$689,370 for 2001. The increase exists because the Company had a higher level of debt outstanding during 2002 than 2001 due to the issuance of convertible debentures during May 2001. The result is a higher amount of non-cash expenses incurred from the amortization of discounts on convertible debentures in 2002 than in the prior year.

The Company was able to cover fixed manufacturing overhead costs and exceeded the break-even at the gross profit level. However, the Company must achieve cumulative annual unit sales of approximately 14 million female condoms based upon the current average selling price per unit in order to cover operating and non-operating expenses or approximately 23% of manufacturing capacity.

## **Factors That May Affect Operating Results and Financial Condition**

The Company's future operating results and financial condition are dependent on the Company's ability to increase consumer demand and to cost-effectively manufacture sufficient quantities of The Female Condom. Inherent in this process are a number of factors that the Company must successfully manage in order to achieve favorable future results and improve its financial condition.

### **Reliance on a Single Product**

The Company expects to derive the vast majority, if not all, of its future revenues from The Female Condom, its sole current product. While management believes the global potential for The Female Condom is significant, the product is in the early stages of commercialization and, as a result, the ultimate level of consumer demand around the world is not yet known. To date, sales of The Female Condom have not been sufficient to cover the Company's operating costs.

### **Distribution Network**

The Company's strategy is to act as a manufacturer and to develop a global distribution network for the product by completing partnership arrangements with companies with the necessary marketing and financial resources and local market expertise. To date, this strategy has resulted in numerous in-country distributions in the public sector, particularly in Africa and Latin America. Several partnership agreements have been completed for the commercialization of The Female Condom in private sector markets around the world. However, the Company is dependent on country governments, as well as city and state public health departments within the United States to continue their commitment to prevention of STDs, including AIDS, by including female condoms in their programs. The Company is also dependent on finding appropriate partners for the private sector markets around the world. Once an agreement is completed, the Company is reliant on the effectiveness of its partners to market and distribute the product. Failure by the Company's partners to successfully market and distribute The Female Condom or failure of country governments to implement prevention programs which include distribution of barrier methods against the AIDS crisis, or an inability of the Company to secure additional agreements for the AIDS crisis, or an inability of the Company to secure additional agreements for new markets either in the public or private sectors could adversely affect the Company's financial condition and results of operations.

As part of this strategy the Company entered into two agreements in the year ended September 30, 2002.

On November 29, 2001, the Company signed a non-binding memorandum of understanding with Hindustan Latex Limited ("HLL"), an Indian government organization and India's largest male condom manufacturer. HLL distributes to public sector customers including government and non-government organizations and to the public sector through 160,000 retail outlets. Jointly with HLL, a marketing strategy will be developed for the country of India. Over time, the Company anticipates that HLL and the Company will explore manufacturing options within India.

On December 18, 2001, the Company announced the appointment of Total Access Group ("TAG") as the exclusive distributor for public sector sales within a 15-state region in the western United States. TAG is a privately held national distributor to the United States public sector and serves over 2,500 customers, which include state and local health departments, community-based organizations, HIV/STD prevention organizations, Planned Parenthood clinics and family planning organizations. TAG is a full-service distributor and will provide marketing, education and customer service support. TAG is required to purchase 2,190,000 units within a three-year period to retain exclusivity distribution rights.

### **Inventory and Supply**

All of the key components for the manufacture of The Female Condom are essentially available from either multiple sources or multiple locations within a source.

### **Global Market and Foreign Currency Risks**

The Company manufactures The Female Condom in a leased facility located in London, England. Further, a material portion of the Company's future sales is likely to be in foreign markets. Manufacturing costs and sales to foreign markets are subject to normal currency risks associated with changes in the exchange rate of foreign currencies relative to the United States dollar. To date, the Company's management has not deemed it necessary to utilize currency hedging strategies to manage its currency risks. On an ongoing basis, management continues to evaluate its commercial transactions and is prepared to employ currency hedging strategies when it believes such strategies are appropriate. In addition, some of the Company's future international sales may be in developing nations where dramatic political or economic changes are possible. Such factors may adversely affect the Company's results of operations and financial condition.



## Government Regulation

The Female Condom is subject to regulation by the FDA pursuant to the federal Food, Drug and Cosmetic Act (the "FDC Act"), and by other state and foreign regulatory agencies. Under the FDC Act, medical devices must receive FDA clearance before they can be sold. FDA regulations also require the Company to adhere to certain "Good Manufacturing Practices," which include testing, quality control and documentation procedures. The Company's compliance with applicable regulatory requirements is monitored through periodic inspections by the FDA. The failure to comply with applicable regulations may result in fines, delays or suspensions of clearances, seizures or recalls of products, operating restrictions, withdrawal of FDA approval and criminal prosecutions. The Company's operating results and financial condition could be materially adversely affected in the event of a withdrawal of approval from the FDA.

## Liquidity and Sources of Capital

Historically, the Company has incurred cash operating losses relating to expenses to develop, manufacture, and promote The Female Condom. Cash used in continuing operations was \$0.4 million for 2002 and \$0.6 million in 2001. Historically, the Company has funded operating losses and capital requirements, in large part, through the sale of common stock or debt securities convertible into common stock.

During 2002, the Company received \$60,000 from the issuance of common stock and \$500,000 of additional borrowings under its credit facility. FHC used these amounts to fund current operations of the Company, repay existing liabilities and pay down \$100,000 of borrowings under the credit facility.

In the near term, FHC management expects operating losses and capital requirements to continue to exceed funds generated from operations due principally to the Company's fixed manufacturing costs relative to current production volumes and the ongoing need to commercialize The Female Condom around the world.

The Company has a \$1 million note due March 25, 2003 to Mr. Stephen Dearholt, a Director of the Company.

On May 18, 2001, the Company entered into an agreement with Heartland Bank providing for a \$2,000,000 credit facility. The unpaid balances on the credit facility are due May 18, 2004 and bear interest payable at a rate of 10% per year. The agreement contains certain covenants which include restrictions on the payment of dividends and distributions and on the issuance of warrants, which the Company was in violation of at September 30, 2002. Under the terms of the agreement, Heartland Bank would have had the right to demand payment of the entire balance of the credit facility as a result of this violation. On December 13, 2002, the Company obtained a waiver from Heartland Bank through the entire fiscal year ending September 30, 2003. The Company may borrow under the credit facility from time to time, subject to a number of conditions, including obtaining personal guarantees of 125% of the amount outstanding under the credit facility. In connection with the credit facility, the Company issued warrants to Heartland Bank to purchase the number of shares of the Company's common stock equal to \$500,000 divided by the warrant purchase price as of the date of exercise. The warrant purchase price is equal to 70% of the market price of the Company's common stock as of the day immediately prior to the date the exercise notice is given to the Company, but in no event shall the per share price be less than \$0.50 or more than \$1.00. The warrants are valued at \$270,800 and are recorded as additional paid in capital and a discount on the credit facility.

During 2002, the Company borrowed the remaining \$500,000 under the credit facility. Eight persons provided guarantees equal in total to the \$2.0 million outstanding under the loan. The guarantors included James R. Kerber, a Director of the Company, Stephen M. Dearholt, a Director of the Company, Richard E. Wenninger, a Director of the Company, and a trust for the benefit of O.B. Parrish, the Chairman of the Board and Chief Executive Officer of the Company. Each guarantor may be liable to Heartland Bank for up to 125% of the guarantor's guarantee amount if the Company defaults under the loan. The Company issued warrants to the guarantors to purchase the number of shares of the Company's common stock equal to the guarantee amount of such guarantor divided by the warrant purchase price as of the date of exercise. The warrant purchase price is the price per share equal to 70% of the market price of the Company's common stock at the time of exercise, but in no event will the warrant purchase price be less than \$0.50 or more than \$1.00. In September 2002, one of the guarantors exercised stock warrants to purchase 183,150 shares of the Company's common stock and the proceeds were utilized to pay down \$100,000 on the credit facility. The Company also issued additional warrants to purchase a total of 300,000 shares of the Company's common stock at an exercise price of \$0.50 per share to three of the guarantors including both Stephen M. Dearholt and Richard E. Wenninger because each of them guaranteed \$500,000 under the credit facility. The guarantors' warrants are valued at \$667,578 and are recorded by the Company as additional paid in capital and a discount on the credit facility.

In accounting for the guarantors' warrants related to the \$500,000 borrowed in 2002, the Company designated 900,000 warrants valued at \$415,427 and these are recorded by the Company as additional paid-in capital and a discount on the credit facility. The credit facility is recorded at September 30, 2002, net of unamortized discount of \$927,546.



