SURGIDYNE INC
Form 10KSB
April 15, 2002

SECURITIES AND EXCHANGE COMMISSION
Washington, D. C. 20549
FORM 10-KSB

(Mark One)
[X] ANNUAL REPORT UNDER SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934 For the Fiscal Year Ended December 31, 2001
[ ] TRANSITION REPORT UNDER SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934

Commission File Number: 33-13058-C

SURG II, INC.
(Name of small business issuer in its charter)

Minnesota	825 Southgate Plaza, 5001 W. 80th Street Bloomington, MN
(State of other jurisdiction of incorporation or organization)	(Address of principal executive offices)
58-1486040	55437
(I.R.S. Employer Identification Number)	(Zip Code)

Issuer's telephone number (952) 830-1230

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

Securities registered pursuant to Section 12(g) of the Act:
Common Stock, no par value
(Title of class)

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 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.
[X] YES ___ NO

Check if disclosure of delinquent filers in response to Item 405 of Regulation S-B contained is not in this form, and no disclosure will be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-KSB or any amendment to this Form 10-KSB. [X]

Issuer's revenues for the year ended December 31, 2001 were $440,234.

The aggregate market value of the common stock held by non-affiliates of the Registrant based upon the closing of the common stock sale price on the OTC bulletin board system on March 28, 2002 was approximately $607,780. For purposes of this calculation, all Directors and Executive Officers of the Registrant have been deemed affiliates.

7,447,085 Shares of Common Stock, no par value, were outstanding at March 29, 2002

DOCUMENTS INCORPORATED BY REFERENCE

NONE

This Form 10-KSB consists of 36 pages (including exhibits). The index to exhibits is set forth on page 26.

ITEM 1. DESCRIPTION OF BUSINESS

General

Surg II, Inc. (the "Company"), a Minnesota corporation, was incorporated in Minnesota in March 1984 under the name of Surgidyne, Inc., and is successor by merger to a corporation of the same name that was incorporated in Georgia in September 1982. In connection with the sale of substantially all of its assets to Sterion Incorporated (f/k/a Oxboro Medical, Inc.), a Minnesota corporation, on January 22, 2002, the Company changed its name to Surg II, Inc. The Company's executive offices are located at 825 Southgate Plaza, 5001 W. 80th Street, Bloomington, Minnesota 55437 (952-830-1230).

Sale of Previous Business

Prior to the sale of substantially all of its assets to Sterion Incorporated, the Company was in the business of the design, development, manufacture and sale of specialty medical and surgical wound drainage products. The Company's products included VariDyne microelectronic A.C./D.C. battery powered suction systems with disposable drainage/collection products for postoperative and other suction drainage applications; disposable SABER and S-VAC 100 bulb evacuators for postoperative closed wound suction drainage; and other related disposable products. The Company sold substantially all of its assets and certain liabilities to Sterion Incorporated on January 22, 2002 for $200,000. The purchase price was determined by arms-length negotiations between the Company and Sterion Incorporated. As a result of the asset sale, the Company currently has no operating business and no employees.

Letter of Intent with Metalclad Corporation Regarding Sale of Capital Stock

On March 21, 2002, the Company signed a non-binding letter of intent with Metalclad Corporation (NASDAQ: MTLC) to sell a majority ownership interest in the Company's capital stock to Metalclad or its subsidiary for $3,000,000 through the sale of approximately 120,000,000 shares of the Company's authorized but unissued shares of common stock. Under the terms of the letter of intent, Metalclad Corporation will own approximately ninety percent (90%) of the outstanding shares of common stock (including all warrants as if converted) of the Company as a result of the stock purchase. Metalclad Corporation provides insulation and asbestos abatement services, primarily on the West Coast, to a wide range of industrial, commercial and public agency clients. The anticipated operation of the Company, as well as the board of director and officer positions, following such stock sale has not yet been determined. One officer of the Company currently owns less than one percent of the outstanding common stock of Metalclad Corporation.

The consummation of the sale of common stock to Metalclad Corporation is contingent upon the occurrence of a number events, including completion of due diligence by Metalclad Corporation. There is no assurance that the Company will close on the sale of common stock to Metalclad Corporation. If the Company does not close on the sale of common stock to Metalclad Corporation it intends to continue to explore strategic opportunities for raising capital for the Company.

