

SUREBEAM CORP  
Form 10-Q  
November 15, 2002

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

**FORM 10-Q**

ý **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934**

For the quarterly period ended September 30, 2002

or

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934**

For the transition period from to

Commission file number 0-31807

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**SureBeam Corporation**

(Exact name of registrant as specified in its charter)

**DELAWARE**

(State or other jurisdiction of  
incorporation or organization)

**33-0921003**

(I.R.S. Employer Identification No.)

**9276 Scranton Road, Suite 600  
San Diego, California 92121**

(Address of principal executive offices, zip code)

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**(858) 795-6300**

(Registrant's telephone number, including area code)

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

The number of shares of registrant's Class A common stock, \$.001 par value, outstanding as of November 5, 2002, was 67,935,962.

The number of shares of registrant's Class B common stock, \$.001 par value, outstanding as of November 5, 2002, was zero.

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**SUREBEAM CORPORATION**  
**FORM 10-Q**  
**FOR THE QUARTER ENDED SEPTEMBER 30, 2002**

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## PART I-FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS

## SureBeam Corporation and Subsidiaries

## CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

(in thousands, except per share data)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2002	2001	2002	2001
<b>Revenues:</b>				
Non-affiliated parties	\$ 815	\$ 3,620	\$ 4,795	\$ 10,404
Investee	2,216	8,042	3,591	15,350
The Titan Corporation	3,961	2,886	16,407	3,887
<b>Total revenues</b>	<b>6,992</b>	<b>14,548</b>	<b>24,793</b>	<b>29,641</b>
<b>Cost of revenues:</b>				
Non-affiliated parties	2,386	2,729	8,007	7,145
Investee	1,264	4,124	2,048	7,872
The Titan Corporation	3,225	2,402	9,687	3,403
<b>Total cost of revenues</b>	<b>6,875</b>	<b>9,255</b>	<b>19,742</b>	<b>18,420</b>
<b>Gross profit</b>	<b>117</b>	<b>5,923</b>	<b>5,051</b>	<b>11,221</b>
Selling, general and administrative expense	11,813	11,923	31,429	69,576
Research and development	55	736	551	1,849
Loss from operations	(11,751)	(7,366)	(26,929)	(60,204)
Interest income	37	333	164	1,062
Interest expense	(331)	(1,576)	(1,282)	(4,756)
Other income, net	1,011		2,932	
Loss before income tax benefit	(11,034)	(8,609)	(25,115)	(63,898)
Income tax benefit		(861)		(6,390)
<b>Net loss</b>	<b>\$ (11,034)</b>	<b>\$ (7,748)</b>	<b>\$ (25,115)</b>	<b>\$ (57,508)</b>
<b>Basic loss per share:</b>				
Net loss	\$ (0.16)	\$ (0.14)	\$ (0.38)	\$ (1.08)
Weighted average shares basic	67,336	56,131	65,683	53,478
<b>Diluted loss per share:</b>				
Net loss	\$ (0.16)	\$ (0.14)	\$ (0.38)	\$ (1.08)
Weighted average shares diluted	67,336	56,131	65,683	53,478

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

## SureBeam Corporation and Subsidiaries

## CONSOLIDATED BALANCE SHEETS

(in thousands, except share information)

	September 30, 2002 (Unaudited)	December 31, 2001
<b>Assets (Pledged)</b>		
Current Assets:		
Cash and cash equivalents	\$ 4,985	\$ 4,131
Investments, available-for-sale		3,766
Accounts receivable-net of allowance of \$1,428 at September 30, 2002, and December 31, 2001	16,216	12,645
Receivable from The Titan Corporation	6,459	12,503
Inventories	19,767	19,764
Prepaid expenses and other	4,180	5,172
Total current assets	51,607	57,981
Property and equipment-net	55,803	41,903
Due from The Titan Corporation	2,319	2,319
Intangible assets-net	3,476	3,549
Other assets	13,665	12,032
Total assets	\$ 126,870	\$ 117,784
<b>Liabilities and Stockholders Equity</b>		
Current Liabilities:		
Accounts payable	\$ 4,203	\$ 9,191
Accrued compensation and benefits	3,028	2,664
Due to The Titan Corporation	1,498	
Other current liabilities	4,404	4,756
Total current liabilities	13,133	16,611
Subordinated promissory note to The Titan Corporation		72,208
Senior credit facility with The Titan Corporation	22,500	
Other long-term liabilities	1,018	613
Total liabilities	36,651	89,432
Commitments and Contingencies		
Stockholders Equity		
Preferred stock, \$.001 par value, 5,000,000 shares authorized, none issued and outstanding	\$	\$
Class A common stock, \$.001 par value, 200,000,000 shares authorized, 67,607,505 issued and 67,603,976 outstanding at September 30, 2002 and 11,605,440 issued and 11,601,911 outstanding at December 31, 2001	66	11
Class B common stock, \$.001 par value, 50,000,000 shares authorized, 50,000,000 issued and 0 outstanding at September 30, 2002 and 46,774,235 issued and outstanding at December 31, 2001		47
Additional paid-in capital	220,816	147,607
Deferred compensation	(13,106)	(26,918)

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Accumulated other comprehensive income		47
Treasury stock, at cost: 3,529 shares at September 30, 2002 and December 31, 2001	(42)	(42)
Accumulated deficit	(117,515)	(92,400)
Total stockholders' equity	90,219	28,352
Total liabilities and stockholders' equity	\$ 126,870	\$ 117,784

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

## SureBeam Corporation and Subsidiaries

## CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

(in thousands)

	Nine Months Ended September 30,	
	2002	2001
<b>Cash Flows from Operating Activities:</b>		
Net loss	\$ (25,115)	\$ (57,508)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Nonmonetary research consideration	(1,586)	(3,231)
Depreciation and amortization	3,862	2,956
Deferred income taxes		(6,390)
Amortization of deferred compensation	13,812	49,155
Loss on disposal of property and equipment	122	
Change in operating assets and liabilities:		
Accounts receivable and receivable from The Titan Corporation	2,473	(21,658)
Inventories	(3)	(5,080)
Prepaid expenses and other	191	688
Other assets	(1,491)	(564)
Accounts payable	(4,988)	4,858
Accrued compensation and benefits	364	1,762
Other accrued liabilities	53	3,992
Due to The Titan Corporation	1,498	
Net cash used in operating activities	(10,808)	(31,020)
<b>Cash Flows from Investing Activities:</b>		
Sale (purchase) of available-for-sale investments	3,719	(12,253)
Capital expenditures	(15,121)	(16,548)
Advances to Tech Ion		(2,775)
Advances to Hawaii Pride	(445)	(911)
Net cash used in investing activities	(11,847)	(32,487)
<b>Cash Flows from Financing Activities:</b>		
Borrowings on senior credit facility with The Titan Corporation	22,500	
Net proceeds from issuance of common stock		59,777
Borrowings on subordinated promissory note	792	14,180
Proceeds from exercise of stock options and warrants	217	1,124
Net cash provided by financing activities	23,509	75,081
Net increase in cash and cash equivalents	854	11,574
Cash and cash equivalents at beginning of period	4,131	



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Cash and cash equivalents at end of period	\$	4,985	\$	11,574
<b>Supplemental Cash Flow Information:</b>				
<b>Non-Cash Financing and Investing Activities:</b>				
Conversion of subordinated promissory note to common stock	\$	73,000	\$	
Increase in fair value of investments, available-for-sale		47		122

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

## SureBeam Corporation and Subsidiaries

## CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY

(Unaudited)

(in thousands)

	Shares of Common Stock		Common Stock		Additional Paid-in Capital	Deferred Compensation	Accumulated Other Comprehensive Income (Loss)	Accumulated Treasury Deficit	Treasury Stock	Total
	Class A	Class B	Class A	Class B						
<b>Nine Months Ended September 30, 2002:</b>										
Balances at December 31, 2001	11,602	46,774	\$ 11	\$ 47	\$ 147,607	\$ (26,918)	\$ 47	\$ (92,400)	\$ (42)	\$ 28,352
Net loss								(25,115)		(25,115)
Issuance of common stock in conjunction with conversion of subordinated promissory note to equity	4,441	3,226	4	3	72,993					73,000
Proceeds from issuance of common stock in conjunction with exercise of stock options	1,561		1		216					217
Amortization of deferred compensation						13,812				13,812
Unrealized loss on investments							(47)			(47)
Conversion of stock associated with the spin-off from Titan	50,000	(50,000)	50	(50)						
Balances at September 30, 2002	67,604		\$ 66	\$ (50)	\$ 220,816	\$ (13,106)	\$ (117,515)	\$ (42)	\$ (42)	\$ 90,219
<b>Nine Months Ended September 30, 2001:</b>										
Balances at December 31, 2000	233	46,584	\$	\$ 47	\$ 5,687	\$ (2,584)	\$ (18,025)			\$ (14,875)
Net loss								(57,508)		(57,508)
Issuance of common stock in IPO, net of issuance costs	6,700		7		59,770					59,777
Proceeds from issuance of common stock in conjunction with exercise of stock options	2,726		2		1,122					1,124
Deferred compensation related to the issuance of stock options					78,604	(78,604)				
Amortization of deferred compensation						49,155				49,155
Unrealized loss on investments							122			122
Balances at September 30, 2001	9,659	46,584	\$ 9	\$ 47	\$ 145,183	\$ (32,033)	\$ 122	\$ (75,533)	\$	\$ 37,795

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



**SureBeam Corporation and Subsidiaries**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**SEPTEMBER 30, 2002**

**(Unaudited)**

**Note (1) Basis of Financial Statement Preparation**

The accompanying consolidated financial information of SureBeam Corporation ( SureBeam or the Company ) should be read in conjunction with the Company s audited consolidated financial statements and notes thereto for the year ended December 31, 2001 included in its Form 10-K filed with the Securities and Exchange Commission on April 1, 2002. The information as of September 30, 2002, and for the three and nine months ended September 30, 2002 and 2001 is unaudited. The accompanying consolidated financial information includes all normal recurring adjustments, which are considered necessary by the Company s management for a fair presentation of the consolidated financial position, results of operations and cash flows for the periods presented. However, these results are not necessarily indicative of results for a full fiscal year. Certain prior year amounts have been reclassified to conform to the 2002 financial statement presentation.

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

On October 16, 2001, The Titan Corporation, or Titan, adopted a definitive plan to spin-off its ownership interest in SureBeam in the form of a tax-free dividend to Titan s stockholders. Effective August 5, 2002, Titan distributed all of its shares of the Company s common stock to the stockholders of Titan. Holders of record of Titan common stock as of the close of business on July 26, 2002, the record date for the distribution, received 0.6986 shares of SureBeam s common stock for every share of Titan common stock held. Previously, Titan held over eighty percent of the Company s common stock and held a higher percentage of the voting power due to Titan s ownership of shares of Class B common stock, which had ten votes per share, as compared to the Class A common stock, which has one vote per share and is traded on the Nasdaq under the symbol SURE. Prior to the distribution of shares of SureBeam s common stock, Titan converted all of its shares of SureBeam s Class B common stock, into shares of SureBeam s Class A common stock. Therefore, stockholders of Titan receiving shares of SureBeam common stock received only shares of Class A common stock. The Class B common stock has now been retired and cannot be reissued. The Company has negotiated other agreements with Titan in connection with the Company s spin-off including a tax sharing and disaffiliation agreement that will subject the Company to liability if it sells the Company s equity or equity linked securities in a manner that causes a change in the Company s ownership of 50% or more in voting power or value as part of Titan s spin-off plan.

Also on October 16, 2001, Titan purchased a perpetual and exclusive, non-royalty bearing license to use the Company s intellectual property for all applications and fields other than the food (excluding water), animal hide and flower markets in consideration of the following: 1) to make available to the Company a \$50.0 million senior credit facility, 2) to exchange the outstanding \$75.0 million debt owed by the Company to Titan for additional shares of the Company s Class B common stock and Class A common stock, and 3) a cash payment of \$8.0 million, with a

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\$4.0 million payment on September 30, 2001 and four installments of \$1.0 million payable on each of March 31, 2002, June 30, 2002, September 30, 2002 and December 31, 2002. With respect to the exchange of the Company's \$75.0 million non-convertible debt for common stock, the Company followed guidance in APB Opinion No. 29, Accounting For Nonmonetary Transactions, and determined that the use of the fair value of the license on the date of the exchange was appropriate. The Company recognized \$1.0 million and \$3.0 million of the cash payments related to the license agreement as other income in the three and nine months ended September 30, 2002, respectively. The Company will recognize \$1.0 million as other income each quarter through September 30, 2003.

The accompanying consolidated financial statements contemplate the realization of assets and the satisfaction of liabilities in the normal course of business. During the three and nine months ended September 30, 2002, consistent with its business plan, the Company has incurred substantial losses from operations.

Management believes it will continue to incur losses through at least 2003, as the Company will continue to make significant investments in infrastructure, sales and marketing and it is not anticipated that the Company's revenues will sufficiently offset these investments until at least 2003. Additionally, the Company's construction and implementation period for systems sales to strategic alliances as well as Company-owned service centers and systems require a substantial use of cash for at least 12 to 18 months. The Company's arrangements to sell food irradiation systems to strategic alliances typically contain milestone provisions for payment, which are typically based upon time, stage of completion and other factors where no material uncertainties exist. Also in connection with the Company's agreements with its customers, it has advanced funds aggregating \$5.5 million to Hawaii Pride LLC, or Hawaii Pride. Although not obligated, the Company anticipates that it will continue to provide cash to Hawaii Pride for working capital purposes, as it is needed. Management does not expect significant repayments of the advances to Hawaii Pride until late 2003. The Company has also entered into a number of commitments to lease land and facilities in connection with construction of our four company-owned service centers of which three are operational with the fourth expected to be operational in the first quarter of 2003. In addition, based on our customer requirements, the Company may expend funds to construct and install in-line systems that the Company will own and operate.