On June 1, 2001, the Company issued an aggregate of \$200,000 of convertible debentures to two accredited investors. The debentures were due May 30, 2004, bear interest payable at a rate of 10% per annum, and were convertible into the Company's common stock based on a price per share equal of \$0.50. The Company did not issue warrants in connection with the issuance of the convertible debentures. On December 5, 2002, each investor converted his debenture into 100,000 shares of the Company's common stock.

On March 30, 2001, the Company issued a \$250,000 convertible debenture to one accredited investor. The debenture is due March 30, 2004, bears interest payable at a rate of 12% per annum, and is convertible into the Company's common stock based on a price of \$0.50 per share. The Company did not issue warrants in connection with the issuance of the convertible debenture.

While the Company believes that revenue from sales of The Female Condom will eventually exceed operating costs, and that, ultimately, operations will generate sufficient funds to meet capital requirements, the Company can make no assurance that it will achieve such level of operations in the near term or at all. Likewise, the Company can make no assurance that the Company will be able to source all or any portion of its required capital through the sale of debt or equity or, if raised, the amount will be sufficient to operate until sales of The Female Condom generate sufficient revenues to fund operations. In addition, any funds raised may be costly to the Company and/or dilutive to its shareholders. If the Company is unable to raise adequate financing when needed, the Company may be required to sharply curtail the Company's efforts to promote The Female Condom, to attempt to sell certain of its assets and rights or to curtail certain of its operations and may ultimately be forced to cease operations. Currently, the Company is focused on growing its business and, therefore, the Company has made no plans to sell any assets nor has it identified any assets to be sold or potential buyers.

As of December 20, 2002, the Company had approximately \$0.9 million in cash, net trade accounts receivable of \$2.6 million and current trade accounts payable of \$1.1 million. It is estimated that the Company's cash burn rate, with revenues, is less than \$0.1 million per quarter. The Company's anticipated debt service obligations for scheduled interest and principal payments are approximately \$1.3 million in fiscal 2003, \$190,000 in fiscal 2004 and \$2.0 million in fiscal 2005. As of December 20, 2002, the Company was in compliance with all of the covenants relating to its outstanding debt.

#### **Impact of Inflation and Changing Prices**

Although the Company cannot accurately determine the precise effect of inflation, the Company has experienced increased costs of product, supplies, salaries and benefits, and increased general and administrative expenses. Historically, the Company has absorbed increased costs and expenses without increasing selling prices.

#### **New Accounting Pronouncements**

Please see "New Accounting Pronouncements" in *Note 1* in financial statements.

### To the Board of Directors and Stockholders, The Female Health Company and Subsidiaries, Chicago, Illinois

We have audited the accompanying consolidated balance sheet of The Female Health Company and Subsidiaries, as of September 30, 2002, and the related consolidated statements of operations, stockholders' equity (deficit), and cash flows for the years ended September 30, 2002 and 2001. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of The Female Health Company and Subsidiaries as of September 30, 2002, and the results of their operations and their cash flows for the years ended September 30, 2002 and 2001, in conformity with accounting principles generally accepted in the United States of America.

The accompanying consolidated financial statements have been presented assuming that The Female Health Company will continue as a going concern. As more fully described in *Note 16*, the Company has experienced slower than expected growth in revenues from its sole product, which has adversely affected the Company's current results of operations and liquidity. These conditions raise substantial doubt about the Company's ability to continue as a going concern. Management's plans in regard to these matters are also described in *Note 16*. The consolidated financial statements do not include any adjustments to reflect the possible future effects on the recoverability and classification of assets or the amounts of classification of liabilities that may result from the outcome of this uncertainty.



Schaumburg, Illinois

November 12, 2002, except for the waiver of  
loan covenant violations discussed in *Note 4*,  
as to which the date is December 13, 2002.

## Consolidated Balance Sheet

<i>Year Ended September 30</i>	<i>2002</i>
<b>ASSETS</b>	
<b>CURRENT ASSETS</b>	
Cash	\$ 558,643
Accounts receivable, net of allowance for doubtful accounts of \$18,000 and allowance for product returns of \$5,000	2,421,425
Inventories	913,184
Prepaid expenses and other current assets	244,224
<b>Total Current Assets</b>	<b>4,137,476</b>
<b>OTHER ASSETS</b>	
Certificate of deposit	121,042
Intellectual property, net of accumulated amortization of \$776,213	388,162
Other	157,555
<b>Total Other Assets</b>	<b>666,759</b>
<b>EQUIPMENT AND FURNITURE AND FIXTURES</b>	
Equipment, furniture and fixtures	4,049,041
Less accumulated depreciation	3,290,406
<b>Net Property, Plant and Equipment</b>	<b>758,635</b>
<b>TOTAL ASSETS</b>	<b>\$ 5,562,870</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>	
<b>CURRENT LIABILITIES</b>	
Note payable, related party, net of unamortized discount of \$147,651	\$ 852,349
Accounts payable	524,947
Current maturities of obligations under capital leases	24,542
Accrued expenses and other current liabilities	691,954
Preferred dividends payable	133,996
<b>Total Current Liabilities</b>	<b>2,227,788</b>
<b>LONG-TERM LIABILITIES</b>	
Note payable, bank, net of unamortized discount of \$972,454	927,546
Obligations under capital leases	52,912
Convertible debentures	450,000
Deferred gain on sale of facility	1,274,339
<b>Total Long-Term Liabilities</b>	<b>2,704,797</b>
<b>STOCKHOLDERS' EQUITY</b>	
Convertible preferred stock, Series 1, par value \$0.01 per share.	
Authorized 5,000,000 shares; issued and outstanding 66,000 shares	660
Common stock, par value \$0.01 per share.	
Authorized 35,500,000 shares; issued and outstanding 18,042,384 shares.	180,424
Additional paid-in capital	54,990,237
Unearned consulting fees	(173,013)
Deferred compensation	(641,017)
Accumulated other comprehensive income	224,953
Accumulated deficit	(53,919,883)
<b>Total Stockholders' Equity</b>	<b>662,361</b>
Treasury Stock, at cost, 20,000 shares of common stock	(32,076)
<b>Total Stockholders' Equity and Treasury Stock</b>	<b>630,285</b>
<b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b>	<b>\$ 5,562,870</b>

See Notes to Consolidated Financial Statements.

## Consolidated Statements of Operations

<i>Years Ended September 30</i>	<i>2002</i>	<i>2001</i>
NET REVENUES	\$ 8,416,512	\$ 6,716,174
COST OF PRODUCTS SOLD	4,855,321	4,406,110
<b>GROSS PROFIT</b>	<b>3,561,191</b>	<b>2,310,064</b>
OPERATING EXPENSES:		
Advertising and promotion	43,832	129,155
Selling, general and administrative	3,064,683	2,539,037
Out of court settlement costs	1,258,210	—
Stock compensation	1,863,956	123,758
<b>Total Operating Expenses</b>	<b>6,230,681</b>	<b>2,791,950</b>
<b>OPERATING (LOSS)</b>	<b>(2,669,490)</b>	<b>(481,886)</b>
NONOPERATING INCOME (EXPENSE):		
Interest expense	(817,714)	(702,039)
Interest income	6,042	12,669
<b>Total Nonoperating Income (Expense)</b>	<b>(811,672)</b>	<b>(689,370)</b>
<b>NET (LOSS)</b>	<b>(3,481,162)</b>	<b>(1,171,256)</b>
Preferred dividends, Series 1	132,005	133,000
<b>NET (LOSS) ATTRIBUTABLE TO COMMON STOCKHOLDERS</b>	<b>\$ (3,613,167)</b>	<b>\$ (1,304,256)</b>
<b>NET (LOSS) PER COMMON SHARE OUTSTANDING</b>	<b>\$ (0.22)</b>	<b>\$ (0.09)</b>
<b>WEIGHTED AVERAGE COMMON SHARES OUTSTANDING</b>	<b>16,244,920</b>	<b>14,630,970</b>