ITEM 2. DESCRIPTION OF PROPERTY

Immediately following the sale of substantially all of its assets in January 2002, the Company began using 825 Southgate Plaza, 5001 W. 80th Street, Bloomington, Minnesota as its administrative headquarters. Management considers that these offices are sufficient for its present operations. The Minnesota Cooperation Office for Small Business and Job Creation, Inc. provides this space to the Company for no charge. The Company anticipates using this space through fiscal year 2002, with its use of the space to terminate earlier if the Company completes its stock sale to Metalclad Corporation.

ITEM 3. LEGAL PROCEEDINGS

None.

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

No matters were submitted to a vote of shareholders of the Company during the fourth quarter ended December 31, 2001.

PART II

ITEM 5. MARKET FOR COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

The Company's common stock is traded on the OTC Bulletin Board under the symbol "SUGR." The following table sets forth for the fiscal period indicated, the high and low bid prices for each quarter of the fiscal years ended December 31, 2001 and December 31, 2000. These quotations reflect inter-dealer prices, without retail mark-up, markdown, or commission and may not represent actual transactions.

	Bid Price Range			
	2001		2000	
Fiscal Period	High	Low	High	Low
First Quarter	$.187	$.10	$.51	$.16
Second Quarter	$.187	$.04	.53	.13
Third Quarter	$.10	$.04	.53	.18
Fourth Quarter	$.09	$.04	.30	.07

On March 28, 2002, the bid price for the common shares as reported on the OTC Bulletin Board was $0.10, and the Company had 385 holders of record of its common shares.

The Company has not paid cash dividends on its common shares and does not plan to pay cash dividends to its common shareholders in the immediate future. On December 1, 1993, the Company's debenture holders elected to convert the face value of the debentures into 1,600,000 shares of unregistered Series A Preferred Stock at $.25 per share. Commencing January 1, 1994, the preferred shareholders are entitled to a dividend equal to 3% of net sales. The dividend in a given year is limited to 50% of the Company's net income. Cumulative dividends cannot exceed $210,000. As of December 31, 2001 cumulative dividends totaled approximately $20,300. All such cumulative dividends were paid to the Series A Shareholders from the proceeds of the Company's asset sale to Sterion Incorporated in the first quarter of fiscal year 2002.

ITEM 6. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATIONS

Overview: On January 22, 2002, pursuant to an agreement and shareholder approval, the Company closed on the sale of substantially all of its net operating assets. The sale resulted in a gain of approximately $13,000 with gross cash proceeds of $200,000. After the sale, the Company has no sources of revenue as the net operating assets sold represented substantially all of its operations. The Company believes that the asset sale will enable the Company to seek a business combination or other transaction with an opportunity that will be more attractive than the Company's former wound drainage business. The Company hopes to utilize its remaining capital structure to attract a business opportunity that will maximize potential value to shareholders. On March 21, 2002, the Company signed a non-binding letter of intent with Metalclad Corporation to sell a majority ownership interest in the Company's common stock. However, there can be no assurance that this transaction will close on terms acceptable to the Company. Moreover, without a source of revenues, the Company's ability to continue as a going concern is dependent on such a business combination or other transaction occurring.

Results of Operations - 2001 compared to 2000
Sales. Sales for the fiscal year 2001 were $440,234 compared to $428,040 in 2000, an increase of approximately 3%. This small increase was primarily the result of an increase in OEM sales including sales to one customer that had not purchased any product for several years. The increase in OEM sales was partially offset by a decrease in both international and domestic wound care drainage product sales.

Gross Profit. Gross profit expressed as a percentage of sales increased from approximately 21% for the year 2000 to 25% in 2001.This increase is due primarily to fixed overhead being allocated over a slightly higher volume of production. Additionally, the increased OEM sales in 2001 had a slightly higher gross margin than other products. Overall, the amount of cost of goods sold was relatively flat between years.

Operating Expenses. Operating expenses increased from $258,921 in 2000 to $301,591 in 2001. This increase was primarily due to an increase in legal and accounting fees associated with the proxy and related sale of net assets. Other operating expenses remained relatively flat between years.

Results of Operations - 2000 compared to 1999
Sales. Sales for the fiscal year 2000 were $428,040 compared to $633,584 in 1999, a decrease of approximately 32%. Of the decrease in sales, 42% is due to the loss of a single OEM account, 21% is due to reduced purchases by Chirmed and 26% is due to a loss in domestic revenues from sales of its VariDyne Vacuum Controllers and disposable canister kits. The reduced canister sales can be attributed to the loss of a major hospital account combined with a somewhat lower use rate by some of the hospital accounts. The balance is due to a general decrease in purchases of the Company's products.