In addition to management's current operating plans, which focus on increasing cash flow from operations, the Company is also evaluating a number of alternative plans to meet its future operating cash needs. These plans include raising additional funds from the capital markets and continuing to draw down on the Company's \$50.0 million senior secured credit facility with Titan. As of the date of the filing of this report, the Company has obtained \$25.0 million under its senior secured credit facility with Titan. If the funds available under the Company's credit facility and from the capital markets are not sufficient for the Company or if it is unable to generate sufficient cash flow from operations, management may need to consider additional actions, including reducing or deferring capital expenditures, reducing or deferring research and development projects, curtailing construction of systems for customers in advance of payment and reducing marketing and other expenditures, which actions may have a material adverse impact on the Company's ability to meet its business objectives.

A variety of currently unanticipated events could require additional capital resources such as the acquisition of complementary businesses or technologies or increased working capital requirements to fund, among other things, construction of systems for the Company's strategic alliances in advance of payment.

#### **Note (2) Initial Public Offering**

On March 16, 2001, the Company consummated its initial public offering and issued 6,700,000 shares of Class A common stock at a price of \$10.00 per share. The Company received proceeds of approximately \$59.8 million, net of underwriting discounts, fees and other initial public offering costs. Concurrent with the closing of the offering, warrants aggregating 2,236,023 shares of the Company's Class A common stock were exercised for proceeds of approximately \$1.1 million.

Also in connection with the completion of the Company's initial public offering, stock options granted under the Nonstatutory Stock Option Plan were converted from variable plan options to fixed plan options. Accordingly, stock-based compensation of \$78.6 million was recorded, representing the extent to which the \$10.00 per share offering price exceeded the exercise price of the options. Additionally, since a substantial portion of these options was vested at the time of completion of the offering, approximately \$38.7 million was recognized as compensation expense at that time. Included in selling, general and administrative expense for the three and nine months ended September 30, 2002, is \$6.0 million and \$13.2 million, respectively, of compensation expense associated with these options. In conjunction with the completion of our spin-off from Titan on August 5, 2002, all options held by Titan employees and directors under this plan became fully vested and as a result, the stock-based compensation charges for this plan increased for the three months ended September 30, 2002 by \$2.9 million.



The remaining stock-based compensation balance related to these options will be recognized as compensation expense over the remaining three-year vesting period of the options. Included in selling, general and administrative expense for the three and nine months ended September 30, 2002 and 2001, is \$202,000 and \$606,000, respectively, of compensation expense related to options granted prior to completion of the Company's initial public offering under the 2000 Stock Option and Incentive Plan for which the fair market value on the date of grant exceeded the exercise price.

**Note (3) Other Financial Information**

During the quarter ended September 30, 2002, the Company had no elements of comprehensive income. The Company had comprehensive income resulting from unrealized losses on investments in available-for-sale securities of \$122,000, which are reflected in the statement of stockholders' equity for the nine months ended September 30, 2001.

The following data summarizes information relating to the per share computation (in thousands, except per share data):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2002	2001	2002	2001
Net loss	\$ (11,034)	\$ (7,748)	\$ (25,115)	\$ (57,508)
Weighted average shares outstanding				
Basic	67,336	56,131	65,683	53,478
Effective diluted securities: stock options				
Diluted	67,336	56,131	65,683	53,478
Net loss per common share - basic	\$ (0.16)	\$ (0.14)	\$ (0.38)	\$ (1.08)
Net loss per common share - diluted	\$ (0.16)	\$ (0.14)	\$ (0.38)	\$ (1.08)

In the three and nine months ended September 30, 2002, respectively, the weighted average number of options to purchase approximately 4,080,000 and 4,748,000 shares of common stock at prices ranging from \$0.14 to \$16.09 per share were not included in the computation of diluted EPS, as the effect would have been anti-dilutive due to the loss from continuing operations. Similarly, the weighted average number of options and warrants to purchase approximately 6,702,000 and 7,368,000 shares of common stock at prices ranging from \$0.14 to \$16.09 per share were not included in the computation of diluted EPS for the three and nine month periods ended September 30, 2001, respectively.



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Following are details concerning certain balance sheet data as of September 30, 2002 and December 31, 2001:

	September 30, 2002	December 31, 2001
<b>Investments, available-for-sale (in thousands):</b>	\$	\$ 3,766

The Company invests its excess cash primarily in mortgage-backed securities. The Company has established guidelines relative to diversification and maturities that maintain safety and liquidity. These guidelines are periodically reviewed and modified to take advantage of trends in yields and interest rates. Cash equivalents are short-term, highly liquid investments with original maturities of less than three months. Cash and cash equivalents of \$5.0 million and \$4.1 million at September 30, 2002 and December 31, 2001, respectively, are primarily invested in commercial paper and money market funds.

The Company classifies its marketable securities as available-for-sale and records the unrealized holding gains or losses as a separate component of stockholders' equity. Realized losses for the three and nine months ended September 30, 2002, were \$0 and \$47,000, respectively. There were no realized gains or losses recorded in the three and nine months ended September 30, 2001.

	September 30, 2002	December 31, 2001
<b>Accounts receivable (in thousands):</b>		
Billed	\$ 111	\$ 53
Unbilled	17,533	14,020
Less allowance for doubtful accounts	(1,428)	(1,428)
	\$ 16,216	\$ 12,645
The Titan Corporation		
Billed	\$ 5,988	\$ 12,503
Unbilled	471	
	\$ 6,459	\$ 12,503

Unbilled receivables primarily represent work-in-process that will be billed in accordance with contract terms and delivery schedules. Also included in unbilled receivables are amounts billable upon final execution of contracts, contract completion or milestones. Unbilled receivables are generally expected to be collected within one year.

	September 30, 2002	December 31, 2001
<b>Inventories (in thousands):</b>		
Materials	\$ 8,895	\$ 15,510
Work-in-process	10,872	4,254
	\$ 19,767	\$ 19,764

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Generally, the Company's systems are customized and are produced on a made-to-order basis. The Company does, however, maintain a stock of long lead-time and general stock items. Inventories include the cost of material, labor and overhead, and are stated at the lower of cost, determined on the first-in, first-out (FIFO) method.

or market. The Company periodically evaluates its on-hand stock and makes appropriate disposition of any stock deemed excess or obsolete.

	September 30, 2002	December 31, 2001
<b>Property and equipment (in thousands):</b>		
Machinery and equipment	\$ 18,648	\$ 9,937
Furniture, fixtures and leasehold improvements	8,963	1,252
Construction in progress	32,066	33,390
	59,677	44,579
Less accumulated depreciation	(3,874)	(2,676)
Property and equipment, net	\$ 55,803	\$ 41,903

Construction in progress primarily represents costs incurred for the construction of two food irradiation service center facilities in the Rio de Janeiro and Los Angeles areas. Such costs will remain in construction in progress until the facilities are completed and placed in service.

	September 30 2002	December 31, 2001
<b>Other assets (in thousands):</b>		
Texas A&M	\$ 8,399	\$ 7,210
Advances to Hawaii Pride net	3,892	3,674
Prepaid rent	728	796
Investment in SureBeam Middle East, LLC.	272	
Loan receivable from officer	168	225
Other	206	127
	\$ 13,665	\$ 12,032

The long-term asset arising from the transaction with Texas A&M represents the long-term portion of the cumulative revenues recognized related to the design, construction, installation, integration and delivery of the system for Texas A&M, net of amortization related to discounted services received. See Note (5).

The Company has advanced \$5.5 million to Hawaii Pride, which is included in the accompanying consolidated balance sheet as other assets, net of impairment charges of \$1.6 million. The impairment charges reflect the Company's estimate of the erosion of the collateral basis in Hawaii Pride. The monies advanced in 1999 and 2000 were utilized for costs relating to the acquisition of land, construction of the building and infrastructure, equipment (excluding the SureBeam system) and other start-up costs. Monies advanced to Hawaii Pride during 2002 and 2001 have been used primarily for working capital purposes. The Company advanced Hawaii Pride \$445,000 during the nine months ended September 30, 2002. Management does not expect significant repayments of the advances to Hawaii Pride until late 2003.

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In April 2002, the Company formed a joint venture under the name SureBeam Middle East, LLC. with RESAL Saudi Corp., or RESAL. As of September 30, 2002, SureBeam owns a 19.9% interest in SureBeam Middle East, LLC. and RESAL and other Saudi nationals own the remaining 80.1%. See Note (5). The Company will

account for its ownership interest in SureBeam Middle East, LLC, using the equity method of accounting under APB Opinion No. 18 The Equity Method of Accounting for Investments in Common Stock.

	September 30, 2002	December 31, 2001
<b>Other current liabilities (in thousands):</b>		
Deferred revenue The Titan Corporation	\$ 3,000	\$ 3,000
Other	1,404	1,756
	\$ 4,404	\$ 4,756

#### Note (4) Recent Accounting Pronouncements

In June 2001, the FASB issued SFAS No. 143, *Accounting for Asset Retirement Obligations* ( SFAS No. 143 ). This statement addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. It applies to (a) all entities and (b) legal obligations associated with the retirement of long-lived assets that result from the acquisition, construction, development and/or normal operation of long-lived assets, except for certain obligations of leasees. 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 believe that the adoption of this statement will have a material impact on its financial position or results of operations.

In April 2002, the FASB issued Statement No. 145, *Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections* ( SFAS No. 145 ). SFAS No. 145 updates, clarifies and simplifies existing accounting pronouncements including: rescinding Statement No. 4, which required all gains and losses from extinguishments of debt to be aggregated and, if material, classified as an extraordinary item, net of related income tax effect and amending Statement No. 13 to require that certain lease modifications that have economic effects similar to sale-leaseback transactions be accounted for in the same manner as sale-leaseback transactions. SFAS No. 145 is effective for fiscal years beginning after May 15, 2002, with early adoption of the provisions related to the rescission of Statement No. 4 encouraged. The Company does not expect the adoption of this statement to have a material impact on its financial position or results of operations.

In July 2002, the FASB issued Statement No. 146, *Accounting for Costs Associated with Exit or Disposal Activities* ( SFAS No. 146 ), which addresses financial accounting and reporting for costs associated with exit or disposal activities. SFAS No. 146 nullifies 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)*. The principal difference between SFAS No. 146 and Issue No. 94-3 relates to the recognition of a liability for a cost associated with an exit or disposal activity. SFAS No. 146 requires that a liability be recognized for those costs only when the liability is incurred, that is, when it meets the definition of a liability in the FASB's conceptual framework. In contrast, under Issue No. 94-3, a company recognized a liability for an exit cost when it committed to an exit plan. SFAS No. 146 also establishes fair value as the objective for initial measurement of liabilities related to exit or disposal activities. The Statement is effective for exit or disposal activities that are initiated after December 31, 2002 although earlier application is encouraged. The Company is unable to determine impact on its financial position or results of operations from the adoption of this statement.

**Note (5) Strategic Transactions**

In connection with the Company's agreement with Texas A&M, SureBeam agreed to provide three electronic food irradiation systems, which are referred to collectively as the system, pursuant to a ten-year lease with title passing to Texas A&M at the end of the ten-year term. The agreement provides the Company access to Texas A&M employees for a variety of free or discounted services, as well as rights to use the system for performing irradiation services for its customers. The Company is currently working with Texas A&M on several research projects which include studies on shelf life extension, food products application testing, and the effectiveness of SureBeam's technology versus other technologies. Since the Company retains the right to use the system through the end of the term of the arrangement, it has accounted for this transaction as a sale-leaseback.

As the consideration in this lease is nonmonetary, the Company has accounted for this element of the agreement in accordance with APB No. 29, Accounting for Nonmonetary Transactions. Sales are recorded on a percentage-of completion basis at the fair market value of the electronic food irradiation system sold to Texas A&M and total system profits of \$518,000 will be deferred and recognized ratably over the remaining term of the arrangement commencing upon delivery of the system.

Under the percentage-of-completion method, the Company recorded revenues of \$50,000 and \$1.9 million for the three and nine months ended September 30, 2002, respectively, and recorded \$2.0 million and \$3.3 million for the three and nine months ended September 30, 2001, respectively. The asset arising from the total cumulative revenues of \$10.0 million, net of \$322,000 of amortization, has been recorded as a short-term and long-term asset at September 30, 2002. As of September 30, 2002, the Company had deferred profits amounting to \$518,000, which are included as other short-term and long-term liabilities in the accompanying consolidated balance sheet. These deferred profits will be amortized ratably to reduce cost of sales over the remaining term of the ten-year term of the arrangement commencing upon delivery of the system to Texas A&M. The short-term and long-term assets arising from this transaction represents the cumulative revenues recognized related to the design, construction, installation, integration and delivery of the system for Texas A&M, net of amortization. In August 2001, the Company agreed to purchase research and development services from Texas A&M for approximately \$200,000, reflecting a discount of approximately \$300,000. The discount has been amortized against the long-term asset arising from the cumulative revenues recorded under this agreement over a period of approximately ten months. During the three and nine months ended September 30, 2002, the Company has recorded \$0 and \$150,000, respectively, of amortization expense related to the research and development services it has received to date. The deferred profit of \$518,000 as of September 30, 2002, represents the difference between the cumulative costs incurred and the cumulative revenues recognized. As of September 30, 2002, \$6,000 of the deferred profit had been amortized to income.

With respect to the impact of the transaction with Texas A&M on the Company's liquidity, the Company has expended funds of approximately \$9.5 million related to the construction of the system through September 30, 2002. These costs have been incurred primarily related to the design of the system, construction of and modification to the physical structure, which house the system, and for the manufacture of the linear accelerators and x-ray components as well as the material handling and conveyor systems. During the third quarter of 2002, the Company completed the delivery of the system to Texas A&M.

In June 2001, the Company received a purchase order with an aggregate value of \$50.0 million from RESAL for ten electronic food irradiation systems to operate in three service centers in the Saudi Arabia region for irradiating poultry and disinfecting and prolonging shelf life of dates. The Company commenced construction of these systems for RESAL and has recognized, under the percentage-of-completion method of accounting, \$2.2 million and \$3.6 million in revenue for the three and nine months ended September 30, 2002, respectively.