*See Notes to Consolidated Financial Statements.*



## Consolidated Statements of Stockholders' Equity (Deficit)

	Preferred Stock	Common Stock	Additional Paid-In Capital	Unearned Consulting Fees	Deferred Compensation	Accumulated Other Comprehensive Income	Accumulated Deficit	Cost of Treasury Stock	Total
<b>BALANCE AT SEPTEMBER 30, 2000 (Balance forwarded)</b>	<b>\$ 6,600</b>	<b>\$ 138,037</b>	<b>\$ 48,231,986</b>	<b>\$ (90,815)</b>	—	<b>\$ 55,661</b>	<b>\$ (49,002,460)</b>	<b>\$ (32,076)</b>	<b>\$ (693,067)</b>
Issuance of 200,000 shares of Common Stock for consulting services		2,000	91,760	(93,760)	—	—	—	—	—
Issuance of warrants with note payable, bank	—	—	938,378	—	—	—	—	—	938,378
Issuance of warrants with notes payable, related parties	—	—	144,813	—	—	—	—	—	144,813
Renewal of expired warrants	—	—	22,661	—	—	—	—	—	22,661
Issuance of 54,322 shares of Common Stock as payment of interest on debentures	—	543	27,353	—	—	—	—	—	27,896
Issuance of 34,908 shares of Common Stock as payment of preferred stock dividends	—	349	23,651	—	—	—	—	—	24,000
Preferred Stock dividends	—	—	—	—	—	—	(133,000)	—	(133,000)
Issuance of 1,600,000 shares of Common Stock	—	16,000	784,000	—	—	—	—	—	800,000
Amortization of unearned consulting fees	—	—	—	123,758	—	—	—	—	123,758
Comprehensive income (loss):									
Net (loss)	—	—	—	—	—	—	(1,171,256)	—	(1,171,256)
Foreign currency translation adjustment	—	—	—	—	—	(31,860)	—	—	(31,860)
COMPREHENSIVE INCOME (LOSS)									(1,203,116)
<b>BALANCE AT SEPTEMBER 30, 2001</b>	<b>\$ 6,600</b>	<b>\$ 156,929</b>	<b>\$ 50,264,602</b>	<b>\$ (60,817)</b>	—	<b>\$ 23,801</b>	<b>\$ (50,306,716)</b>	<b>\$ (32,076)</b>	<b>\$ 52,323</b>

See Notes to Consolidated Financial Statements.

## Consolidated Statements of Stockholders' Equity (Deficit)

	Preferred Stock	Common Stock	Additional Paid-In Capital	Unearned Consulting Fees	Deferred Compensation	Accumulated Other Comprehensive Income	Accumulated Deficit	Cost of Treasury Stock	Total
<b>BALANCE AT SEPTEMBER 30, 2001 (balance forwarded)</b>	<b>\$ 6,600</b>	<b>\$ 156,929</b>	<b>\$ 50,264,602</b>	<b>\$ (60,817)</b>	<b>\$ —</b>	<b>\$ 23,801</b>	<b>\$ (50,306,716)</b>	<b>\$ (32,076)</b>	<b>\$ 52,323</b>
Issuance of 100,000 shares of Common Stock for consulting services	—	1,000	66,000	(67,000)	—	—	—	—	—
Issuance of 150,000 stock options for consulting services	—	—	188,830	(188,830)	—	—	—	—	—
Conversion of 594,000 shares of Preferred Stock into 824,911 shares of Common Stock	(5,940)	8,250	(2,310)	—	—	—	—	—	—
Issuance of 92,549 shares of Common Stock upon exercise of stock options	—	925	42,083	—	—	—	—	—	43,008
Issuance of 450,000 shares of Common Stock and extension of warrants for out of court settlement	—	4,500	1,253,710	—	—	—	—	—	1,258,210
Stock compensation relating to the Company's stock option plans	—	—	1,720,322	—	—	—	—	—	1,720,322
Issuance of 469,000 restricted shares of Common Stock	—	4,690	503,559	—	(641,017)	—	—	—	(132,768)
Issuance of 183,150 shares of Common Stock upon exercise of stock warrants	—	1,832	98,168	—	—	—	—	—	100,000
Issuance of warrants with note payable, bank	—	—	415,427	—	—	—	—	—	415,427
Issuance of warrants with note payable, related party	—	—	265,710	—	—	—	—	—	265,710
Renewal of expired warrants	—	—	30,436	—	—	—	—	—	30,436
Issuance of 39,180 shares of Common Stock as payment of interest on debentures	—	392	49,608	—	—	—	—	—	50,000
Issuance of 70,585 shares of Common Stock as payment of preferred stock dividends	—	706	35,292	—	—	—	—	—	35,998
Preferred stock dividends	—	—	—	—	—	—	(132,005)	—	(132,005)
Issuance of 120,000 shares of Common Stock	—	1,200	58,800	—	—	—	—	—	60,000
Amortization of unearned consulting fees	—	—	—	143,634	—	—	—	—	143,634
Comprehensive income (loss):									
Net (loss)	—	—	—	—	—	—	(3,481,162)	—	(3,481,162)
Foreign currency translation adjustment	—	—	—	—	—	201,152	—	—	201,152
COMPREHENSIVE INCOME (LOSS)									(3,280,010)
<b>BALANCE AT SEPTEMBER 30, 2002</b>	<b>\$ 660</b>	<b>\$ 180,424</b>	<b>\$ 54,990,237</b>	<b>\$ (173,013)</b>	<b>\$ (641,017)</b>	<b>\$ 224,953</b>	<b>\$ (53,919,883)</b>	<b>\$ (32,076)</b>	<b>\$ 630,285</b>

See Notes to Consolidated Financial Statements.

## Consolidated Statements of Cash Flows

<i>Years Ended September 30</i>	<i>2002</i>	<i>2001</i>
<b>OPERATING ACTIVITIES</b>		
Net (Loss)	\$ (3,481,162)	\$ (1,171,256)
ADJUSTMENTS TO RECONCILE NET (LOSS) TO NET CASH (USED IN) OPERATING ACTIVITIES:		
Depreciation	410,173	425,795
Amortization of intellectual property rights	109,245	106,779
(Recovery of) inventory obsolescence	(1,768)	(28,623)
(Recovery of) doubtful accounts, returns and discounts	(4,554)	(135,593)
Interest added to certificate of deposit	(6,042)	—
Amortization of unearned consulting fees	143,634	123,758
Amortization of discounts on notes payable and convertible debentures	458,501	375,541
Amortization of deferred income realized on U.K. grant	(26,557)	(25,956)
Amortization of deferred gain on sale and leaseback of building	(83,896)	(82,000)
Out of court settlement	1,258,210	—
Stock compensation	1,720,322	—
Gain on sale of equipment and furniture and fixtures	(1,105)	—
CHANGES IN OPERATING ASSETS AND LIABILITIES:		
Accounts receivable	(801,872)	(466,630)
Inventories	(237,449)	(97,696)
Prepaid expenses and other assets	(114,357)	(41,565)
Accounts payable	31,747	135,609
Accrued expenses and other current liabilities	248,279	256,818
<b>NET CASH (USED IN) OPERATING ACTIVITIES</b>	<b>(378,651)</b>	<b>\$ (625,019)</b>
<b>INVESTING ACTIVITIES</b>		
Purchase of certificate of deposit	—	(115,000)
Capital expenditures	(35,009)	\$ (57,791)
Proceeds on sale of equipment and furniture and fixtures	1,105	—
<b>NET CASH (USED IN) INVESTING ACTIVITIES</b>	<b>(33,904)</b>	<b>\$ (172,791)</b>
<b>FINANCING ACTIVITIES</b>		
Proceeds from issuance of common stock	60,000	800,000
Proceeds from exercised stock options	43,008	—
Proceeds from exercise of common stock warrants	100,000	—
Proceeds from note payable, bank	500,000	1,500,000
Payments on note payable, bank	(100,000)	—
Proceeds from convertible debentures issued	—	450,000
Payments on convertible debentures	—	(1,500,000)
Dividend paid on preferred stock	(95,825)	(107,186)
Payments on related party notes	—	(300,000)
Payments on capital lease obligations	(8,403)	—
<b>NET CASH PROVIDED BY FINANCING ACTIVITIES</b>	<b>498,780</b>	<b>\$ 842,814</b>
Effect of exchange rate changes on cash	3,012	(32,720)
<b>Net increase in cash</b>	<b>89,237</b>	<b>12,284</b>
Cash at beginning of year	469,406	457,122
<b>CASH AT END OF YEAR</b>	<b>558,643</b>	<b>469,406</b>
<b>SUPPLEMENTAL CASH FLOW DISCLOSURES:</b>		
Interest paid	381,578	303,837
<b>SUPPLEMENTAL SCHEDULE OF NON-CASH INVESTING AND FINANCING ACTIVITIES</b>		
Issuance of warrants on notes payable	681,137	1,105,852
Common stock issued for payment of preferred stock dividends and convertible debenture interest	85,998	51,896
Preferred dividends declared, Series 1	132,005	133,000
Renewal of notes payable with related parties	1,000,000	1,300,000
Capital lease obligations incurred for capital expenditures	81,076	—

See Notes to Consolidated Financial Statements.