Gross Profit. Gross profit expressed as a percentage of sales decreased from approximately 39% for the year 1999 to 21% in 2000. This decrease is due primarily to fixed overheads being allocated over a much smaller volume of production. Also, the Company had increased costs of components and labor. Additionally, the loss of sales to the one OEM customer contributed to lower gross margins.

Operating Expenses. Operating expenses increased from $199,425 in 1999 to $258,921 in 2000. This increase was primarily due to a $16,721 increase in legal and accounting fees (with increased accounting fees of $12,648 being attributed to the new SEC regulations effective in the year 2000), and

$54,089 for the amortization expense of the consulting agreement signed in June 2000 (See Note 11).

Critical Accounting Policies

Our significant accounting policies are summarized in the footnotes to our financial statements. Some of the most critical policies are discussed below.

As a matter of policy, we review our major assets for impairment. Our major operating assets are accounts receivable and inventory. We have not experienced significant bad debts expense and our reserve for doubtful accounts of $4,200 should be adequate for any exposure to loss in our December 31, 2001 accounts receivable. We have also established reserves for slow moving and obsolete inventories and believe the reserve of $10,000 is adequate. We depreciate our furniture and equipment over their estimated useful lives and we have not identified any items that are impaired.

Liquidity and Capital Resources

At December 31, 2001 the Company had a working capital deficit of $60,892 compared to working capital of $128,531 at December 31, 2000. The erosion of working capital was primarily the result of the net loss for the year coupled with increased levels of accounts payable.

The net cash used in operating activities for the year 2001 of $15,641 was comprised of the net loss of $198,089 partially offset by non-cash expenses of depreciation and amortization and a change in net operating assets (primarily the increase in accounts payable). Net cash used in financing activities was the result of payments made on the capital lease and note payable obligations.

As discussed in the overview above, the ability of the Company to continue as a going concern and its short-term liquidity is dependent upon obtaining additional debt and/or equity financing to fund a business combination or other transaction. The Company hopes to utilize its remaining capital structure to attract a business opportunity that will maximize potential value to shareholders. However, there can be no assurance that the possible sale of Company's common stock to Metalclad Corporation, as discussed above and in Item 1, will actually close. Moreover, without a source of revenues, the Company's ability to continue as a going concern is dependent on a business combination or other transaction occurring. Without raising additional debt or equity, the Company may be forced to cease any further activities in the near term.

Recently Issued Accounting Pronouncements

In July 2001, FAS 141, Business Combinations, and FAS 142, Goodwill and Other Intangible Assets, were issued. These pronouncements provide that all business combinations initiated after June 30, 2001 be accounted for using the purchase method and that goodwill be reviewed for impairment rather than amortized, beginning on January 1, 2002. The Company does not believe that the adoption of these pronouncements will have a material effect on its financial statements. Any business combination transactions in the future would be accounted for under this new guidance.

In September 2001, the FASB issued Statement 143, Asset Retirement Obligations. This Statement addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. The Statement will be effective for the Company's fiscal year ending December 2003. The Company does not believe that the adoption of this pronouncement will have a material effect on its financial statements.

In August 2001, the FASB issued Statement 144, Accounting for Impairment or Disposal of Long-Lived Assets. This Statement addresses financial accounting

and reporting for the impairment or disposal of long-lived assets. The Statement will be effective for the Company's fiscal year ending December 2002. The Company does not believe that the adoption of this pronouncement will have a material effect on its financial statements.

Forward-looking statements contained in this annual report on Form 10-KSB, including without limitation in Management's Discussion and Analysis, are made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Certain important factors could cause results to differ materially from those anticipated by some statements made herein. Investors are cautioned that all forward-looking statements involve risks and uncertainties. A number of factors that could cause results to differ materially are those discussed in our Annual Report on Form 10-KSB and other recent filings with the Securities and Exchange Commission. Additional factors that could cause results to differ materially include but are not limited to, the Company's ability to consummate the sale of capital stock to Metalclad Corporation or to identify, negotiate and consummate another transaction that raises capital for the Company if the stock sale to Metalclad Corporation is not completed. All such forward-looking statements, whether written or oral, and whether made by or on behalf of the Company are expressly qualified by these cautionary statements. In addition, the Company disclaims any obligation to update forward-looking statements to reflect events or circumstances after the date hereof.