In April 2002, the Company formed a joint venture under the name SureBeam Middle East, LLC. with RESAL. As of September 30, 2002, SureBeam owns a 19.9% interest in SureBeam Middle East, LLC. and RESAL and other Saudi nationals own the remaining 80.1%. The Company accounts for its ownership interest in SureBeam Middle East, LLC. using the equity method of accounting under APB Opinion No. 18 The Equity Method of Accounting for Investments in Common Stock. In accordance with the joint venture agreement, RESAL's purchase order dated June 2001 may be assigned to SureBeam Middle East, LLC. at such time as the joint venture receives sufficient funds from third party investors. As of September 30, 2002, a portion of the purchase order has been assigned to SureBeam Middle East, LLC. As a result, revenue recognized under the contract is presented in the consolidated statements of operations as revenues from investee and the Company has eliminated its 19.9% interest in the profit recognized under the percentage-of-completion method of accounting in connection with the original purchase order. The Company received a payment of \$1.5 million from SureBeam Middle East, LLC. in the second quarter of 2002 based on milestone payments and expects to continue to receive milestone payments as they become due and payable until the contract is complete. The Company estimates that the total profit under the original contract that will be eliminated as a result of SureBeam's equity interest in SureBeam Middle East, LLC. will be approximately \$2.0 million to \$3.0 million. The joint venture will govern the strategic relationship with the operator of these systems, including royalty and management fees and a minority equity ownership of the operator that will operate the service centers.

In October 2001, the Company contracted to manufacture eight SureBeam systems for an aggregate of \$26.0 million for Titan in connection with Titan's agreement with the United States Postal Service, or USPS. During the three months ended June 30, 2002, the Company's purchase order from Titan related to the United States Postal Service was closed out at \$19.5 million. Under this agreement, Titan had arranged to provide electron beam systems and services to sanitize mail by eliminating the threat of anthrax. The Company worked with Titan and Titan's business units, in providing the systems to the United States Postal Service. The Company was the principal subcontractor to build systems for Titan under Titan's prime contract. For the three and nine months ended September 30, 2002, the Company recognized \$50,000 and \$7.0 million, respectively, as revenues from The Titan Corporation under this contract. In accordance with the milestone payments of the contract, the Company received \$19.5 million in cash from Titan during the nine months ended September 30, 2002.

In June 2002, the Company entered into a contract with Son Son Company, a private food processing corporation headquartered in Vietnam, for one electronic food irradiation system to operate in Vietnam for irradiating shrimp, seafood, and frog legs and prolonging shelf life of foods. The Company commenced construction on the system and has recognized, under the percentage-of-completion method of accounting, \$503,000 and \$2.1 million in revenue for the three and nine months ended September 30, 2002, respectively. The Company received a \$2.0 million milestone payment in November 2002 and expects to receive future milestone payments as they become due and payable until the contract is complete.

In September 2002, the Company received an order from Titan for \$6.0 million in connection with a new contract with the USPS. Under this agreement, the Company is to provide two linear accelerators to sanitize the mail. During the three months ended September 30, 2002, the Company recorded revenue of \$500,000. It expects to receive milestone payments as they become due and payable on this contract.

#### **Note (6) Subordinated Promissory Note**

In August 2000, in connection with the contribution by Titan to SureBeam of its electronic food irradiation business, the Company assumed the cumulative advances of \$39.0 million and due to additional advances the balance was \$72.2 million as of December 31, 2001. These advances were evidenced by a subordinated promissory note payable to Titan. On February 13, 2002, the Company exchanged the outstanding balance, including principal and accrued interest, of \$73.0 million, under its subordinated promissory note payable to Titan for 3,225,765 and 4,441,496 shares of Class B and Class A common stock, respectively, of the Company.





**Note (7) Senior Secured Credit Facility with The Titan Corporation**

Titan has extended a \$50.0 million senior secured credit facility to SureBeam that allows SureBeam to borrow, in addition to its previous borrowings, up to \$12.5 million per quarter during the fourth quarter of 2002 through the fourth quarter of 2003, subject to the \$50.0 million limitation on borrowing. The amount available for borrowing in each of the second, third and fourth quarters of 2003 is based upon SureBeam's earnings before interest, taxes, depreciation and amortization (EBITDA) for the prior quarter as a percentage of the EBITDA target in its annual operating plan. If EBITDA is less than 25% of target EBITDA, then the amount available in the applicable quarter is \$5.0 million, provided that no amounts are available unless the Company covenants during the current quarter to limit its total operating expenses (defined as research and development and selling, general and administrative expenses) to \$5.0 million. If EBITDA is 25% of target, then the amount available is \$6.25 million or 50% of the quarterly maximum and for each percentage of EBITDA above 25% of target, the percentage of the quarterly maximum above 50% will be increased on a pro rata basis. To the extent SureBeam does not fully borrow the maximum amount during any quarter of 2002, the unutilized amount can be borrowed in the subsequent quarter. As of September 30, 2002, SureBeam had borrowed \$22.5 million on this facility and had \$4.5 million in unutilized amounts. SureBeam borrowed an additional \$2.5 million on October 31, 2002 bringing the total borrowings on this senior secured credit facility to \$25.0 million as of the filing date of this report. If SureBeam is unable to receive funds as anticipated under this credit facility or if its capital requirements vary from its current plans, it may require additional financing sooner than it anticipates. In such circumstance no assurance can be made that the Company would be able to obtain additional financing on terms reasonable to the Company, or at all, which could have a material adverse effect on its results of operations and financial condition.

Under the new senior secured credit facility the Company is obligated to make quarterly principal payments as follows: 13.75% of the outstanding principal balance as of December 31, 2003 during each quarter in 2004; 25% of the outstanding principal balance as of December 31, 2004 during each quarter in 2005; and all remaining principal by December 31, 2005. In addition, with some exceptions, the Company is obligated to use net proceeds from the sale of assets and its securities to repay amounts advanced under this facility. The interest rate is Titan's effective weighted average term debt rate under Titan's credit agreement plus three percent. Interest is payable monthly beginning in January 2003. The credit agreement contains affirmative and negative covenants, including covenants limiting the Company's incurrence of debt, capital expenditures, operating expenses, investments, declaration of dividends and other restricted payments, sale of stock of subsidiaries and consolidations and mergers. The credit agreement, however, does not contain any financial covenants requiring the Company to maintain specific financial ratios. The credit agreement is secured by a first priority lien on all of the Company's assets.

**Note (8) Acquisitions**

In May 2000, Tech Ion Industrial Brasil S.A., or Tech Ion, placed purchase orders with the Company for eleven electronic food irradiation systems for \$55.0 million, of which \$22.4 million was recognized as revenue through September 30, 2001. SureBeam Brasil Ltda., or SureBeam Brasil, which was jointly established by Tech Ion, the Company's exclusive partner in Brazil, and Titan SureBeam Brazil Ltd., the Company's wholly owned subsidiary, planned to provide, among other things, food irradiation services through four planned service centers to various food companies in Brazil. In October 2001, in order to ensure the completion of the project with Tech Ion to build service centers in Brazil that were under construction, the Company entered into a stock purchase agreement with Tech Ion to purchase an additional 60.1% of SureBeam Brasil bringing the Company's total equity ownership to 80% in SureBeam Brasil. In connection with the additional equity interest, the Company paid Tech Ion \$750,000 upon the execution of the agreement and will pay an additional \$250,000 upon the transfer of title of the linear accelerators and material handling systems for the Rio de Janeiro service center from Tech Ion to SureBeam Brasil. The Company also exchanged its trade receivables of \$22.4 million due from Tech Ion and forgave \$3.5 million of a loan the Company had previously made to Tech Ion for building improvements and equipment. The Company has recorded an intangible asset of \$2.5 million that represents the total consideration amount of the agreement that exceeded the fair market value of the assets purchased. The intangible asset will be amortized over five years. Prior to the acquisition, the Company was building eleven linear accelerators for Tech Ion for \$55.0 million. This contract



began in May 2000, and was at various stages of completion at the date the Company began to negotiate to acquire the above described assets. Through the date the Company began negotiations, the Company recognized revenues of \$6.8 million in fiscal year 2001 and \$22.4 million in total related to this contract. On April 1, 2002, the Company exchanged the remaining \$1.5 million owed by Tech Ion in consideration for its remaining 20% interest in SureBeam Brasil. The \$1.5 million was included in prepaid expense and other current assets in the accompanying balance sheet at December 31, 2001. Due to the exchange the Company has recorded an additional \$700,000 as an intangible asset which will be amortized over the remaining 54 month life of the existing intangible asset. The remaining \$800,000 was recorded as part of the service center building cost.

#### **Note (9) Commitments and Contingencies**

The Company periodically is a defendant in cases incidental to its business activities. Furthermore, providers of products and services to the U.S. government are generally subject to multiple levels of audit and investigation by various U.S. government agencies. Any liabilities arising from audits by the federal government are being retained by Titan as part of the contribution by Titan to SureBeam. In the opinion of management, the amount of ultimate liability, if any, with respect to these actions will not materially affect the financial position or results of operations of the Company.

#### **Note (10) Related Party Transactions**

In connection with the contribution agreement with Titan, the Company entered into a number of other agreements with Titan for such items as corporate services, facilities, filing of income tax returns and employee benefit plans. These agreements provided for, among other things, continuation of services, which were historically provided by Titan to SureBeam while the Company built its corporate infrastructure on a stand-alone basis. As consideration for these services, Titan charged to the Company an allocation of the cost for these services to the extent that they pertained to SureBeam. All service agreements with Titan terminated effective as of the spin-off distribution of SureBeam on August 5, 2002, and the Company will no longer receive services from Titan. During the three and nine months ended September 30, 2002, the Company recorded an allocation for general and administrative expense of \$0 and \$1.1 million, respectively.

Titan has subcontracted the Company to design and construct SureBeam systems for Titan's various contracts with third parties. These systems are designed for applications other than the food (excluding water), animal hide and flower markets. Revenues derived from sales to Titan are recognized under cost plus 20% or fixed price contracts and were \$4.0 million and \$16.4 million for the three and nine months ended September 30, 2002, respectively. Of the revenue from Titan, \$550,000 and \$7.5 million for the three and nine months ended September 30, 2002, respectively, related to the subcontract the Company has with Titan on the United States Postal Service contracts, and the remaining \$3.4 million and \$8.9 million for the three and nine months ended September 30, 2002, respectively, was recorded in relation to Titan's medical sterilization business and government linear accelerator business.

Effective August 5, 2002, Titan distributed all of its shares of the common stock of SureBeam to the stockholders of Titan. Titan announced that holders of record of Titan common stock as of the close of business on July 26, 2002, the record date for the distribution, were to receive 0.6986 shares of SureBeam common stock for every share of Titan common stock held.

Previously, Titan held over eighty percent of the common stock of SureBeam and held a higher percentage of the voting power of SureBeam due to Titan's ownership of shares of Class B common stock, which had ten votes per share, as compared to SureBeam's Class A common stock, which has one vote per share and is traded on the Nasdaq under the symbol SURE.



In September 2002, the Company received an order from Titan for \$6.0 million in connection with a new contract with the USPS. Under this agreement, the Company is to provide two linear accelerators to sanitize the mail. During the three months ended September 30, 2002, the Company recorded revenue of \$500,000 related to this contract. It expects to receive milestone payments as they become due and payable on this contract.

In April 2002, the Company formed a joint venture under the name SureBeam Middle East, LLC. with RESAL. As of September 30, 2002, SureBeam owns a 19.9% interest in SureBeam Middle East, LLC. and RESAL and other Saudi nationals own the remaining 80.1%. The Company has a purchase order with an aggregate value of \$50.0 million from RESAL. In accordance with the joint venture agreement, RESAL's purchase order dated June 2001 may be assigned to SureBeam Middle East, LLC. at such time as the joint venture receives sufficient funds from the third party investors. Revenues are derived using the percentage-of-completion method of accounting and are classified as revenues from investee on the consolidated statements of operations.

**Note (11) Subsequent Events**

In November 2002, the Company entered into an equipment purchase agreement with Salubris Limited Partnership, or Salubris, to sell a SureBeam system for \$8.9 million. The purchase of this system will allow Salubris to build and operate a new service center in the Forth Worth, Texas area. The Company will receive per pound processing royalties once the service center is operational.

This agreement allows Fort Worth-San Diego Investments, LLC, the general partner in Salubris, the right of first negotiation on certain future opportunities in the five-state area of Texas, New Mexico, Oklahoma, Arkansas and Louisiana to purchase SureBeam systems and to provide SureBeam processing.

## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion of the financial condition and results of operations of SureBeam Corporation should be read in conjunction with the unaudited financial statements and the related notes thereto included elsewhere in this Form 10-Q, the audited financial statements and notes thereto and Management's Discussion and Analysis of Financial Condition and Results of Operations included in the Company's Form 10-K for the year ended December 31, 2001.

When you read this section of this Form 10-Q, it is important that you also read the financial statements and related notes included elsewhere in this Form 10-Q. This section of this Form 10-Q contains forward-looking statements that involve risks and uncertainties, such as statements of our plans, objectives, expectations and intentions. We use words such as may, will, should, expect, plan, intend, anticipate, believe, predict, potential, or continue, the negative of such terms or other terminology to identify forward-looking statements. Our actual results could differ materially from those anticipated in these forward-looking statements for many reasons. These forward-looking statements involve risks and uncertainties including, but not limited to, those referred to in this report as well as in the Company's public filings with the SEC, including the Company's Annual Report on Form 10-K for the year ended December 31, 2001, regarding the risk of gaining consumer acceptance, risks relating to the Company's history of losses and liquidity and risks of international operations.

### Overview

We are a leading provider of electronic irradiation systems and services for the food industry. We were formed in August 2000 in connection with the contribution by Titan of the assets, liabilities and operations related to its electronic food irradiation business. Titan's electronic food irradiation business had previously been operated as part of a division of Titan, together with Titan's medical equipment sterilization business and its government linear electron beam accelerator business. References to SureBeam, the Company or us in this discussion and analysis section and in the historical financial statements refer to this division of Titan prior to the date of the contribution of the electronic food irradiation business to us by Titan. Our spin-off from Titan was completed on August 5, 2002 when Titan distributed all of its shares of the common stock of SureBeam to the stockholders of Titan.