## Note 1. Nature of Business and Significant Accounting Policies

### Principles of consolidation and nature of operations:

The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries, The Female Health Company - UK and The Female Health Company - UK, plc. All significant intercompany transactions and accounts have been eliminated in consolidation. The Female Health Company ("FHC" or the "Company") is currently engaged in the marketing, manufacture and distribution of a consumer health care product known as the "FC Female Condom" in the U.S., and "Femidom" or "Femy" outside the U.S. The Female Health Company - UK, is the holding company of The Female Health Company - UK, plc, which operates a 40,000 sq. ft. leased manufacturing facility located in London, England.

The product is currently sold or available in either or both commercial (private sector) and public sector markets in over 100 countries. The product is marketed in 17 countries by various country-specific commercial partners. The Company's credit terms are primarily on a net 30-day basis.

### Significant Accounting Policies:

Use of estimates: The preparation of financial statements requires management to make estimates and use assumptions that affect certain reported amounts and disclosures. Actual results may differ from those estimates.

Significant accounting estimates include the following:

Trade receivables include a provision for sales returns and trade allowances, which is based on management's estimate of future product returns from customers in connection with unsold product which has expired or is expected to expire before it is sold. The estimated costs for product returns, price discounts and trade allowances are accrued when the initial sale is recorded.

The market value of inventory is based on management's best estimate of future sales and the time remaining before the existing inventories reach their expiration dates.

The Company evaluates intellectual property rights for impairment by comparing the net present value of the asset's estimated future income stream to the asset's carrying value.

Although management uses the best information available, it is reasonably possible that the estimates used by the Company will be materially different from the actual results. These differences could have a material effect on the Company's future results of operations and financial condition.

Inventories: Inventories are valued at the lower of cost or market. The cost is determined using the first-in, first-out (FIFO) method. Inventories are also written down for management's estimates of product which will not sell prior to its expiration date. Write downs of inventories establish a new cost basis which is not increased for future increases in the market value of inventories or changes in estimated obsolescence.

Foreign currency translation: In accordance with Financial Accounting Standards No. 52, *Foreign Currency Translation*, the financial statements of the Company's international subsidiaries are translated into U.S. dollars using the exchange rate at each balance sheet date for assets and liabilities, the historical exchange rate for stockholders' equity and a weighted average exchange rate for each period for revenues, expenses, and gains and losses. Translation adjustments are recorded as a separate component of stockholders' equity as the local currency is the functional currency.

Equipment and furniture and fixtures: Depreciation and amortization are computed using primarily the straight-line method. Depreciation and amortization are computed over the estimated useful lives of the respective assets which range as follows:

Equipment	5 - 10 years
Furniture and fixtures	3 years



Intellectual property rights: The Company holds patents on The Female Condom in the United States, the European Union, Japan, Canada, Australia and The People's Republic of China and holds patents on the manufacturing technology in various countries. The Company has the registered trademark "FC Female Condom" in the United States and has trademarks on the names "Femidom" and "Femy" in certain foreign countries. Intellectual property rights are amortized on a straight-line basis over their estimated useful life of twelve years.

Financial instruments: The Company has no financial instruments for which the carrying value materially differs from fair value.

Reclassification: Certain expenses on the statements of operations for the year ended September 30, 2001, have been reclassified to be consistent with the presentation shown for the year ended September 30, 2002.

Revenue recognition: Revenues from product sales are recognized as the products are shipped to the customers.

Stock-based compensation: The value of stock options awarded to employees is measured using the intrinsic value method prescribed by Accounting Principles Board Opinion No. 25 (APB 25), *Accounting for Stock Issued to Employees*. The Company has provided pro forma disclosures in Note 8 of net income as if the fair-value-based method prescribed by Financial Accounting Standard No. 123, *Accounting for Stock-Based Compensation* (FAS 123), was used in measuring compensation expense.

Advertising: The Company's policy is to expense production costs in the period in which the advertisement is initially presented to consumers.

Income taxes: The Company files separate income tax returns for its foreign subsidiaries. Statement of Financial Accounting Standards No. 109, *Accounting for Income Taxes* (FAS 109), requires recognition of deferred tax assets and liabilities for the expected future tax consequences of events that have been included in the financial statements or tax returns. Under this method, deferred tax assets and liabilities are determined based on the differences between the financial statements and tax bases of assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to reverse. Deferred tax assets are also provided for carryforwards for income tax purposes. In addition, the amount of any future tax benefits is reduced by a valuation allowance to the extent such benefits are not expected to be realized.

Earnings per share (EPS): Basic EPS is computed by dividing income available to common stockholders by the weighted average number of common shares outstanding for the period. Diluted EPS is computed giving effect to all dilutive potential common shares that were outstanding during the period. Dilutive potential common shares consist of the incremental common shares issuable upon conversion of convertible preferred shares or convertible debt and the exercise of stock options and warrants for all periods. Fully diluted (loss) per share is not presented since the effect would be anti-dilutive.

Other comprehensive income: Accounting principles generally require that recognized revenue, expenses, gains and losses be included in net income. Although certain changes in assets and liabilities, such as foreign currency translation adjustments, are reported as a separate component of the equity section of the balance sheet, such items, along with net income, are components of comprehensive income.

New accounting pronouncements: In July 2001, the Financial Accounting Standards Board issued SFAS 141, *Business Combinations*, and SFAS 142, *Goodwill and Other Intangible Assets*. SFAS 141 addresses financial accounting and reporting for business combinations and is effective for all business combinations initiated after June 30, 2001. SFAS 142 addresses financial accounting and reporting for acquired goodwill and other intangible assets and is effective for fiscal years beginning after December 15, 2001. Management does not anticipate that the adoption of these Statements will have a significant effect on the Company's financial statements.

In August 2001, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards (SFAS) No. 143, *Asset Retirement Obligations*. This Statement addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated retirement costs. SFAS 143 applies to legal obligations associated with the retirement of long-lived assets that result from the acquisition, construction, development and (or) the normal operation of a long-lived asset, except for certain obligations of lessees. As used in this Statement, a legal obligation is an obligation that a party is required to settle as a result of an existing or enacted law, statute, ordinance, or written or oral contract or by legal construction of a contract under the doctrine of promissory estoppel. This Statement amends FASB Statement No. 19, *Financial Accounting and Reporting by Oil and Gas Producing Companies*, and is effective for financial statements issued for fiscal years beginning after June 15, 2002. Management does not anticipate that the adoption of this Statement will have a significant effect on the Company's financial statements.

In October 2001, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards (SFAS) No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. This Statement addresses the financial accounting and reporting for the impairment or disposal of long-lived assets and supersedes FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of*, and the accounting and reporting provisions of APB Opinion No. 30, *Reporting the Results of Operations-Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*, for the disposal of a segment of a business (as previously defined in that Opinion). SFAS 144 also amends ARB No. 51, *Consolidated Financial Statements*, to eliminate the exception to consolidation for a subsidiary for which control is likely to be temporary. The provisions of this Statement are effective for financial statements issued for fiscal years beginning after December 15, 2001. Management does not anticipate that the adoption of this Statement will have a significant effect on the Company's financial statements.

In April 2002, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards (SFAS) No. 145, *Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections*. SFAS 145 rescinds SFAS 4, *Reporting Gains and Losses from Extinguishment of Debt*, and an amendment of that Statement, SFAS 64, *Extinguishments of Debt Made to Satisfy Sinking-Fund Requirements*. This Statement also rescinds SFAS 44, *Accounting for Intangible Assets of Motor Carriers*. This Statement amends SFAS 13, *Accounting for Leases*, to eliminate an inconsistency between the required accounting for sale-leaseback transactions and the required accounting for certain lease modifications that have economic effects that are similar to sale-leaseback transactions. SFAS 145 also amends other existing authoritative pronouncements to make various technical corrections, clarify meanings, or describe their applicability under changed conditions. SFAS 145 is effective for financial statements issued for fiscal years beginning after May 15, 2002. Management does not anticipate that the adoption of this Statement will have a significant effect on the Company's financial statements.

In June 2002, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards (SFAS) No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*. SFAS 146 addresses financial accounting and reporting for costs associated with exit or disposal activities and nullifies Emerging Issues Task Force (EITF) Issue No. 94-3, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)." SFAS 146 is effective for exit or disposal activities initiated after December 31, 2002. Management does not anticipate that the adoption of this Statement will have a significant effect on the Company's financial statements.