### Results of Operations

#### *Revenues*

We have three classifications of revenues on the face of our consolidated statements of operations: revenues from non-affiliated parties, revenues from investee and revenues from The Titan Corporation, or Titan. Revenues from non-affiliated parties represent all revenue generated from food processing and all electronic food irradiation system sales not associated with SureBeam Middle East, LLC. or Titan. Revenues from investee represent electronic food irradiation system sales generated from SureBeam Middle East, LLC. To date, all of the revenues from investee relate to our \$50.0 million Saudi RESAL purchase order. Revenues from Titan represents sales of our electronic irradiation systems and services related to Titan Scan Technologies medical sterilization business, Titan's government linear accelerator business and revenues in support of Titan's United States Postal Service contracts. Although Titan has not been an affiliate of SureBeam since August 5, 2002, we classify revenues from Titan separately to provide easier comparability to earlier periods.

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Our total revenues decreased from \$14.5 million and \$29.6 million in the three and nine months ended September 30, 2001, respectively, to \$7.0 million and \$24.8 million in the three and nine months ended September 30, 2002, respectively. The decrease of \$7.5 million in total revenue for the three months ended September 30, 2002 compared to the same period last year was a result of a decrease of \$2.8 million of revenues from non-affiliated parties and a decrease of \$5.8 million of revenues from investee which was offset by an increase of \$1.1 million of revenues from Titan. For the three months ended September 30, 2002 and 2001, we had electronic food irradiation system sales and food processing revenue from non-affiliated parties of \$815,000 or 12% of total revenues and \$3.6 million or 25% of total revenues, respectively. For the nine months ended September 30, 2002 and 2001, we had electronic food irradiation system sales and food processing revenue from non-affiliated parties of

\$4.8 million or 19% of total revenues and \$10.4 million or 35% of total revenues, respectively. For the three months ended September 30, 2002, 68%, or \$552,000, of the \$815,000 of revenues from non-affiliated parties, was derived from sales of electronic food irradiation systems to two customers and 32%, or \$263,000, was derived from food processing services. For the three months ended September 30, 2001, 92%, or \$3.3 million, of the \$3.6 million of revenues from non-affiliated parties was derived from sales of electronic food irradiation systems to two customers and 8%, or \$280,000, was derived from food processing services. For the nine months ended September 30, 2002, 83%, or \$4.0 million, of the \$4.8 million of revenues from non-affiliated parties was derived from sales of electronic food irradiation systems to two customers and 17%, or \$810,000, was derived from food processing services. For the nine months ended September 30, 2001, 92%, or \$9.6 million, of the \$10.4 million of revenues from non-affiliated parties was derived from sales of electronic food irradiation systems to three customers and 8%, or \$802,000, was derived from food processing services.

The 2002 revenues from non-affiliated parties were related to revenue recognized from sales of our electronic food irradiation systems, using the percentage-of-completion method of accounting, to Texas A&M University, or Texas A&M, (see discussion below) and Son Son Company, a private food processing corporation headquartered in Vietnam. The 2001 revenues from non-affiliated parties were primarily related to revenue recognized from sales of our electronic food irradiation systems, using the percentage-of-completion method of accounting, principally to Texas A&M and Tech Ion Industrial Brasil, S.A., a Brazilian food irradiation company. Food processing service revenues were primarily derived in connection with our customer production runs as well as test marketing programs. We expect that both the systems sales and the processing revenues from non-affiliated parties will increase as new contracts are signed for systems sales and as the production increases at our company-owned services centers as demand for products processed using SureBeam technology increases.

Our revenues from investee decreased from \$8.0 million and \$15.4 million in the three and nine months ended September 30, 2001, respectively, to \$2.2 million and \$3.6 million in the three and nine months ended September 30, 2002, respectively. The revenues from investee are related to revenue recognized from sales of our electronic food irradiation systems, using the percentage-of-completion method of accounting from RESAL Saudi Corp., or RESAL, a subsidiary of a private Saudi conglomerate headquartered in Riyadh, Saudi Arabia. The decrease in revenues of \$11.8 million from 2001 to 2002 is due to the timing of the work performed on the contract.

Our revenues from Titan increased from \$2.9 million and \$3.9 million in the three and nine months ended September 30, 2001, respectively, to \$4.0 million and \$16.4 million in the three and nine months ended September 30, 2002, respectively. For the three and nine months ended September 30, 2002, \$550,000 or 14% and \$7.5 million or 46%, respectively, of revenues from Titan were from sales of our electronic irradiation systems using the percentage of completion method of accounting, in support of Titan's two United States Postal Service contracts for which we are the main subcontractor. The remaining \$3.4 million and \$8.9 million of revenues from Titan for the three and nine months ended September 30, 2002, respectively, were for the sale of equipment and services related to Titan Scan Technologies' medical sterilization business and Titan's government linear accelerator business.

In connection with our agreement with Texas A&M, we agreed to provide three electronic food irradiation systems (collectively, the system) pursuant to a ten-year lease with title passing to Texas A&M at the end of the ten-year term. The agreement provides us access to Texas A&M employees for a variety of free or discounted services, as well as rights to use the system for performing irradiation services for our customers. We are currently working with Texas A&M on several research projects which include studies on shelf life extension, food products application testing, and the effectiveness of Sure Beam's technology versus other technologies. Since we retain the right to use the system through the end of the term of the arrangement, we have accounted for this transaction as a sale-leaseback.

As the consideration in this lease is nonmonetary, we have accounted for this element of the agreement in accordance with APB No. 29, Accounting for Nonmonetary Transactions. Sales are recorded on a percentage-of-completion basis at the fair market value of the electronic food irradiation system sold to Texas A&M and total system profits of \$518,000 will be deferred and recognized ratably over the remaining term of the arrangement commencing upon delivery of the system.



Under the percentage-of-completion method, we recorded revenues of \$50,000 and \$1.9 million for the three and nine month periods ended September 30, 2002, respectively, and recorded \$2.0 million and \$3.3 million

for the three and nine month periods ended September 30, 2001, respectively. The asset arising from the total cumulative revenues of \$10.0 million, net of \$322,000 of amortization, has been recorded as a short-term and long-term asset at September 30, 2002. As of September 30, 2002, we had deferred profits amounting to \$518,000, which are included as other short-term and long-term liabilities in the accompanying consolidated balance sheet. These deferred profits will be amortized ratably to reduce cost of sales over the remaining term of the ten-year term of the arrangement commencing upon delivery of the system to Texas A&M. The short-term and long-term assets arising from this transaction represents the cumulative revenues recognized related to the design, construction, installation, integration and delivery of the system for Texas A&M, net of amortization. In August 2001, we agreed to purchase research and development services from Texas A&M for approximately \$200,000, reflecting a discount of approximately \$300,000. The discount has been amortized over a period of approximately ten months from the long-term asset arising from the cumulative revenues recorded under this agreement. For the three and nine months ended September 30, 2002, we have recorded \$0 and \$150,000, respectively, of amortization expense related to the research and development services we have received to date. The deferred profit of \$518,000 as of September 30, 2002, represents the difference between the cumulative costs incurred and the cumulative revenues recognized. During September 2002, the final delivery of the system had taken place and the facility became operational and \$6,000 of deferred profit has been amortized to income.

With respect to the impact of the transaction with Texas A&M on our liquidity, we have expended funds of approximately \$9.5 million related to the construction of the system through September 30, 2002, which includes \$50,000 and \$1.9 million expended during the three and nine months ended September 30, 2002, respectively. These costs have been incurred primarily in relation to the design of the system, construction of and modification to the physical structure that will house the system, and for the manufacture of the linear accelerators and x-ray components as well as the material handling and conveyor systems.

Our cost of revenues consists primarily of the components and materials associated with the linear accelerator, material handling system and controls and direct labor to assemble, install and integrate the medical equipment sterilization and electronic food irradiation systems, as well as overhead such as travel, indirect labor and fringe benefits related to the production of the systems and the manufacturing of linear electron beam accelerators. Also included in cost of revenues are all direct and indirect costs associated with providing medical equipment sterilization and electronic food irradiation services. These costs are comprised of direct and indirect labor, depreciation, rent, dosimetry supplies, maintenance and utilities as well as other related costs to operate a service center. Dosimetry supplies are consumables used during facility operations to monitor performance and to ensure the integrity of the dose of the irradiation delivered to the product for quality assurance purposes and to satisfy federal requirements.

Our gross margins decreased from 41% and 38% for the three and nine months ended September 30, 2001, respectively, to 2% and 20% for the three and nine months ended September 30, 2002, respectively. The decrease is due to a low gross margin on food processing due to underutilization of the service centers and higher percentage of revenues from Titan, which have a lower gross margin than systems sales from non-affiliated parties and systems sales to the investee. We anticipate that our gross margins will increase as the utilization at the service centers increases and the percentage of revenue from Titan, which has a lower gross profit, decreases as a percentage of total revenue.

#### *Selling, General and Administrative*

Our selling, general and administrative expense decreased from \$11.9 million and \$69.6 million in the three and nine months ended September 30, 2001, respectively, to \$11.8 million and \$31.4 million in the three and nine months ended September 30, 2002, respectively. The decrease of \$110,000 for the three months ended September 30, 2002 compared to the same period last year is attributed to an increase of \$1.1 million in stock-based compensation as a result of our spin-off from Titan, an increase of \$735,000 in sales and marketing spending, and was offset by a decrease of \$689,000 of amortization related to intangible assets acquired from Applied Power Associates, Inc., or APA, in May 2002, which are fully amortized, and a decrease of \$263,000 of corporate allocation from Titan as a result of our spin-off on August 5, 2002. The decrease of \$38.1 million for the nine months ended September 30, 2002 compared to the same period last year is attributed to a decrease of \$35.3 million in stock-based compensation, \$570,000 in sales and marketing spending, \$1.1 million of amortization related to the APA intangible assets and

\$266,000 in corporate allocation from Titan. See the discussion of stock-based

compensation below. We expect general and administrative expenses will increase due to higher sales and marketing expense associated with new customer product rollouts into new regions.

#### *Stock-based Compensation*

In connection with the completion of our initial public offering in March 2001, stock options granted under our Nonstatutory Stock Option Plan were converted from variable plan options to fixed plan options. Accordingly, stock-based compensation of \$78.6 million was recorded, representing the extent to which the \$10.00 per share offering price exceeded the exercise price of the options. We recognized \$4.9 million and \$48.5 million as compensation expense included in selling, general and administrative expense in the accompanying consolidated statements of operations for the three and nine months ended September 30, 2001, respectively. Since substantial portions of these options were vested at the time of completion of the offering, we recognized \$38.7 million as compensation expense at that time. For the three and nine months ended September 30, 2002, \$6.0 million and \$13.2 million was recognized, respectively, as compensation expense and included in selling, general and administrative expense. In conjunction with the completion of our spin-off from Titan on August 5, 2002, all options held by Titan employees and directors under this plan became fully vested and as a result increased the amortization of the stock-based compensation charges for this plan for the three months ended September 30, 2002 by \$2.9 million. The remaining stock-based compensation balance of the remaining participants related to these options will be recognized as expense over the remaining four-year vesting period of the options. Additional stock-based compensation expense is included in selling, general and administrative expense related to options granted prior to the completion of the Company's initial public offering under the 2000 Stock Option and Incentive Plan for which the fair market value on the date of grant exceeded the exercise price. Stock-based compensation expense related to these options was \$202,000 and \$606,000 for the three and nine months ended September 30, 2001 and 2002, respectively.

#### *Research and Development*

Our research and development expense decreased from \$736,000 and \$1.8 million in the three and nine months ended September 30, 2001, respectively, to \$55,000 and \$551,000 in the three and nine months ended September 30, 2002, respectively. The decrease of our research and development expense in the current year is due to our extensive ongoing research and development work performed for Titan, the costs of which we bill to Titan based on the work performed. As these efforts for Titan decrease and our internal efforts increase, we expect the research and development expense to increase in the future. Our current research and development activities are focused on increasing the capability and efficiency of our existing technology, minimizing the space occupied by our SureBeam systems and developing new food product applications. We have assembled a team of experts in our industry to enhance and drive our research and development efforts. Our research and development experts have many years of experience in the area of enhancing food safety and extending shelf life using irradiation in addition to their broad experience with linear accelerators and charged particle beams. In addition, we have an agreement with Texas A&M University and the Texas Agricultural Experiment Station for the purpose of researching and developing product applications for our technology. We are currently working with Texas A&M on several research projects which include studies on shelf life extension, food products application testing, and the effectiveness of SureBeam's technology versus other technologies. In addition, we often benefit from the research and development efforts of our component suppliers.

#### *Interest Income*

Our interest income decreased from \$333,000 and \$1.1 million in the three and nine months ended September 30, 2001, respectively, to \$37,000 and \$164,000 in the three and nine months ended September 30, 2002, respectively. The decrease is due to the reduced cash and marketable securities on hand for the three and nine months ended September 30, 2002. Due to our initial public offering in March 2001, our cash and

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marketable securities balances were \$39.6 million at September 30, 2001 as compared to \$5.0 million at September 30, 2002. See Note (2) in Notes to Consolidated Financial Statements.

*Interest Expense*

Our interest expense decreased from \$1.6 million and \$4.8 million in the three and nine months ended September 30, 2001, respectively, to \$331,000 and \$1.3 million in the three and nine months ended

September 30, 2002, respectively. The decrease is due to the exchange of \$73.0 million of our subordinated promissory note payable to Titan for our common stock. See Note (6) in Notes to Consolidated Financial Statements. This exchange of debt resulted in a decrease in our interest expense. However, as we require additional financing, either drawing down on the senior secured credit facility with Titan or obtaining other financing, we will likely incur increased interest expense in the future.

*Other Income (Expense), Net*

During the three and nine months ended September 30, 2002, we recorded \$1.0 million and \$2.9 million, respectively, of other income, net. For the three and nine months ended September 30, 2002 we recorded \$1.0 million and \$3.0 million, respectively, of license fee income from Titan that was reduced by realized losses from the sale of available-for-sale marketable securities and other miscellaneous expenses. During the fourth quarter of 2001, Titan agreed to purchase a perpetual and exclusive, non-royalty bearing license to use our intellectual property for all applications and fields other than food (excluding water), animal hide and flower markets for \$8.0 million. As part of this agreement, we are recording \$1.0 million of license fee income in each quarter for eight quarters, which began in the fourth quarter of 2001. There was no other income, net for the three and nine months ended September 30, 2001.

*Income Taxes*

Income taxes reflect an effective rate of 0% for the three and nine months ended September 30, 2002, compared to 10% for the three months and nine months ended September 30, 2001. Pursuant to our tax sharing agreement, Titan will compensate us for any tax benefit received by Titan from the use of our losses in their consolidated return. The amount is payable on the earlier of when we could have used the loss ourselves or when the losses expire (20 years). We had an operating loss for the first nine months of 2002 and 2001 and expect to continue to incur losses for the remainder of 2002. Our tax benefit is dependent upon the usage of our losses by Titan. The amount expected to be received from Titan under the tax sharing agreement related to losses incurred for the twelve months ended December 31, 2001 is \$2.3 million and is reflected as due from Titan in the accompanying balance sheet. In conjunction with the spin-off, we have been subsequently deconsolidated from Titan and Titan will no longer have the right to use our losses. Accordingly, we have not recorded any benefit for income taxes for the three and nine months ended September 30, 2002.

*Net Loss*

Our net loss increased from \$7.7 million and decreased from \$57.5 million in the three and nine months ended September 30, 2001, respectively, to \$11.0 million and \$25.1 million in the three and nine months ended September 30, 2002, respectively. The increased loss of \$3.3 million for the three months ended September 30, 2002 over the same period last year primarily related to \$5.8 million of lower gross profit offset by a reduction of \$681,000 of research and development expense, \$1.2 million of interest expense and \$861,000 of income tax benefit. The decreased loss of \$32.3 million for the nine months ended September 30, 2002 over the same period last year for the quarter was primarily due to a reduction of stock-based compensation amortization expense of approximately \$35.3 million for nine months ended September 30, 2002.

**Liquidity and Capital Resources**

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We have used cash principally to construct systems for our strategic alliances and fund working capital advances for these strategic alliances, to construct company-owned service centers and systems, to construct systems for Texas A&M, to expand our manufacturing capacity and to fund our working capital requirements. At September 30, 2002, we had available cash, cash equivalents and investments available-for-sale of \$5.0 million. Our future cash obligations consist primarily of current liabilities and our fixed lease costs associated with the operation of our service centers. As of September 30, 2002, we expect to pay approximately \$2.8 million in lease obligations during the next 12 months.

Since our initial public offering on March 16, 2001, our cash requirements have been met primarily through proceeds of approximately \$59.8 million, net of underwriting commissions, fees and other offering costs, from our

initial public offering, advances under the \$75.0 million credit facility and the \$50.0 million senior secured credit facility with Titan discussed below, payments from Titan for work performed on medical sterilization, \$19.5 million associated with mail sanitation system sales and payments totaling \$7.0 million from Titan associated with the perpetual license related to non-food items. In connection with the contribution by Titan to SureBeam in August 2000, we assumed the cumulative advances of approximately \$39.0 million, as evidenced by a subordinated, unsecured promissory note payable to Titan. Under this note, Titan agreed to lend us a maximum amount of \$75.0 million, including accrued interest, and we borrowed \$75.0 million. The promissory note was due in August 2005 and bore interest at the greater of the rate of 10% per annum or Titan's effective weighted average interest rate under its senior credit facility. On December 31, 2001, \$2.0 million of the subordinated note payable to Titan was exchanged by Titan for 190,385 shares of our Class B common stock. Additionally, the remaining \$73.0 million of the subordinated note payable to Titan was exchanged on February 13, 2002 for 4,441,496 shares of our Class A common stock and 3,225,765 shares of our Class B common stock.

Titan has extended a \$50.0 million senior secured credit facility to us that allows us to borrow, in addition to our previous borrowing, up to \$12.5 million per quarter during in the fourth quarter of 2002 through the fourth quarter of 2003, subject to the \$50.0 million limitation on borrowing. The amount available for borrowing in the second, third and fourth quarters of 2003 is based upon our earnings before interest, taxes, depreciation and amortization (EBITDA) for the prior quarter as a percentage of the EBITDA target in our annual operating plan. If EBITDA is less than 25% of target EBITDA, then the amount available is \$5.0 million, provided that no amounts are available unless we covenant during the current quarter to limit our total operating expenses (defined as research and development and selling, general and administrative expenses) to \$5.0 million. If EBITDA is 25% of target EBITDA, then the amount available is \$6.25 million or 50% of the quarterly maximum and for each percentage of EBITDA above 25% of target EBITDA, the percentage of the quarterly maximum above 50% will be increased on a pro rata basis. To the extent we do not fully borrow the maximum amount during any quarter of 2002, the unutilized amount can be borrowed in the subsequent quarters. As of September 30, 2002, we had borrowed \$22.5 million on this facility and had \$4.5 million in unutilized amounts. We borrowed an additional \$2.5 million on October 31, 2002, bringing our total borrowings on this senior secured credit facility to \$25.0 million. If we are unable to receive funds as anticipated under this credit facility or if our capital requirements vary from our current plans, we may require additional financing sooner than we anticipate. An inability in such circumstance to obtain additional financing on terms reasonable to us, or at all, could have a material adverse effect on our results of operations and financial condition.

Under the senior secured credit facility we are obligated to make quarterly principal payments as follows: 13.75% of the outstanding principal balance as of December 31, 2003 during each quarter in 2004; 25% of the outstanding principal balance as of December 31, 2004 during each quarter in 2005; and all remaining principal by December 31, 2005. In addition, with some exceptions, we are obligated to use net proceeds from the sale of assets and securities to repay amounts advanced under this facility. Interest is payable monthly beginning in January 2003. The credit agreement contains affirmative and negative covenants, including covenants limiting our incurrence of debt, capital expenditures, operating expenses, investments, declaration of dividends and other restricted payments, sale of stock of subsidiaries and consolidations and mergers. The credit agreement, however, does not contain any financial covenants requiring us to maintain specific financial ratios. The credit agreement is secured by a first priority lien on all of our assets.

In addition, Titan has guaranteed some of our lease obligations, and we are obligated to reimburse Titan for any payments they make under these guaranties. Any guarantee payments Titan makes reduces amounts available for future borrowing under the credit agreement. We will pay Titan a monthly fee of 10% of the guaranteed monthly payments. Some of the guaranteed leases have longer terms than the credit facility. If Titan remains a guarantor at the maturity date for the credit facility, then we plan to enter into a reimbursement agreement with Titan covering the outstanding guarantees.

Our operating activities used cash of \$10.8 million for the nine months ended September 30, 2002, primarily due to a decrease in accounts receivable and receivable from Titan of \$2.5 million, amortization and depreciation expense of \$17.6 million, which was offset by a decrease of \$4.6 million related to accounts payable and accrued compensation. The decrease in accounts receivable principally relates to collection of \$19.5 million from Titan related to the United States Postal Service and the collection of \$1.5 million from the RESAL contract





during the nine months ended September 30, 2002. The \$21.0 million, collected during the nine months ended September 30, 2002, was received in accordance with the milestone payments of the contracts.

Our investing activities used cash of \$11.8 million for the nine months ended September 30, 2002, primarily due to the sale of available-for-sale investments of \$3.7 million, offset by capital expenditures of \$15.1 million primarily related to our service centers under construction. Also included in cash used for investing activities for the nine months ended September 30, 2002 were advances to Hawaii Pride aggregating \$445,000 for working capital requirements.

In June 2001, we received an order in the aggregate amount of \$50.0 million from RESAL for ten electronic food irradiation systems to operate in three service centers in the Saudi Arabia region for irradiating poultry and disinfesting and prolonging shelf life of dates. We commenced construction on eight of these systems for RESAL and have recognized, under the percentage-of-completion method of accounting, \$15.8 million in revenue, which has been recorded on this contract through September 30, 2002, of which \$3.6 million was recognized during the nine months ended September 30, 2002. Revenues derived from this order are classified as revenues from investee in the accompanying consolidated statements of operations. Three electronic food irradiation systems are scheduled to be shipped in early 2003, with the remainder being shipped within twelve months thereafter. We received a payment of \$1.5 million in the second quarter of 2002 based on milestone payments and expect to continue to receive milestone payments as they become due and payable until the contract is complete.

In April 2002, we formed a joint venture under the name SureBeam Middle East, LLC. with RESAL. SureBeam Middle East, LLC. will provide, among other things, food irradiation services through planned service centers in the Saudi Arabia region. As of September 30, 2002, we own a 19.9% interest in SureBeam Middle East, LLC. and RESAL and other Saudi nationals own the remaining 80.1%. We account for our ownership interest in SureBeam Middle East, LLC. using the equity method of accounting under APB Opinion No. 18 The Equity Method of Accounting for Investments in Common Stock. In accordance with the joint venture agreement, RESAL's purchase order dated June 2001 may be assigned to SureBeam Middle East, LLC. at such time as the joint venture receives sufficient funds from the third party investors. As of September 30, 2002, a portion of the purchase order has been assigned to SureBeam Middle East, LLC. As a result, revenue recognized under the contract is presented in the consolidated statements of operations as revenue from investee and we have eliminated our 19.9% interest in the profit recognized under the percentage-of-completion method of accounting in connection with the original purchase order. We estimate that the total profit under the original contract that will be eliminated as a result of our equity interest in SureBeam Middle East, LLC. will be approximately \$2.0 million to \$3.0 million. Pursuant to the joint venture agreement, for five years following the date of SureBeam Middle East, LLC.'s commercial registration, SureBeam Middle East, LLC. has an exclusive right of first negotiation to negotiate and enter into agreements to provide irradiation services for the treatment of food products (excluding water), animal hides and flowers in Saudi Arabia, Egypt, Lebanon, Syria, Iraq, Iran, Libya, Tunisia and Algeria. The joint venture will govern our strategic relationship with the operator of these systems, including royalty and management fees and a minority equity ownership of the operator that will operate the service centers.

In October 2001, we contracted to manufacture eight SureBeam systems for \$26.0 million for Titan in connection with Titan's agreement with the United States Postal Service, or USPS. During the three months ended September 30, 2002, our purchase order from Titan related to the USPS was closed out at \$19.5 million dollars. Under this agreement, Titan arranged to provide electron beam systems and services to sanitize mail by eliminating the threat of anthrax. We worked with Titan and Titan's business units in providing the systems to the USPS. We were a principal subcontractor to Titan under its prime contract. In accordance with the milestone payments of the contract, we received \$19.5 million in cash from Titan during the nine months ended September 30, 2002.

In June 2002, we received an order in the aggregate amount of approximately \$5.3 million from Son Son Company, a private food-processing corporation headquartered in Vietnam, for one electronic food irradiation system to operate in Vietnam for irradiating shrimp, seafood, and frog legs and prolonging shelf life of foods. We commenced construction on the system and have recognized, under the percentage-of-completion method of accounting, \$2.1 million in revenue, which has been recorded on this contract through September 30, 2002, of which \$503,000 was recognized during the three months,

ended September 30, 2002. In November 2002, we received a \$2.0 million milestone payment on this contract. We expect to receive milestone payments as they become due and payable until the contract is complete.

In September 2002, we received an order from Titan for \$6.0 million in connection with a new contract with the USPS. Under this agreement, we are to provide two linear accelerators to sanitize the mail. During the three

months ended September 30, 2002, we recorded revenue of \$500,000. We expect to receive milestone payments as they become due and payable on this contract.

The accompanying consolidated financial statements contemplate the realization of assets and the satisfaction of liabilities in the normal course of business. During the nine months ended September 30, 2002, we have incurred substantial losses from operations and investments in infrastructure. Management believes that as we continue to make significant investments in infrastructure, sales and marketing, it is not anticipated that our revenues will sufficiently offset these investments until at least 2003. Additionally, our construction and implementation period for systems sales to strategic alliances as well as our service centers and systems require a substantial use of cash for at least 12 to 18 months. Our arrangements to sell food irradiation systems to strategic alliances typically contain milestone provisions for payment, which are typically based upon time, stage of completion, and other factors. As a result, our unbilled receivables from our customers have increased \$4.0 million during the nine months ended September 30, 2002. Also in connection with our agreements with our customers, we have advanced funds aggregating \$5.5 million to Hawaii Pride, which was used primarily for land acquisition and for working capital purposes. Although not obligated, we anticipate that we will continue to provide cash to Hawaii Pride for working capital purposes, as it is needed. We do not expect significant repayments of the advances from Hawaii Pride until at least late 2003. We also have entered into a number of commitments to lease land and facilities in connection with construction of our four company-owned service centers of which three are operational with the fourth expected to be operational in the first quarter of 2003. In addition, based on our customer requirements, we may expend funds to construct and install in-line systems that we will own and operate.

In addition to our current operating plans, which focus on increasing cash flow from operations, we are also evaluating a number of alternative plans to meet our future operating cash needs. These plans include raising additional funds from the capital markets and drawing down on our \$50.0 million senior secured credit facility with Titan. As of the date of the filing of this report, we have obtained \$25.0 million under the senior secured credit facility with Titan. If the funds available under the credit facility and from the capital markets are not sufficient for us or if we are unable to generate sufficient cash flow from operations, we may need to consider additional actions, including reducing or deferring capital expenditures, reducing or deferring research and development projects, curtailing construction of systems for customers in advance of payment and reducing marketing expenditures, which actions may have a material adverse impact on our ability to meet our business objectives.