In November 2002, the Financial Accounting Standards Board (FASB) issued FASB Interpretation (FIN) No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness to Others*. FIN 45 elaborates on the disclosures to be made by a guarantor in its interim and annual financial statements about its obligations under certain guarantees that it has issued. It also clarifies that a guarantor is required to recognize, at the inception of certain guarantee contracts, a liability for the fair value of the obligation undertaken in issuing the guarantee. FIN 45 also incorporates, without change, the guidance in FIN 34, *Disclosure of Indirect Guarantees of Indebtedness of Others*, which is being superseded. FIN 45 is effective for financial statements issued for fiscal years ending after December 15, 2002. Management does not anticipate that the adoption of this Statement will have a significant effect on the Company's financial statements.

## Note 2. Inventories

The components of inventory consist of the following at September 30, 2002:

Raw materials	\$ 574,952
Work in process	84,880
Finished goods	298,568
Less allowance for obsolescence	(45,216)
<b>Net inventory</b>	<b>\$ 913,184</b>

## Note 3. Operating Leases and Rental Expense

The Company has a lease agreement for office space with an unrelated third party which expires September 2006. The lease requires monthly payments of \$5,763 plus real estate taxes, utilities, and maintenance expenses. The Company was required to make an initial security deposit of \$115,000 which has been reduced to \$92,000 as of September 30, 2002. The security deposit is in the form of an irrevocable letter of credit from a bank. The Bank presently requires the Company to hold a \$92,000 certificate of deposit as collateral for the letter of credit.

The Company guaranteed an affiliate's lease with an unrelated third party which expired January 31, 2001. On November 1, 1998, the office space was sublet for the remaining term of the lease. Rental expense under the affiliate lease was \$3,495 in 2001 which is net of sublease rentals of \$9,891.

On December 10, 1996, the Company entered into what is in essence a sale and leaseback agreement with respect to its 40,000 square foot manufacturing facility located in London, England. The Company received \$3,365,000 (£1,950,000) for leasing the facility to a third party for a nominal annual rental charge and for providing the third party with an option to purchase the facility for one pound during the period December 2006 to December 2027.

As part of the same transaction, the Company entered into an agreement to lease the facility back from the third party for base rents of \$396,021 (£268,125) per year payable quarterly until 2016. The lease is renewable through December 2027. The Company was also required to make an initial security deposit of \$396,021 (£268,125) which has been reduced to \$153,075 (£97,500) and is included in other assets in the balance sheet at September 30, 2002. The facility had a net book value of \$1,398,819 (£810,845) on the date of the transaction. The \$1,966,181 (£1,139,155) gain which resulted from this transaction will be recognized ratably over the initial term of the lease. Unamortized deferred gain as of September 30, 2002, was \$1,274,339 (£811,681).

The Company also leases equipment under lease agreements which expire at various dates between October 2004 and December 2005. The aggregate monthly rental was \$3,405 at September 30, 2002.

Details of operating lease expense in total and separately for transactions with related parties are as follows:

<i>Years ended September 30</i>	<i>2002</i>	<i>2001</i>
Operating lease expense:		
Factory and office leases	\$ 622,037	\$ 551,039
Affiliate lease (net of sublease rentals)	—	3,495
Other	10,217	20,000
<b>Total lease expense</b>	<b>\$ 632,254</b>	<b>\$ 574,534</b>

Future minimum payments under operating leases consisted of the following at September 30, 2002:

	<i>Operating</i>
2003	473,733
2004	475,450
2005	472,434
2006	470,487
2007	396,020
Thereafter	3,645,853
<b>Total minimum payments</b>	<b>\$ 5,933,977</b>

#### **Note 4. Notes Payable and Long-Term Debt**

During 2001, the Company renewed a \$1,000,000 note with Mr. Dearholt, a current director of the Company. The outstanding note payable bears interest at 12 percent. As part of the transaction, the Company issued Mr. Dearholt warrants to purchase 280,000 shares of the Company's common stock at \$0.40 per share which represented 80 percent of the average trading price for the five trading days prior to the closing date for the transaction and resulted in an initial discount on the note of \$113,881. Any stock issued under the warrants carries certain registration rights. The warrants expire in 2011. The discount in combination with the note's 12 percent coupon resulted in an effective interest rate of 25 percent on the note.

Additionally, during 2001, the Company renewed a \$250,000 note with Mr. Dearholt and a \$50,000 note with O.B. Parrish, also a current director of the Company. Each note payable bears interest at 12 percent. As part of the transactions, the Company issued Mr. Dearholt and Mr. Parrish warrants to purchase 70,000 and 14,000 shares of the Company's common stock, respectively, at \$0.40 per share, which represented 80 percent of the average trading price for the five trading days

prior to the closing date for the transaction and resulted in an initial discount on the notes of \$25,238 and \$5,694, respectively. Any stock issued under the warrants carries certain registration rights. The warrants expire in 2011 for each note. The discount in combination with the notes' 12 percent coupon resulted in an effective interest rate of 23 percent for each note. Both notes were paid off in June 2001.

During 2002, the Company renewed the \$1,000,000 note with Mr. Dearholt. The outstanding note payable bears interest at 12 percent and is payable in full in March 2003. As part of the transaction, the Company issued Mr. Dearholt warrants to purchase 300,000 shares of the Company's common stock at \$1.18 per share which represented 80 percent of the average trading price for the five trading days prior to the closing date for the transaction and resulted in an initial discount on the note of \$265,710. Any stock issued under the warrants carries certain registration rights. The warrants expire in 2012. In addition, if the Company defaults on its obligation under the note, the Company is required to issue an additional 300,000 shares of its common stock to Mr. Dearholt in addition to all other remedies to which Mr. Dearholt may be entitled. The note is recorded at September 30, 2002, net of unamortized discount of \$147,651. The discount, in combination with the note's 12 percent coupon resulted in an effective interest rate of 46 percent on the note.

On May 19 and June 3, 1999, the Company issued an aggregate of \$1,500,000 of convertible debentures. Interest on the convertible debentures is due at a rate of 8 percent per annum, payable quarterly in either cash or, at the investor's option, common stock of the Company at its then current market value. Concurrent with obtaining the credit facility discussed in the next paragraph, the Company paid off \$1,500,000 of convertible debentures which were due between May 19 and June 3, 2001.

On May 18, 2001, the Company entered into an agreement with Heartland Bank providing for a \$2,000,000 credit facility. The Company may borrow under this credit facility from time to time subject to a number of conditions, including obtaining personal guarantees of 125 percent of the amount outstanding under the credit facility. The unpaid balances on the credit facility are due May 18, 2004, and bear interest payable at an annual rate of 10 percent. The agreement contains certain covenants which include restrictions on the payment of dividends and distributions and on the issuance of warrants. The Company paid dividends on the Company's Class A Preferred Stock – Series 1 and issued warrants on its short-term note, both of which are covenant violations of the credit facility. The violations were waived by the bank on December 13, 2002.

Heartland Bank was issued warrants to purchase the number of shares of the Company's common stock equal to \$500,000 divided by the warrant purchase price as of the date of exercise. The warrant purchase price is equal to 70 percent of the "market price" of the common stock as of the day immediately prior to the date the exercise notice is given to the Company, but in no event shall the per share price be less than \$0.50 or more than \$1.00. In accounting for Heartland Bank's warrants, the Company has designated 1,000,000 warrants valued at \$270,800 and these are recorded by the Company as additional paid-in capital and a discount on the credit facility. During 2001, the Company borrowed \$1,500,000 under the credit facility and obtained personal guarantees of a total of 125 percent of the amount outstanding on the loan from five persons, three of which are current directors of the Company and one of which is a trust for the benefit of a current officer and director of the Company. During 2002, the Company borrowed the remaining \$500,000 under the credit facility and obtained personal guarantees of a total of 125 percent of the amount outstanding on the loan from three additional persons. The Company paid down \$100,000 on the credit facility in September 2002.

For giving their personal guarantees, the Company issued to the eight guarantors warrants to purchase the number of shares of the Company's common stock equal to the guarantee amount of each guarantor divided by the warrant purchase price as of the date of exercise. The warrant purchase price is equal to 70 percent of the "market price" of the common stock as of the day immediately prior to the date the exercise notice is given to the Company, but in no event shall the per share price be less than \$0.50 or more than \$1.00.

In 2001, the Company also issued additional warrants to purchase 100,000 shares of common stock to two guarantors with a warrant purchase price of \$0.50 per share. In accounting for the guarantors' warrants related to the \$1,500,000 borrowed in 2001, the Company designated 3,200,000 warrants valued at \$667,578 and these are recorded by the Company as additional paid-in capital and a discount on the credit facility. The value of the warrants in combination with the credit facility's 10 percent coupon resulted in an effective interest rate of 50 percent on that portion of the note.

In 2002, the Company also issued additional warrants to purchase 100,000 shares of common stock to one guarantor with a warrant purchase price of \$0.50 per share. In accounting for the guarantors' warrants related to the \$500,000 borrowed in 2002, the Company designated 900,000 warrants valued at \$415,427 and these are recorded by the Company as additional paid-in capital and a discount on the credit facility. The credit facility is recorded at September 30, 2002, net of unamortized discount of \$927,546. The value of the 2002 warrants in combination with the credit facility's 10 percent coupon resulted in an effective interest rate of 101 percent on that portion of the note.

On March 30, 2001, the Company issued a \$250,000 convertible debenture to one accredited investor. The debenture is due March 30, 2004, bears interest payable at a rate of 12 percent and is convertible into the Company's common stock based on a price of \$0.50 per share. The Company's common stock was trading at less than \$0.50 per share at the commitment date of this transaction.



On June 1, 2001, the Company issued an aggregate \$200,000 of convertible debentures to two accredited investors. The debentures are due May 30, 2004, bear interest payable at a rate of 10 percent per annum, and are convertible into the Company's common stock based on a price per share equal to \$0.50 which was the market price at the commitment date of this transaction. These convertible debentures were converted to common stock in December 2002.

Interest expense to related parties was \$322,659 and \$528,769 for the years ended September 30, 2002 and 2001, respectively.

## Note 5. Capital Leases

The Company leases vehicles under capital leases. The assets and liabilities under the leases were recorded at the present value of future minimum rental payments.

Minimum future lease payments under capital leases as of September 30, 2002, are as follows:

<i>Years ending September 30</i>	
2003	29,536
2004	32,019
2005	20,906
Total minimum lease payments	82,461
Less the amount representing interest	5,007
Present value of net minimum lease payments	77,454
Less current portion	24,542
<b>Long-term obligations under capital leases</b>	<b>\$ 52,912</b>

The cost and accumulated amortization of the leased assets at September 30, 2002, are approximately \$104,000 and \$12,000, respectively. There was no amortization of leased assets for the year ended September 30, 2001.

## Note 6. Income Taxes

A reconciliation of income tax expense and the amount computed by applying the statutory federal income tax rate to loss before income taxes as of September 30, 2002 and 2001, are as follows:

<i>Years ended September 30</i>	<i>2002</i>	<i>2001</i>
Income tax credit at statutory rates	\$ (1,184,000)	\$ (398,000)
Non-deductible expenses	486,000	58,700
State income tax, net of federal benefits	(244,000)	(55,700)
Benefit of net operating loss not recognized, increase in valuation allowance	942,000	395,000
<b>Income tax expense</b>	<b>\$ —</b>	<b>\$ —</b>

As of September 30, 2002, the Company had federal and state net operating loss carryforwards of approximately \$40,800,000 and \$23,180,000, respectively, for income tax purposes expiring in years 2005 to 2022. The benefit relating to \$1,537,800 of these net operating losses relates to exercise of common stock options and will be credited directly to stockholders' equity when realized. The Company also has investment tax and research and development credit carryforwards for income tax purposes aggregating approximately \$105,000 at September 30, 2002, expiring in years 2006 to 2010. The Company's UK subsidiary, The Female Health Company - UK, plc has UK net operating loss carryforwards of approximately \$67,960,000 as of September 30, 2002. These UK net operating loss carryforwards can be carried forward indefinitely to be used to offset future UK taxable income. Significant components of the Company's deferred tax assets and liabilities are as follows at September 30, 2002:

Deferred tax assets:	
Federal net operating loss carryforwards	\$ 13,871,000
State net operating loss carryforwards	1,178,000
Foreign net operating loss carryforwards	20,388,000
Foreign capital allowances	227,000
Tax credit carryforwards	105,000
Other	16,000
Total gross deferred tax assets	35,785,000
Valuation allowance for deferred tax assets	(35,785,000)
<b>Net deferred tax assets</b>	<b>\$ —</b>

The valuation allowance increased (decreased) by \$696,000 and \$(105,000) for the years ended September 30, 2002 and 2001, respectively.

## Note 7. Royalty Agreements

The Company had a royalty agreement for sales of its products which provide for royalty payments based on sales quantities and achievement of specific sales levels. Royalty expense was \$27,102 for the year ended September 30, 2001. There was no royalty expense for the year ended September 30, 2002.

## Note 8. Common Stock

### Stock Option Plans

The Company has various stock option plans that authorize the granting of options to officers, key employees and directors to purchase the Company's common stock at prices generally equal to the market value of the stock at the date of grant. Under these plans, the Company has 2,245,808 shares available for future grants as of September 30, 2002. The Company has also granted options to one of its legal counsel, an affiliate and consultants. Certain options are vested and exercisable upon issuance, others over periods up to four years and still others based on the achievement of certain performance criteria by the Company and market prices of its common stock.

In September 2001, the holders of exercisable stock options waived their rights to exercise their options until the Company amended its articles of incorporation to increase the number of shares of common stock authorized for issuance. To obtain this waiver, the Company agreed to re-price these options at \$0.56 per share once the amendment was approved. The Company's common stock was trading at less than \$0.56 per share when the waivers were obtained. The total number of options that were waived at September 30, 2001, was 2,659,800.

On May 8, 2002, the shareholders approved an amendment to the Amended and Restated Articles of Incorporation to increase the total number of authorized shares of common stock from 27,000,000 to 35,500,000 shares. Since the amendment was approved, the stock options have been re-priced to \$0.56 per share. The Company has accounted for all of these stock options in accordance with variable plan accounting guidance provided in APB No. 25 and related interpretations. The reduction in the exercise price of the re-priced options and the increase in the stock price of the Company's common stock as of September 30, 2002 resulted in \$1,720,322 of stock compensation expense due to the repricing for the year ended September 30, 2002.

Effective September 2002, the holders of outstanding options to purchase a total of 2,365,980 shares of common stock agreed to exchange their options for:

- a total of 469,000 shares of restricted common stock in the case of U.S. option holders or the right to receive a total of 122,495 shares of deferred common stock in September 2003 in the case of U.K. option holders; and
- the right to receive a grant of new options to purchase a total of 2,365,980 shares of common stock on the first business day that is at least six months and one day after the effective date of the exchange.

The shares of restricted common stock and the right to receive the shares of deferred common stock are subject to forfeiture if the participant voluntarily resigns or is terminated for cause on or before September 26, 2003 and may not be transferred on or before September 26, 2003. As of September 30, 2002, the Company had issued the restricted common stock to U.S. option holders and accrued for the issuance to U.K. option holders. The restricted and deferred shares have been recorded as deferred compensation within stockholders' equity as of September 30, 2002, and will be amortized over the employees' one-year service periods.

The new options will have an exercise price equal to 100% of the fair market value of the common stock on the grant date and a vesting schedule of 1/36 per month for each of the first 36 months after the date of grant. The new options, when granted, will be accounted for in accordance with fixed plan accounting guidance provided in APB No. 25. Options to purchase a total of 320,000 shares of common stock did not participate in the exchange and will continue to be accounted for in accordance with variable plan accounting guidance.

Summarized information regarding all of the Company's stock options is as follows:

	<i>Number of Shares</i>	<i>Weighted Average Exercise Price</i>
<b>Outstanding at September 30, 2000</b>	<b>2,917,400</b>	<b>\$ 1.27</b>
Granted	—	—
Exercised	—	—
Expired or canceled	(37,600)	2.00
<b>Outstanding at September 30, 2001</b>	<b>2,879,800</b>	<b>\$ 0.64</b>
Granted	190,000	1.11
Exercised	92,549	0.56
Expired or canceled	(2,572,349)	0.56
<b>Outstanding at September 30, 2002</b>	<b>590,000</b>	<b>\$ 0.88</b>

Option shares exercisable at September 30, 2002 and 2001, are 196,700 and 40,000, respectively.

#### Options Outstanding and Exercisable

<i>Options Outstanding</i>			<i>Options Exercisable</i>		
<i>Exercise Price</i>	<i>Number Outstanding at 9/30/02</i>	<i>Weighted Average Remaining Life</i>	<i>Weighted Average Exercise Price</i>	<i>Number Exercisable at 9/30/02</i>	<i>Weighted Average Exercise Price</i>
\$ 0.56	320,000	5.95	0.56	6,700	\$ 0.56
0.66	150,000	9.25	0.66	150,000	0.66
2.00	120,000	2.20	2.00	40,000	2.00
<b>\$ .56 to \$2.00</b>	<b>590,000</b>	<b>6.03</b>	<b>\$ 0.88</b>	<b>196,700</b>	<b>\$ 0.93</b>

In 2002, the Company granted 40,000 options to employees with exercise prices equal to fair market value of the Company's stock at the date of grant. Therefore, no compensation expense was recognized related to these options under APB 25 at the date of grant.