On October 16, 2001, Titan adopted a definitive plan to spin-off its ownership interest in SureBeam in the form of a tax-free dividend to Titan's stockholders. Effective August 5, 2002, Titan distributed all of its shares of our common stock to its stockholders. Titan announced that holders of record of Titan common stock as of the close of business on July 26, 2002, the record date for the distribution, were to receive 0.6986 shares of our common stock for every share of Titan common stock held. Previously, Titan held over eighty percent of the our common stock and held a higher percentage of the voting power due to Titan's ownership of shares of Class B common stock, which had ten votes per share, as compared to the Class A common stock, which has one vote per share and is traded on the Nasdaq under the symbol SURE. Prior to the distribution of shares of our common stock, Titan converted all of its shares of our Class B common stock, into shares of our Class A common stock. Stockholders of Titan receiving SureBeam shares in its distribution received only shares of Class A common stock. Under the terms of the Class B common stock, it has now been retired and cannot be reissued. As of November 5, 2002, there were 67,297,362 shares of common stock issued and outstanding, all of which are Class A common stock. We have negotiated other agreements with Titan in connection with our spin-off including a tax sharing and disaffiliation agreement that will subject us to liability if we sell our equity or equity linked securities in a manner that causes a change in our ownership of 50% or more in voting power or value as part of Titan's spin-off plan. This risk could limit our ability to access public equity markets. In addition, the recent downturn in the capital markets may limit our ability to raise capital through public equity or debt offerings. If funds from our senior secured credit facility or other sources are not sufficient to us and/or if we are unable to generate sufficient cash flow from operations, we may need to consider additional actions, including reducing or deferring capital expenditures, reducing or deferring research and development projects, reducing construction of systems for customers in advance of payment and reducing marketing expenditures. The deferral or cancellation of these projects may have a material adverse impact on our ability to meet our short-term business objectives. In order to borrow funds under our senior secured credit facility, we must be in compliance with our operating expense and capital expenditure covenants and we may have to curtail these activities to be in compliance with these covenants.



At September 30, 2002, we had \$5.0 million of cash, cash equivalents and investments available-for-sale. We believe that this balance along with the remaining availability on the \$50.0 million senior secured credit facility from Titan will be sufficient to meet our cash needs through 2003. However, a variety of currently unanticipated events could require additional capital resources such as the acquisition of complementary businesses or technologies or increased working capital requirements to fund, among other things, construction of systems for our strategic alliances in advance of payment. Additionally, if we are unable to receive funds under the credit facility with Titan or if our requirements vary from our current plans, we may require additional financing sooner than we anticipate. An inability in such circumstance to obtain additional financing on terms reasonable to us, or at all, could have a material adverse effect on our results of operations and financial condition.

### ITEM 3. QUALITATIVE AND QUANTITATIVE DISCLOSURES ABOUT MARKET RISK

We currently are exposed to market risks related to changes in interest rates. Titan has extended us a \$50.0 million senior secured credit facility, which bears interest equal to Titan's effective weighted average term debt rate under Titan's credit agreement plus three percent. As of November 14, 2002, we have drawn \$25.0 million against this credit facility. See Note (7) in Notes to Consolidated Financial Statements. At September 30, 2002, the effective interest rate on this credit facility was 8.5%. We anticipate our future borrowings will have a variable component that will fluctuate as interest rates change. If market interest rates were to increase immediately and uniformly by 10%, there would not be a material impact on our financial condition or results of operations.

#### Risk Factors

#### Risks Related to Our Business

**We will require significant additional capital to fund operations, which may not be available on acceptable terms or at all.**

We will require additional funds to execute our current business plan which includes building new SureBeam® in-line systems and service centers, funding working capital, including in relation to our international and domestic strategic alliances, and funding our ongoing operations, including our corporate infrastructure, as a stand-alone entity. However, our future capital requirements will depend on many factors, including:

Fluctuations in our working capital requirements, including the continued or increased demand to build our systems in advance of payment;

Unexpected delays in collecting accounts receivable from sales of our systems;

The volume of food processed at our service centers and the fixed costs of operating these facilities at substantially less than current capacity;

The costs of components for our systems, and the production cost of assembling our systems;

The adequacy of our manufacturing and other facilities to meet demand for our products and services;

The size and complexity of, and the progress in, our research and development programs;

The costs of filing and prosecuting patent applications, and maintaining, defending and enforcing our patents;  
and

The timing, scope and results of market testing by food processors.

**If our revenues from operations do not meet our expectations, we may have a heightened need for additional capital from a source other than our current credit facility.**

Titan has extended to us a \$50.0 million senior secured credit facility secured by substantially all of our assets. It allows us to borrow up to a maximum of \$12.5 million per quarter beginning in the fourth quarter of 2002 through the fourth quarter of 2003, subject to the \$50.0 million aggregate limitation on borrowing. The amount available for borrowing in each of the second, third and fourth quarters of 2003 is based upon our earnings before interest, taxes, depreciation and amortization (EBITDA) for the prior quarter as a percentage of the EBITDA target in our annual operating plan. If our operating revenues do not meet our expectations, it is likely that (i) our EBITDA will not meet our EBITDA target, which will limit the amount which we can borrow under the Titan credit facility; and (ii) because of the shortfall in revenues, we will have a greater need to borrow funds to fulfill our current business plan. Therefore, failure to meet our expected operating revenues could have a compounded effect, which could require us to obtain additional financing sooner than currently anticipated in order to fulfill our current business plan. In such circumstance, no assurance can be made that we would be able to obtain additional financing on terms reasonable to us, or at all, which could have a material adverse effect upon our results of operations and financial condition.

**Our current credit facility may not be sufficient for our capital requirements.**

In the past, Titan financed a significant portion of our working capital and other capital requirements and Titan has extended to us a new \$50.0 million senior secured credit facility secured by substantially all of our assets. This facility is subject to limits in the amounts that can be drawn each quarter, and subject to certain financial covenants and affirmative and negative covenants. As of November 14, 2002, we have borrowed \$25.0 million under this senior secured credit facility. We cannot give assurance that the \$50.0 million senior secured credit facility will be adequate for our liquidity needs or that we will be able to obtain any additional credit on as favorable terms or at all. We believe our current liquidity, including the senior secured credit facility with Titan, will allow us to continue our operations through 2003; however, if our capital requirements vary from our current plans, we may require additional financing sooner than we anticipate. We expect we will need to obtain additional debt or equity financing in order to execute our business strategy. Future equity financings would be dilutive to the existing holders of our



common stock. Future debt financings would most likely involve restrictive covenants and would need to be approved by Titan. Additional financing from Titan or from third parties may be unavailable to us when needed. If we are unable to obtain future equity financing or debt financing or obtain additional funding from Titan or other financing sources on terms acceptable to us or at all or if we are unable to generate sufficient cash flow from operations, we believe we would have sufficient funds to continue our operations through 2003, but we would have to significantly reduce our current business plan and delay, curtail or eliminate some of our operations or capital expenditures in 2004 and beyond, which could have a material adverse effect on our results of operations and financial condition.

**Our business is at an early stage of development. We are subject to the risks of new enterprises and the commercialization of a technology that requires consumer acceptance.**

Our early stage of development makes it difficult to assess our prospects or predict our future operating results. We are subject to risks and uncertainties frequently encountered by early stage companies that involve the new application of an existing technology. These risks include our inability to:

Build consumer confidence in the benefits of food irradiation and establish the acceptance of our SureBeam electronic irradiation technology;

Establish and maintain a sufficient number of food industry customers and strategic relationships; and

Obtain substantial capital to support the further development of our technology and the commercialization of our systems and services.

If we do not successfully address these risks, we may not be able to increase revenues or commercialize our SureBeam system.

**If we are unable to successfully achieve broad market acceptance of our SureBeam system, we may not be able to generate enough revenues in the future to achieve or sustain profitability.**

We are dependent on the successful commercialization of our SureBeam system. The market for electronically irradiated food is at an early stage of development and has developed slower than we had originally expected. As of September 30, 2002, eleven food processors were selling food electronically irradiated by us and the volume of food being processed is still a very small percentage of the market of ground beef. To date, no market has developed for chicken. The FDA still has not approved the irradiation of processed food, which represents a substantial potential market. We processed 11.1 million pounds of food products in 2001, up from 5.9 million pounds processed in 2000. Through September 30, 2002, we have processed 10.3 million pounds of food products. Other food processors are testing our technology and it is uncertain whether or when they will begin commercial production, which in some cases depends on obtaining regulatory approval. We also do not know whether or when more fast food or other national chain restaurants or food retailers will decide to offer irradiated meat and create demand for our electronic irradiation systems. We expect that some food processors will not irradiate food unless industry leaders first commit to distribute irradiated food.

The markets for our SureBeam system are unproven. Our SureBeam technology may not gain adequate commercial acceptance or success. A variety of the risk factors discussed in this section will determine the success of our market development and commercialization efforts and the rate and extent of market acceptance of our SureBeam system.

**Public concerns over the irradiation of food could negatively impact market acceptance of our SureBeam process and SureBeam® branded food products.**

Irradiation of food by any technology, whether using an electron beam or radioactive isotopes, is opposed by several organized and vocal consumer groups who claim that irradiated food products are unsafe for consumption or pose a danger to the environment. These groups attempt to influence public policy and promote consumer opposition to irradiated food through activities such as picketing stores that offer irradiated food and by lobbying politicians. Because irradiation of foods by electron beam technology is a new process, consumers need to be informed about the benefits and safety of food irradiation. Since irradiation of food by any method, whether using electron beam or radioactive isotopes, must be disclosed under the same label "Treated with Radiation" or "Treated by Irradiation," consumers may fear that our process makes food unsafe for consumption, has unknown future health effects or poses a danger to the environment. We risk not being able to overcome these fears through our educational efforts or to distinguish our process from gamma irradiation. If the public or our potential customers perceive our systems and services as unsafe or undesirable, our systems and services may not gain market acceptance, which would severely limit our ability to market and sell our products. In addition, negative public attitudes may prompt state legislatures to prohibit the sale of irradiated food. Further, consumers may be unwilling to pay for the higher cost of food products processed by our SureBeam system, which could negatively impact the market acceptance of our process.

**We have a history of losses and we may not achieve or sustain profitability.**

We have incurred operating losses in each quarter since we commenced operations. As of September 30, 2002, we had an accumulated deficit of approximately \$117.5 million, and our net loss for the first three quarters of 2002 was \$25.1 million. Our net loss for the year ended December 31, 2000 was approximately \$1.8 million, and our net loss for the year ended December 31, 2001 was approximately \$74.4 million, including approximately \$54.3 million of non-cash stock-based compensation expense. At the time of our initial public offering, we recorded stock-based compensation of approximately \$78.6 million, of which \$53.5 million was recognized as an expense during the year ended December 31, 2001. We will recognize this charge in accordance with the vesting provisions of the related options through 2004. This charge will have a significant adverse impact on our earnings from 2002 through 2004. We expect to derive our future revenues from sales of our SureBeam systems and related food processing services. However, these revenues are highly uncertain. We expect to devote substantial resources to continue our sales and marketing activities, including our consumer branding efforts, further develop our administrative infrastructure and expand our research and development activities. As a result, we expect that our operating losses will increase and that we will incur operating losses through at least 2003.

**Revenues from system sales may decline in the future if we fail to make new system sales or the timing of expected contract execution is delayed.**

Our system sales revenues are dependent on a few large contracts and the recognition of revenues under these long-term contracts is based upon work performed. Consequently, the timing of the execution of these contracts and the timing of work performed under them, which is partially outside of our control, could cause us to generate lower than expected revenues. To date, our revenues have been primarily attributable to the design and construction of systems for a limited number of customers, for which revenues are recognized under the percentage-of-completion method. For example, for the year ended December 31, 1999 revenue from three customers represented approximately 40% of our total revenues, for the year ended December 31, 2000 revenue from three customers represented approximately 79% of our total revenues, and for the year ended December 31, 2001 revenue from three customers represented approximately 89% of our total revenues. During the first three quarters of 2002, approximately 81% of our revenues were from two customers. Most of these systems are not yet fully constructed, installed or integrated and we expect to continue to derive system sales revenue as we complete construction, installation and integration of these systems. A reduction or delay of system sales to one or more significant customers could significantly reduce our revenues. Once the food irradiation systems become operational, we will no longer derive revenue from these system sales, but expect to derive income from food processing revenues commensurate with our existing or potential equity ownership in the entities that own and operate the third party service centers. In

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addition, we expect to derive revenue from processing by company-owned service centers and in-line systems. There are no assurances that we will continue to derive revenues from these customers, that revenues from these customers will continue at current or historical levels, that we will be able to derive revenue from new

customers or that we will be able to derive income from significant food processing revenues in the future at anticipated levels.

**We may be required to take impairment charges for receivables if a customer defaults on its payment obligations.**

We account for our revenues derived from sales of electronic food irradiation systems under fixed-price contracts using the percentage-of-completion method. These systems currently take a total of approximately 12 to 18 months to design, construct, install, integrate and deliver. Our unbilled receivables from our contracts for systems have increased substantially over the past twelve months. If a customer defaults on its payment obligations under a contract accounted for using the percentage-of-completion method or if we determine that the contract is otherwise impaired, we would take an impairment charge to earnings for the receivable arising from previously recorded revenues in respect of such contract at that time. We cannot assure you that one or more of our customers will not default on its payment obligations. For example, in December 1999, we agreed to sell a SureBeam system to a new entity, Zero Mountain SureBeam, to be formed by Zero Mountain Cold Storage. Under the agreement, a facility was to be constructed and the entity would operate an electronic food irradiation service center in Arkansas. Management of Zero Mountain Cold Storage had not moved forward with its obligation under the contract. Accordingly, in December 2001, we recorded an allowance for doubtful accounts of \$1.2 million against our receivable from Zero Mountain Cold Storage.

**We have not generated positive cash flow from operations and our cash flow from operations may be insufficient to meet operating requirements for the foreseeable future.**

We used net cash from operations of \$17.8 million in 2000 and \$49.0 million in 2001. Through September 30, 2002, we used net cash from operations of \$10.8 million. Also, in connection with our agreements with our customers, we have advanced funds aggregating \$5.5 million to a strategic alliance entity in Hawaii Pride to be used primarily for land acquisition, building construction, and for working capital purposes. We do not expect significant repayments of these advances until 2003. We received a progress payment of \$1.5 million on the RESAL contract in the second quarter of 2002 and will continue to receive payments based on the payment schedule in the contract. In addition, we have entered into a number of commitments to lease land and facilities in connection with construction of our four company-owned service centers of which three are operational with the fourth to be operational in the first quarter of 2003. Based on our customer requirements, we may expend funds to construct and install in-line systems that we will own and operate. We have limited sources of committed liquidity including our cash resources. Titan has extended to us a new \$50.0 million senior credit facility secured by all of our assets. As of November 14, 2002, we have obtained \$25.0 million under this credit facility. This facility will be subject to limits in the amounts that can be drawn each quarter, subject to financial covenants and affirmative and negative covenants. No assurance can be given that we will be able to generate sufficient positive cash flow from operations to meet operating requirements for the foreseeable future.

**Our customer contracts for processing can be cancelled on short notice with little penalty and these contracts allow the customers to use other electronic irradiation providers in limited circumstances.**

While our customer contracts for processing generally provide for a term of more than one year, the customers may terminate such contracts with a nominal termination fee and upon short notice, typically one month. If one or more customers that are processing a significant volume of products decide to terminate their contracts, our results of operations would be adversely affected. While a termination of a contract by a customer would not generally release a customer from the exclusive provider arrangement in the customer's contract, we generally must release a customer from the exclusive provider arrangement if they can find an alternative food irradiation source that can provide a comparable service at a lower price, or if we cannot fully meet the customer's demand.

**Our customer contracts for processing do not obligate our customers to use a minimum amount of irradiation services, only to use us for their irradiation needs, if any.**

Our customer contracts for processing generally provide that the customer is obligated to use our irradiation services for their food irradiation need, if any. No assurance can be made, however, that our customers will require a significant amount, or any food irradiation services during the term of their respective contracts.

**If we cannot establish and maintain relationships with food processors, distributors, retailers and food service operators, we may not be able to increase revenues or commercialize our SureBeam system.**

In order to increase our revenues and successfully commercialize our SureBeam system, we must establish and maintain relationships with our existing and potential customers and strategic partners. A reduction, delay or cancellation of orders from one or more significant customers or the loss of one or more key customers could significantly reduce our revenues and could damage our reputation among our current and potential customers as well as with consumers. We cannot assure you that our current customers will continue to place orders with us, that our current customers evaluating the technology will elect to enter into commercial production, that orders by existing commercial customers will increase, or that we will be able to obtain orders from new customers or continue to secure additional strategic relationships.

**If we experience quality control problems or supply shortages from component suppliers, our revenues and profit margins may suffer.**

Our dependence on third party suppliers for components of our systems involves several risks, including limited control over pricing, availability of materials, quality and delivery schedules. These components include the microwave cavities of our linear accelerators, which we currently obtain from a single source. We may experience quality control problems or supply shortages with respect to these components in the future. Any quality control problems or interruptions in supply with respect to one or more components or increases in component costs could materially adversely affect our customer relationships, revenues and profit margins.

**The use of our systems to irradiate food is subject to significant government regulation that could prohibit the sale of irradiated food in various jurisdictions, increase the cost of using our products and delay or prevent the use of our systems and services by our customers.**

Food irradiation is subject to significant regulation as a food additive by the FDA. Use of our SureBeam system, including product labeling, is also subject to regulation by the U.S. Department of Agriculture's Food Safety and Inspection Service and by health and environmental safety departments within various states. The FDA has approved the use of irradiation for beef, poultry, pork, fruits and vegetables. The FDA has not yet approved the use of irradiation for two of the primary food markets we expect to target: processed foods and seafood. The failure of the FDA to approve irradiation of processed foods and seafood would prevent us from generating revenues from the application of our technology in these significant markets. Furthermore, the FDA could remove or restrict its approval of the use of irradiation for currently approved food products, which would severely limit our ability to provide services and systems.

In addition, FDA regulations require that all food that has been irradiated must carry the Radura symbol, an international symbol for irradiation, and state that the product has been "Treated with Radiation" or "Treated by Irradiation" on the label. States such as Vermont have similar labeling requirements. These labeling regulations may increase the risk that consumers will not purchase goods that have been treated by our products or services, which could negatively impact our revenues.

FDA regulations also require approval for packaging materials used by our customers. While the FDA has approved a number of packaging materials, many other materials commonly used for packaging food have not been approved. Failure or delay in receiving such approvals could have a material adverse effect on our customer relationships and revenues.

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We also are required to obtain regulatory approval from foreign regulatory authorities before we can offer our systems and services in those jurisdictions. These jurisdictions may apply different criteria than the U.S. regulatory agencies in connection with their approval processes. Monitoring changes in, and our compliance with, diverse and numerous foreign regulatory requirements may increase our costs. Regulatory approvals in foreign countries that regulate irradiation are subject to similar risks and uncertainties as are regulatory approvals in the United States. If we are unable to obtain approval to sell our products and services in these markets, our ability to generate revenues from these markets would be adversely affected.



Our service centers also are subject to various other federal, state and municipal regulations regarding health, safety and environmental issues. Our service centers are subject to continuous supervision, in the case of the USDA, or periodic inspection by other regulators.

**Efforts to change the labeling requirements with respect to electronic food irradiation may not be successful and may result in consumer confusion.**

Along with food industry groups and others, we are seeking to change the labeling requirements for foods treated with electronic irradiation to allow the use of words like cold pasteurization or electronic pasteurization instead of irradiation or radiation. Although we believe that the proposed changes may improve the overall acceptance of our SureBeam process, we cannot assure you that the proposed changes will be accepted, or if accepted, that we will recognize any benefit from such changes. Additionally, a continued reference to our SureBeam process as irradiation or radiation could adversely affect the consumer acceptance of our process.

**International expansion will subject us to risks associated with international operations that could increase our costs and decrease our profit margins in both our domestic and our international operations.**

Our success will depend in part on our ability to expand internationally as we obtain regulatory approvals to market and sell our SureBeam® systems in other countries. We have received an order to install systems in Saudi Arabia and we are building a service center in Brazil for extending the shelf life of fruits and vegetables. Expansion of our international operations could impose substantial burdens on our resources, divert management's attention from domestic operations and otherwise adversely affect our business. Furthermore, international operations are subject to several inherent risks that could increase our costs and decrease our profit margins including:

Reduced protection of intellectual property rights;

Changes in foreign currency exchange rates;

Changes in a specific country's or region's political or economic conditions, including military action or war in or near countries containing our international operations;

Trade protective measures and import or export licensing requirements or other restrictive actions by foreign governments;

Laws affecting the enforceability of our contracts and our ability to collect accounts receivable; and

Changes in tax laws.

**If we cannot effectively manage our internal growth, our business prospects, revenues and profit margins may suffer.**

If we fail to effectively manage our internal growth in a manner that minimizes strains on our resources, we could experience disruptions in our operations and ultimately be unable to generate revenues or profits. We expect that we will need to significantly expand our operations to successfully implement our business strategy. As we add manufacturing, marketing, sales, and other personnel, both domestically and internationally, and expand our manufacturing, irradiation processing and research and development capabilities, we expect that our operating expenses and capital requirements will increase. To effectively manage our growth, we must continue to expend funds to improve our operational, financial and management controls, and our reporting systems and procedures. In addition, we must effectively expand, train and manage our employee base. If we fail in our efforts to manage our internal growth, our business prospects, revenues and profit margins may suffer.

**We intend to continue to pursue strategic transactions, which could disrupt our operations, increase our costs and negatively impact our earnings.**

We intend to continue to pursue strategic transactions that provide access to new technologies, products or markets. These transactions could include acquisitions, partnerships, joint ventures, business combinations and investments. Any transaction may require us to incur non-recurring or ongoing charges and may pose significant integration challenges and/or management and business disruptions, any of which could increase our costs and negatively impact our earnings. In addition, we may not succeed in retaining key employees of any business that we acquire. We may not consummate these transactions on favorable terms or obtain the benefits we anticipate from a transaction.

**Our technology competes against other food irradiation technologies. Competition in our market may result in pricing pressures, reduced margins or the inability of our products and services to achieve market acceptance.**

We compete against several companies seeking to address the food safety market. Our electronic food irradiation technology competes against gamma ray technology and alternatives to irradiation, such as thermal sterilization, fumigation, lactoferrin and chemical washes. We may be unable to compete successfully against our current and potential competitors, which may result in price reductions, reduced margins and the inability to achieve market acceptance for our products.

The current level of market penetration for food irradiation products is relatively low when compared to the overall size of the food markets to which we are targeting our food irradiation services and products. If food irradiation gains consumer acceptance and the market increases, we expect competition to grow significantly. Our competitors include Flow International Corporation, Ion Beam Applications, S.A., MDS/Nordion Food Technologies Service, Inc. and STERIS Corporation. These organizations may have significantly more capital, research and development, regulatory, manufacturing, marketing, human and other resources than we do. As a result, they may be able to devote greater resources to the manufacture, promotion and sale of their products, initiate or withstand substantial price competition, or take advantage of acquisition or other opportunities more readily.

**Our inability to protect our patents and proprietary rights in the United States and foreign countries could materially adversely affect our business prospects and competitive position.**

Our success depends on our ability to obtain and maintain patent and other proprietary-right protection for our technology and systems and services in the United States and other countries. The laws of some foreign countries do not protect proprietary rights to the same extent as the laws of the United States, and many companies have encountered significant problems and costs in protecting their proprietary rights in these foreign countries. If we are unable to obtain or maintain these protections, we may not be able to prevent third parties from using our proprietary rights. In addition, we may incur significant expense in protecting our intellectual property and defending or assessing claims with respect to intellectual property owned by others.

We periodically assess the strength of our patent and intellectual property protection for our technologies and products. Our electronic food irradiation system combines our patented conveyor and shielding systems and proprietary software with publicly available electron beam, x-ray and linear accelerator technology. Despite our assessments and our belief in the strength of our patent protection for particular technologies or products, our patents may not provide effective barriers to entry against competitors because our competitors may develop competing technologies and products that do not infringe upon our patents. Further, our patents do not cover electron beam, x-ray or linear accelerator

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technology, which are publicly available. We also could choose to modify or abandon one or more planned or current products because of these assessments or actual or threatened claims by other companies. Our patents or pending patent applications may be challenged, narrowed or invalidated. In addition, we are not certain that our pending patent applications will be issued.

We also rely on trade secrets, proprietary know-how and continuing technological innovation to remain competitive. We have taken measures to protect our trade secrets and know-how, including the use of confidentiality agreements with our employees, consultants and advisors. It is possible that these agreements may be breached and that any remedies for a breach will not be sufficient to compensate us for damages incurred. We generally control

and limit access to, and the distribution of, our product documentation and other proprietary information. Despite our efforts to protect these proprietary rights, unauthorized parties may copy aspects of our products and obtain and use information that we regard as proprietary. We also cannot guarantee that other parties will not independently develop our know-how or otherwise obtain access to our technology.

**Companies may claim that we infringe their intellectual property or proprietary rights, which could cause us to incur significant expenses or prevent us from selling our products.**

Our success depends on our ability to operate without infringing the patents and proprietary rights of third parties. Product development is inherently uncertain in a rapidly evolving technological environment in which there may be numerous patent applications pending, many of which are confidential when filed, with regard to similar technologies. Future patents issued to third parties may contain claims that conflict with our patents. Although we believe that our current product does not infringe the proprietary rights of any third parties, third parties could assert infringement claims against us in the future. Any litigation or interference proceedings, regardless of their outcome, would probably be costly and require significant time and attention of our key management and technical personnel. Litigation or interference proceedings could also force us to:

Stop or delay selling, manufacturing or using products that incorporate the challenged intellectual property;

Pay damages; or

Enter into licensing or royalty agreements that may be unavailable on acceptable terms.

**Product liability claims could materially adversely affect our customer relationships and costs.**

Our involvement in the processing of food results in a significant risk that we will be subject to product liability claims resulting from the consumption of contaminated food. We may be held liable or incur costs to settle or defend liability claims if any of our systems cause, or are claimed to cause, injury or are found unsuitable during product testing, manufacturing, marketing, sale or use. These risks exist even with respect to products that have received, or may in the future receive, regulatory approval, registration or clearance for commercial use. Also, we may be liable to our customers for the costs they incur from product recalls. We cannot guarantee that we will be able to avoid product liability exposure.

While we currently maintain product liability insurance at levels that we believe are sufficient and consistent with industry standards for companies at our stage of development, we cannot guarantee that our product liability insurance is adequate. It is also possible that at any time our insurance coverage may become unavailable on commercially reasonable terms or at all. A product liability claim or product recall could result in liability to us greater than our assets and/or insurance coverage. Moreover, product liability claims, recalls and expenses associated with defending against claims or recalls could have an adverse impact on us even if we have adequate insurance coverage. Further, a product liability claim against us, whether merited or not, or a product recall claim against us would damage our reputation and severely undermine our branding campaign and our efforts to gain consumer acceptance.

**If we cannot retain key personnel or attract qualified personnel, our customer relationships, competitive position and revenues could suffer.**

Our success depends to a significant extent upon the efforts of our key management, sales and marketing, technical support and research and development personnel, none of whom have entered into agreements not to compete with us. The loss of any key personnel could adversely affect us. We believe that our future success will depend in large part upon our continuing ability to attract and retain highly skilled managerial, sales and marketing, technical support and research and development personnel. Like other emerging growth companies, we face intense competition for our personnel needs, and we have at times experienced and continue to experience difficulty in recruiting qualified personnel. We face the additional challenge of carefully balancing the growth of our employees commensurate with our anticipated revenue growth. If our revenue growth or attrition levels vary significantly, our

results of operations or financial condition could be adversely affected. Further, our common stock price has been, and may continue to be extremely volatile. When our common stock price is less than the exercise price of stock options granted to employees, turnover is likely to increase, which could adversely affect our results of operations or financial condition. Additionally, there are several proposals in the United States Congress and in the accounting industry to require corporations to include a compensation expense in their statement of operations relating to the issuance of employee stock options. If such a measure is approved, we may decide to issue fewer stock options. As a result, we may be impaired in our efforts to attract and retain necessary personnel. We cannot assure you that we will be successful in attracting, assimilating and retaining additional qualified personnel in the future. If we were to lose the services of one or more of our key personnel, or if we failed to attract and retain additional qualified personnel, it could materially and adversely affect our customer relationships, competitive position and revenues.