Had compensation cost for the Company's stock option plans been determined based on the fair value at the grant dates for all awards consistent with the method set forth under FASB Statement No. 123, *Accounting for Stock-Based Compensation* (FAS 123), the Company's net loss and loss per share would have been decreased (increased) to the pro forma amounts indicated below:

<i>Years ended September 30</i>	<i>2002</i>	<i>Loss per Share</i>	<i>2001</i>	<i>Loss per Share</i>
Net loss attributable to common stockholders	\$ (3,613,167)	\$ (0.22)	\$ (1,304,256)	\$ (0.09)
Stock option re-pricing, net of previously recognized expense of \$1,720,322 under APB 25	786,740	0.05	—	—
Compensation expense related to stock options	(47,533)	—	(355,753)	(0.02)
<b>Total</b>	<b>\$ (2,873,960)</b>	<b>\$ (0.17)</b>	<b>\$ (1,660,009)</b>	<b>\$ (0.11)</b>

The fair value of options was estimated at the date of grant using the Black-Scholes option pricing model assuming expected volatility of 63.4 percent and risk-free interest rates of 5.38 percent, respectively, and expected lives of one to three years and no dividend yield for the year ended September 30, 2002. The weighted average fair value of employee options granted for the year ended September 30, 2002, was \$0.56. 40,000 options were granted to employees for the year ended September 30, 2002. There were no options granted to employees for the year ended September 30, 2001.

The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options which have no vesting restrictions and are fully transferable. Because the Company's employee stock options have characteristics different from those of traded options, and because changes in the input assumptions can materially affect the fair value estimate, the model may not provide a reliable single measure of the fair value of its employee stock options.

### Common Stock Purchase Warrants

The Company enters into consulting agreements with separate third-party professionals to provide investor relations services and financial advisory services. In connection with the consulting agreements, the Company granted warrants to purchase common stock.

During 2002, 183,150 warrants were exercised. No warrants were exercised during 2001. At September 30, 2002, the following warrants were outstanding and exercisable:

	<i>Number Outstanding</i>
Warrants issued in connection with:	
Financial advisory services contract	\$ 75,000
Convertible debentures	2,587,500
Convertible preferred stock	30,900
Note payable, bank	5,100,000
Notes payable	1,889,000
<b>Outstanding at September 30, 2002</b>	<b>\$ 9,682,400</b>

### Warrants Outstanding and Exercisable

At September 30, 2002, the Company had reserved a total of 9,982,400 shares of its common stock for the exercise of options and warrants outstanding. This amount includes shares reserved to satisfy obligations due if the Company defaults on the payment of interest or principal on a \$1.0 million note due in March 2003.

<i>Range of Exercise Prices</i>	<i>Number Outstanding at 9/30/02</i>	<i>Weighted Average Remaining Life</i>	<i>Weighted Average Exercise Price</i>
\$ 0.40 to \$ 0.50	5,464,000	5.7	\$ 0.49
\$ 0.51 to \$ 1.00	2,912,500	4.7	0.97
\$ 1.01 to \$ 3.10	1,305,900	4.8	1.87
<b>\$ 0.40 to \$ 3.10</b>	<b>9,682,400</b>	<b>5.3</b>	<b>\$ 0.82</b>

### Issuance of Stock

The Company has issued common stock to consultants for providing investor relation services. In 2001, the Company issued 200,000 shares of common stock with a market value of \$93,760 which was recorded as unearned consulting fees and is being recognized over the term of the agreement. In 2002, the Company issued 100,000 shares of common stock with a market value of \$67,000 which was recorded as unearned consulting fees and is being recognized over the term of the agreement. The Company also issued 150,000 options to purchase shares of its common stock with a market value of \$188,830 which was recorded as unearned consulting fees and is being recognized over the term of the agreement.

## Note 9. Preferred Stock

During September 2002, the Company offered the holders of the outstanding preferred stock the right to convert their shares of preferred stock into shares of common stock based on a price of \$1.80 per share. This resulted in a conversion rate of approximately 1.39 shares of common stock per share of preferred stock rather than the 1 to 1 conversion rate set forth in the Company's Articles of Incorporation. As of September 30, 2002, a total of 594,000 shares of Series 1 Preferred Stock were converted into a total of 824,911 shares of common stock.

The Company has 66,000 outstanding shares of 8 percent cumulative convertible preferred stock (Series 1). Each share of preferred stock is convertible into one share of the Company's common stock on or after August 1, 1998. Annual preferred stock dividends will be paid if and as declared by the Company's Board of Directors. No dividends or other distributions will be payable on the Company's common stock unless dividends are paid in full on the preferred stock. The preferred stock may be redeemed at the option of FHC, in whole or in part, on or after August 1, 2000, subject to certain conditions, at \$2.50 per share plus accrued and unpaid dividends. In the event of a liquidation or dissolution of the Company, the preferred stock would have priority over the Company's common stock.

## Note 10. Equity Line of Credit

On November 19, 1998, the Company executed an agreement with a private investor (the "Equity Line Agreement"). The Equity Line Agreement provided for the Company, at its sole discretion, subject to certain restrictions, to sell ("put") to the investor up to \$6.0 million of the Company's common stock, subject to a minimum put of \$1.0 million over the duration of the Equity Line Agreement. The Equity Line Agreement expired on February 12, 2001. Since the Company was not able to satisfy the minimum put of \$1.0 million, the Company was required to pay the investor a fee on the portion not drawn. The Company paid the investor approximately \$50,000 during the year ended September 30, 2001, which is included in interest expense on the statement of operations.

## Note 11. Employee Retirement Plan

The Company has a Simple Individual Retirement Account (IRA) plan for its employees. Employees are eligible to participate in the plan if their compensation reaches certain minimum levels and are allowed to contribute up to a maximum of \$7,500 annual compensation to the plan. The Company has elected to match 100 percent of employee contributions to the plan up to a maximum of 3 percent of employee compensation for the year ended September 30, 2001. Company contributions were \$17,102 and \$15,303 for 2002 and 2001, respectively.

## Note 12. Industry Segments and Financial Information About Foreign and Domestic Operations

The Company currently operates primarily in one industry segment which includes the development, manufacture and marketing of consumer health care products.

The Company operates in foreign and domestic regions. Information about the Company's operations by geographic area is as follows.

Years ended September 30	Net Sales to External Customers		Long-Term Assets	
	2002	2001	2002	2001
<i>(Amounts in thousands)</i>				
United States	\$ 2,547	\$ 2,715	\$ 158	\$ 136
Brazil	2,248	766	—	—
South Africa	691	733	—	—
Ghana	*	547	—	—
Japan	*	382	—	—
United Kingdom	*	*	1,267	1,571
Zimbabwe	898	*	—	—
Other	2,033	1,573	—	—
<b>Total</b>	<b>\$ 8,417</b>	<b>\$ 6,716</b>	<b>\$1,425</b>	<b>\$ 1,707</b>

\*Less than 5 percent of total net sales

### **Note 13. Out of Court Settlement**

The former holders of the \$1,500,000 convertible debentures issued on May 19, 1999 and June 3, 1999, had alleged that the Company was in default with respect to the perfection of the former holders' security interest in the Company's assets. On July 23, 2002, the Company settled this dispute out of court. The Company agreed to issue 450,000 shares of common stock to the former convertible debenture holders and to extend the expiration dates of 2,250,000 warrants held by the former holders to 2007. The former convertible debenture holders agreed to release their security interest in the Company's assets and they agreed not to sell, offer or make any short sale of the 450,000 shares prior to June 24, 2003, without the Company's prior written consent. In accounting for the litigation settlement, the common stock and extension of warrants was valued at \$1,258,210.

### **Note 14. Contingent Liabilities**

The testing, manufacturing and marketing of consumer products by the Company entail an inherent risk that product liability claims will be asserted against the Company. The Company maintains product liability insurance coverage for claims arising from the use of its products. The coverage amount is currently \$5,000,000 for FHC's consumer health care product.