**Delays in the construction and installation of our systems could negatively affect our revenues.**

Our business model depends on the successful deployment of our systems, whether the systems are constructed and installed in our company-owned service centers or in a customer's production line. A number of factors beyond our control can slow or delay the deployment of our systems such as site preparation, zoning and permitting requirements, the availability of skilled construction personnel and construction equipment, and adverse weather conditions.

**If our stock price becomes less than \$1.00 per share for an extended period, we could be delisted from the Nasdaq.**

Maintaining the listing of our common stock on the Nasdaq National Market is important to us. The delisting of our common stock from the Nasdaq would have a material adverse effect upon the marketability of our common stock and could, among other things, materially and adversely affect our ability to raise additional equity capital or to obtain financing through other sources. The Nasdaq has numerous requirements which must be complied with for a company to maintain its security's listing on the Nasdaq, one of which is that the minimum bid price of the security must be \$1.00 or greater per share. If the price of our common stock were below \$1.00 per share for a period of 30 or more consecutive business days, the Nasdaq could take action to delist our common stock from the Nasdaq. While the price of our common stock on the Nasdaq has not traded below \$1.00 since our initial public offering, we cannot assure you that the price of our common stock will not fall below \$1.00 in the future. On November 11, 2002, the closing price per share of our common stock was \$5.00.

If our common stock were delisted from the Nasdaq, trading would thereafter be reported in the National Association of Securities Dealers Over the Counter Bulletin Board or in the pink sheets. The investing in securities traded in the Bulletin Board or in the pink sheets is generally considered to be subject to more risk than comparable investing in securities, which are traded on one of the major national securities exchanges such as the Nasdaq or the New York Stock Exchange. In the event of delisting from the Nasdaq, our common stock may be classified as a penny stock by the SEC and would become subject to rules adopted by the SEC regulating broker-dealer practices in connection with transactions in penny stocks. Broker-dealers recommending a penny stock must, among other things, document the suitability of the investment for the specific customer, obtain a written agreement of the customer to purchase the penny stock, identify such broker-dealer's role, if any, as a market maker in the particular stock, and provide information with respect to market prices of the common stock and the amount of compensation that the broker-dealer will earn in the proposed transaction. These disclosure requirements may have the effect of reducing the level of trading activity in the market for our common stock. If our common stock became subject to the penny stock rules, many broker-dealers may be unwilling to engage in transactions in our securities because of the added disclosure requirements, thereby making it more difficult for purchasers of our common stock to dispose of their shares of our common stock. The ownership of penny stock is generally considered to subject the owner to greater risks than the ownership of common stock as a whole due, among other things, to the smaller trading volume in such stocks and to the substantial impact upon the stock's overall value which results from small stock price variations.





**Risks related to our relationship with Titan**

**Our independent status from Titan involves a variety of risks for SureBeam, including risks related to access to financing sources and corporate services and facilities previously provided by Titan. Our inability to successfully address these risks could negatively impact the operation of our business and financial results.**

Titan has distributed its shares of our common stock to Titan stockholders following its receipt of a favorable ruling from the Internal Revenue Service. We now have substantially complete separation from Titan, other than our various contracts with Titan. While the continued control of our company by Titan involved a variety of risks, our separation from Titan also involves numerous risks.

If we require additional financing other than that provided by our credit facility with Titan, we would be required to develop our own credit and other liquidity sources. Titan had historically provided for our general corporate and administrative support, which was principally comprised of administrative and clerical functions necessary to implement our management decisions and operations, including benefits administration and information technology support, through a corporate services agreement. In connection with the spin-off, various agreements with Titan have terminated and we have developed our own systems and services. However, we may not be able to retain these services successfully or at a comparable cost to that as provided by Titan.

**Our business may suffer because we have entered into affiliate agreements with Titan that may not have been based on arms length negotiations.**

We have entered into various agreements with Titan including a tax allocation agreement, tax sharing and disaffiliation agreement, license agreement, and credit agreement. Because we were a majority-owned subsidiary of Titan at the time these agreements were entered into, these agreements were negotiated between related parties, and the results may differ from results obtained from arms-length third parties. Under the license agreement, Titan purchased a perpetual and exclusive, non-royalty bearing license to use our intellectual property on all applications other than the food, animal hide and flower markets in return for the following: 1) to make available to us a \$50.0 million line of credit, 2) to convert the current \$75.0 million debt owed Titan to equity via an exchange for our stock, and 3) a cash payment of \$8.0 million.

Under the tax allocation agreement, Titan will determine the amount of separate taxable income and tax liability that we would realize if we filed a separate tax return. In addition, because we have filed a consolidated tax return with Titan, we may be obligated to pay taxes for the entire group of Titan companies if those companies defaulted in the payment of their taxes. If Titan offsets taxable gains with our losses, Titan will have to compensate us in cash for the benefit it receives for its use of our losses when we demonstrate we are able to utilize those losses or they would have otherwise expired. In addition, any benefit from our losses used to offset Titan profits resulting in a tax savings, is subject to Titan's position at that time.

**We have entered into a license agreement with Titan that prevents us from capitalizing on newly discovered uses of our technology in applications that are not related to food (excluding water), animal hides and flowers except through a manufacturing contract.**

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Titan purchased from us a perpetual and exclusive non-royalty bearing license to use our intellectual property in all applications and fields other than in the fields of food (excluding water), animal hides and flowers. Because Titan's license is an exclusive license, we cannot use our intellectual property in applications other than food (excluding water), animal hides and flowers. Applications which we believe are reserved for Titan's use include medical equipment sterilization and sterilization of mail to eliminate the threat of anthrax contamination.

Under the terms of the license agreement with Titan, future sales of electronic irradiation equipment to Titan, if any, will be sold on a cost plus 20% markup basis, unless otherwise negotiated. Titan is obligated to purchase electronic irradiation equipment it requires, if any, from SureBeam until December 31, 2003, after which it may purchase equipment from any source. Therefore, after December 31, 2003, we anticipate we will receive no revenue from any commercialization of our licensed technology by Titan or any new applications for our licensed technology developed by Titan unless Titan chooses to purchase equipment from us or enter into other arrangements with us under which we would receive revenue. Titan is not obligated to purchase any electronic irradiation

equipment from us in the future, and should Titan not purchase any electronic irradiation equipment from us, it could have a material adverse effect upon our financial condition and results of operations.

**One of our directors is also a director of Titan, which could cause Titan's interests to receive priority over our interests.**

One of our directors, Susan Golding, also is a director of Titan. During 2001, Ms. Golding was a consultant to Titan. Titan is currently our primary creditor because it has extended to us a \$50.0 million secured credit facility, under which we have obtained \$25.0 million as of November 14, 2002. Therefore, Ms. Golding may consider not only the short-term and long-term impact of financial and operating decisions on us, but also the impact of these decisions on Titan's consolidated financial results and its stockholders. In some instances, the impact of these decisions could be disadvantageous to us while advantageous to Titan. We cannot guarantee that all conflicts will be resolved in a manner that is favorable to us or that such conflicts will not result in harmful consequences to our business or prospects.

**Maintaining the tax-free status of the distribution of our common stock by Titan to its stockholders restricts certain of our activities.**

For the distribution of our stock by Titan to qualify as tax-free to Titan, there must not be a change in ownership of 50% or more in either the voting power or value of either our stock or Titan's stock that is considered to be part of a plan or a series of related transactions related to Titan's intended distribution of our stock to its stockholders. Accordingly, we may be significantly limited in our ability to raise additional equity financing, use our stock for acquisitions and other similar strategic transactions or for compensation of employees and others. Further, in connection with the spin-off, we have entered into a tax sharing and disaffiliation agreement that provides for, among other things, an agreement with Titan that if we take any action that causes Titan's representations with respect to the letter ruling to be untrue or engage in transactions after the distribution that cause the spin-off to be taxable to Titan, we would be required to indemnify Titan for any and all taxes resulting from the failure of the spin-off to qualify as a tax-free transaction. In addition, we may be required to indemnify Titan for half of any taxes incurred as a result of the spin-off if the spin-off is taxable for reasons that were not caused by actions taken by either Titan or us and to share proportionately with Titan such taxes if they are caused by actions by both us and Titan, in proportion to our relative contribution to the imposition of these taxes. Any indemnification payments by us would most likely be material.

**Our sales through Titan generally produce lower profit margins than our sales to other parties. A higher percentage of sales through Titan could reduce our overall profit margins.**

Historically, Titan has purchased a substantial amount of equipment from us as a subcontractor, in order to allow Titan to fulfill various contracts. These sales have typically been structured on a fixed price basis or cost plus basis. Therefore, sales to or through Titan have historically, and likely will in the future, carry a lower profit margin than comparable sales to other parties. A higher percentage of sales through Titan could reduce our overall profit margins.

**Risks related to the securities markets and ownership of our common stock**

**Our securities have not been publicly traded very long and our stock price may be subject to significant fluctuations and volatility.**

The market price of our common stock has been subject to significant fluctuations since the date of our initial public offering on March 16, 2001. These fluctuations could continue. Among the factors that could affect our stock price are:

Quarterly variations in our operating results;

Changes in revenue or earnings estimates or publication of research reports by analysts;

Speculation in the press or investment community;

Strategic actions by us such as new joint ventures, acquisitions or restructuring;

Actions by institutional stockholders;

General market conditions; and

Domestic and international economic factors unrelated to our performance.

The stock markets in general have experienced extreme volatility that has often been unrelated to the operating performance of particular companies. These broad market fluctuations may adversely affect the trading price of our common stock.

**Provisions in our charter documents and Delaware law may delay or prevent acquisition of us, which could decrease the value of your shares.**

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Our certificate of incorporation and bylaws and Delaware law contain provisions that could make it harder for a third party to acquire us without the consent of our board of directors. These provisions include a classified board of directors and limitations on actions by our stockholders by written consent. In addition, our board of directors has the right to issue preferred stock without stockholder approval, which could be used to dilute the stock ownership of a potential hostile acquirer. Delaware law also imposes some restrictions on mergers and other business combinations between us and any holder of 15% or more of our outstanding common stock. Although we believe these provisions provide for an opportunity to receive a higher bid by requiring potential acquirers to negotiate with our board of directors, these provisions apply even if the offer may be considered beneficial by some stockholders.

**ITEM 4. CONTROLS AND PROCEDURES**

We maintain a system of disclosure and procedures designed to ensure the reliability of our consolidated financial statements and other disclosures. Within the 90 day period prior to the date of filing of this quarterly report, our President and Chief Executive Officer and our Senior Vice President and Chief Financial Officer carried out, under the supervision and with the participation of our management, an evaluation of the effectiveness of design and operation of our disclosure controls and procedures (as defined in Rules 13a-14(c) and 15d-14(c) under the Securities Exchange Act of 1934, as amended). Our President and Chief Executive Officer and our Senior Vice President and Chief Financial Officer concluded that, as of the date of the evaluation, our disclosure controls and procedures were effective in all material respects in alerting them in a timely manner to the material information about us that we are required to include in the periodic reports that we file with the Securities and Exchange Commissions. There have been no significant changes in our internal controls or, to our knowledge, in other factors that could significantly affect internal controls subsequent to that evaluation.

**PART II-OTHER INFORMATION**

**Item 1. Legal Proceedings**

Periodically, we are a defendant in cases incidental to our business activities. Furthermore, providers of products and services to the U.S. government are generally subject to multiple levels of audit and investigation by various U.S. government agencies. Any liabilities arising from audits by the federal government are being retained by Titan as part of the contribution by Titan to SureBeam. In the opinion of management, the amount of ultimate liability, if any, with respect to these actions will not materially affect the financial position or results of operations.

**Item 2. Changes in Securities and Use of Proceeds**

Not applicable.

**Item 3. Defaults Upon Senior Securities**

Not applicable.

**Item 4. Submission of Matters to a Vote of Security Holders**

Not applicable.

**Item 5. Other Information**

Not applicable.

**Item 6. Exhibits and Reports on Form 8-K**

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(a) Exhibits:

10.48*	Agreement for Purchase of a SureBeam X-Ray System dated effective March 27, 2002 between the Company and Son Son Co., Ltd.
10.49*	Letter Agreement dated October 1, 2002, amending Agreement dated effective March 27, 2002 between the Company and Son Son Co., Ltd.
10.50*	Agreement for Purchase of a SureBeam Electronic Beam System dated August 1, 2002 between Salubris Limited Partnership and the Company.
99.1	Periodic Report Certification by Chief Executive Officer of Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2002.
99.2	Periodic Report Certification by Chief Financial Officer of Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2002.

(b) Reports on Form 8-K:

(1) Current report on Form 8-K dated August 5, 2002 describing the spin-off of Titan's ownership interest in SureBeam to Titan's stockholders.

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\* Confidential treatment has been requested for certain portions of this exhibit. Omitted portions have been filed separately with the Securities and Exchange Commission.



**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Dated: November 14, 2002

SUREBEAM CORPORATION

By: */s/ Lawrence A. Oberkfell*  
Lawrence A. Oberkfell  
*President and Chief Executive Officer*

By: */s/ David A. Rane*  
David A. Rane  
*Senior Vice President,  
Chief Financial Officer  
(Principal Accounting Officer)*

**CERTIFICATION OF CHIEF EXECUTIVE OFFICER**

I, Lawrence A. Oberkfell, certify that:

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

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a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and

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

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

Dated: November 14, 2002

By: /s/ Lawrence A. Oberkfell  
Lawrence A. Oberkfell  
President, Chief Executive Officer  
and Chairman of the Board

**CERTIFICATION OF CHIEF FINANCIAL OFFICER**

I, David A. Rane, certify that:

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

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

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

Dated: November 14, 2002

By: /s/ David A. Rane  
David A. Rane  
Senior Vice President,  
Chief Financial Officer