### **Note 15. Related Parties**

It has been and currently is the policy of the Company that transactions between the Company and its officers, directors, principal shareholders or affiliates are to be on terms no less favorable to the Company than could be obtained from unaffiliated parties. The Company intends that any future transactions between the Company and its officers, directors, principal shareholders or affiliates will be approved by a majority of the directors who are not financially interested in the transaction.

### **Note 16. Continuing Operations**

The Company's consolidated financial statements have been prepared on a going concern basis which contemplates the realization of assets and the settlement of liabilities and commitments in the normal course of business. The Company incurred a loss of \$3.6 million for the year ended September 30, 2002, and as of September 30, 2002, had an accumulated deficit of \$53.9 million. At September 30, 2002, the Company had working capital of \$1.9 million and stockholders' equity of \$0.6 million. In the near term, the Company expects operating and capital costs to continue to exceed funds generated from operations, due principally to the Company's fixed manufacturing costs relative to current production volumes and the ongoing need to commercialize The Female Condom around the world. As a result, operations in the near future are expected to continue to use working capital. Management recognizes that the Company's continued operations may depend on its ability to raise additional capital through a combination of equity or debt financing, strategic alliances and increased sales volumes.

At various points during the developmental stage of the product, the Company was able to secure resources, in large part through the sale of equity and debt securities, to satisfy its funding requirements. As a result, the Company was able to obtain FDA approval, worldwide rights, manufacturing facilities and equipment and to commercially launch The Female Condom.

Management believes that recent developments, including the Company's agreement with the UNAIDS, a joint United Nations program on HIV/AIDS, provide an indication of the Company's early success in broadening awareness and distribution of The Female Condom and may benefit efforts to raise additional capital and to secure additional agreements to promote and distribute The Female Condom throughout other parts of the world.

During the year ended September 30, 2001, the Company completed private placements where 1,600,000 shares of the Company's common stock were sold for \$800,000. The stock sales were directly with accredited investors and included one current director of the Company. The Company sold the shares to these investors at the price of \$0.50 per share.

On March 30, 2001, the Company issued a \$250,000 convertible debenture to one accredited investor. The debenture is due March 30, 2004, bears interest payable at a rate of 12 percent and is convertible into the Company's common stock based on a price of \$0.50 per share.

On June 1, 2001, the Company issued an aggregate \$200,000 of convertible debentures to two accredited investors. The debentures are due May 30, 2004, bear interest payable at a rate of 10 percent per annum, and are convertible into the Company's common stock based on a price per share equal to \$0.50 per share which was the market price at the com-

mitment date of this transaction. These convertible debentures were converted to common stock in December 2002.

On May 18, 2001, the Company entered into an agreement with Heartland Bank providing for a \$2,000,000 credit facility. The Company may borrow under the credit facility from time to time, subject to certain conditions, including obtaining personal guarantees of 125 percent of the amount outstanding under the credit facility. The Company has an outstanding balance of \$1,900,000 under this facility as of September 30, 2002. The unpaid balances on the credit facility are due May 18, 2004, and bear interest payable at a rate of 10 percent.

During the year ended September 30, 2002, the Company completed a private placement where 120,000 shares of the Company's common stock were sold for \$60,000. The stock sale was directly with an accredited investor. The Company sold the shares to the investor at a price of \$0.50 per share.

While the Company believes that its existing capital resources will be adequate to fund its currently anticipated capital needs, if they are not, the Company may need to raise additional capital until its sales increase sufficiently to cover operating expenses.

Further, there can be no assurance, assuming the Company successfully raises additional funds or enters into business agreements with third parties, that the Company will achieve profitability or positive cash flow. If the Company is unable to obtain adequate financing, management will be required to sharply curtail the Company's efforts to promote The Female Condom and to curtail certain other of its operations or, ultimately, cease operations.

## Profile

The Female Health Company (FHC) is the maker of FC Female Condom, a revolutionary option for contraception and the prevention of sexually transmitted diseases, including HIV/AIDS.

FHC was created as a worldwide company in February 1996 with the purchase of Chartex Resources Ltd., the holder of exclusive worldwide rights to FC. FHC is the sole manufacturer and marketer of FC in the world.

The corporation holds exclusive product and technology patents in the United States, Australia, Brazil, Canada, the European Patent Convention, France, Germany, Italy, Spain, the United Kingdom, the People's Republic of China, South Korea and Japan. The company now has the registered trademark FC Female Condom® in the United States.

FC is available through public-sector agencies in 87 countries and throughout the United States. It is also sold commercially in 21 countries — including the United States, the United Kingdom, the Czech Republic, Australia, Belgium, Brazil, Canada, Denmark, France, Germany, Holland, Italy, Jamaica, Japan, Mexico, New Zealand, Spain, Suriname, Switzerland, Turkey and Venezuela.

## Product

FC is designed for use by women to help prevent HIV/AIDS, other sexually transmitted diseases and unintended pregnancy. Made of polyurethane, the soft, thin sheath lines the vagina and covers the labia during intercourse; it is held in place with a soft ring at each end.

Clinical studies in the United States and Japan show that FC is 95% to 98% efficacious in protecting against pregnancy when used correctly and consistently. Studies have shown FC to be a highly effective barrier to the viruses and bacteria that cause sexually transmitted diseases, including HIV/AIDS.

The Female Health Company and its partners currently market The Female Condom under FC Female Condom® brand name in the United States, and Reality®, Femidom, Femy, Care, MyFemy, and Dominique in the rest of the world.

**"Safe Harbor" Statement under the Private Securities Litigation Reform Act of 1995:** The statements in this release which are not historical fact are forward-looking statements based upon the Company's current plans and strategies, and reflect the Company's current assessment of the risks and uncertainties related to its business, including such things as product demand and market acceptance; the economic and business environment and the impact of government pressures; currency risks; capacity; efficiency and supply constraints; and other risks detailed in the Company's press releases, shareholder communication and Securities and Exchange Commission filings. Actual events affecting the Company and the impact of such events on the Company's operations may vary from those currently anticipated.



## Officers

**O.B. Parrish**  
Chief Executive Officer

**Mary Ann Leeper, Ph.D.**  
President/Chief Operating Officer

**William R. Gargiulo Jr.**  
Vice President/Secretary (retired)

**Michael Pope**  
Vice President, U.K. Operations

**Mitchell Warren**  
Vice President, International Affairs

**Jack Weissman**  
Vice President, Sales



## Board of Directors



Left to right, standing: 1, 2, 3, 4, 5; seated: 6, 7, 8

- 7 **O.B. Parrish**  
Chairman of the Board  
Chief Executive Officer  
The Female Health Company  
Chicago, Illinois
- 6 **Mary Ann Leeper, Ph.D.**  
President/Chief Operating Officer  
The Female Health Company  
Chicago, Illinois
- 8 **William R. Gargiulo, Jr.**  
Vice President/Secretary (retired)  
The Female Health Company  
Chicago, Illinois
- 2 **David R. Bethune**  
Chairman and Chief Executive Officer  
Atrix Laboratories  
Fort Collins, Colorado
- 1 **Stephen M. Dearholt**  
Partner  
Insurance Processing Center  
Milwaukee, Wisconsin
- 4 **James R. Kerber**  
Consultant to the insurance industry  
Englewood, Colorado
- 3 **Michael R. Walton**  
President/Owner  
Sheboygan County Broadcasting Co.  
Milwaukee, Wisconsin
- 5 **Richard E. Wenninger**  
Chairman, Wenninger Company Inc.  
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**Manufacturing Headquarters**  
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**Transfer Agent and Registrar**  
Firststar Trust Company  
Milwaukee, Wisconsin

**Independent Auditors**  
McGladrey & Pullen, LLP  
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**Legal Counsel**  
Reinhart Boerner Van Deuren, s.c.  
Milwaukee, Wisconsin

**Stock Exchange Listing**  
The Female Health Company  
common shares are traded on  
the OTC Bulletin Board.  
Symbol: FHCO

**Inquiries**  
Shareholders, prospective investors,  
stockbrokers, financial analysts and  
other parties seeking additional  
information about The Female Health  
Company (including Securities and  
Exchange Commission Form 10-KSB  
and Quarterly Reports to Shareholders)  
should contact Investor Relations at  
312.595.9123. Send an e-mail request  
to [info@femalehealth.com](mailto:info@femalehealth.com), or write to:

Investor Relations  
The Female Health Company  
515 North State Street  
Suite 2225  
Chicago, Illinois 60610

For more information about The Female  
Health Company and The Female Condom,  
visit [www.femalehealth.com](http://www.femalehealth.com) or  
[www.femalecondom.org](http://www.femalecondom.org). Also, dial our  
fax-on-demand service—800-PROINFO—  
and enter the company code: FHCO.

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