Risk Factors

The Company may not consummate the sale of common stock to Metalclad Corporation. There is no assurance that the Company will close on the sale of common stock to Metalclad Corporation. If the Company does not close with Metalclad Corporation it intends to continue to explore strategic opportunities for raising capital for the Company. However, there can be no assurance that the Company will be able to complete a transaction with another operating business. Further, even if such a transaction is completed with Metalclad Corporation or another operating business, there can be no assurances that the market price of the Company's common stock will improve.

The Company's current shareholders will be diluted if the Company closes on the sale of common stock to Metalclad Corporation. The sale of approximately 120,000,000 shares of the Company's common stock to Metalclad Corporation will immediately reduce the percentage ownership of our then current shareholders.

The Company's current shareholders may be diluted if the Company is successful in its efforts to convert outstanding preferred stock into common stock and to have all outstanding warrants exercised. The Company intends to make a proposal to its preferred shareholders to convert each share of preferred stock into two shares of common stock. In addition, the Company intends to make a proposal to its warrant holders to exercise their warrants such that a certain number of warrants will be cancelled in exchange for shares of the Company's common stock, and no cash would be paid for such exercise and exchange. The issuance of the Company's common stock upon such preferred share conversions and warrant exercises may cause our shareholders to incur substantial dilution in net book value per share of common stock.

ITEM 7. FINANCIAL STATEMENTS

SURG II, INC. (Formerly known at Surgidyne, Inc.)

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INDEPENDENT AUDITOR'S REPORT

To the Board of Directors
Surg II, Inc.
Bloomington, Minnesota

We have audited the accompanying balance sheets of Surg II, Inc. (formerly known as Sugidyne, Inc.) as of December 31, 2001 and 2000, and the related statements of operations, stockholders' equity (deficit), and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Surg II, Inc. (formerly known as Surgidyne, Inc.) as of December 31, 2001 and 2000, and the results of its operations and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note 2 to the financial statements, subsequent to year-end, the Company sold substantially all of its net operating assets. After the sale, the Company has no sources of revenue. The Company is currently seeking additional equity or debt financing to fund a business combination or other transaction. However, there can be no assurance that such a transaction will occur and with no sources of revenue, substantial doubt exists regarding the Company's ability to continue as a going concern. Management's plans in regards to these matters are also described in Note 2. The financial statements do not include any adjustments that might result from the outcome of this

uncertainty.

McGLADREY & PULLEN,LLP

Minneapolis, Minnesota
April 9, 2002

SURG II, INC. (Formerly known as Surgidyne, Inc.)
BALANCE SHEETS

	December 31, 2001	December 31, 2000
ASSETS		
Current Assets		
Cash	$ 8,150	$ 33,924
Accounts receivable, less allowance for doubtful accounts of $4,200 (Note 10)	44,734	31,002
Inventories (Note 3)	124,712	160,687
Prepaid expenses	12,243	11,913
Prepaid consulting expense (Note 11)	-	38,635
Total current assets	189,839	276,161
Furniture and Equipment, at cost (Notes 4 and 9)	353,917	353,917
Less accumulated depreciation and amortization	338,003	328,673
Total furniture and equipment	15,914	25,244
Other Assets	3,627	8,140
Total assets	$ 209,380	$ 309,545

See Notes to the Financial Statements

	December 31, 2001	December 31, 2000
LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIT)		
Current Liabilities		
Current maturities of capital lease	$ 5,000	$ 4,590
Notes payable to officer and director (Note 5)	8,474	8,474
Other demand notes payable (Note 5)	61,646	47,192

Accounts payable	119,210	33,582
Accrued liabilities (Note 6)	56,401	53,972
Total current liabilities	250,731	147,810
Capital lease obligation, less current maturities (Note 9)	5,507	10,504
Stockholders' Equity (Deficit) (Notes 6 and 7)		
Series A Preferred stock, at liquidation value, authorized 1,600,000 shares; 1,600,000 shares issued and outstanding	400,000	400,000
Common stock, no par value; authorized 200,000,000 shares; 7,447,085 issued and outstanding	4,606,266	4,606,266
Accumulated deficit	(5,053,124)	(4,855,035)
Total stockholders' equity	(46,858)	151,231
Total liabilities and stockholders' equity	$ 209,380	$ 309,545

SURG II, INC. (Formerly known as Surgidyne, Inc.)
STATEMENT OF OPERATIONS

For years ended December 31,	2001	2000
Net sales (Note 10)	$ 440,234	$ 428,040
Cost of goods sold (Note 10)	331,658	336,364
Gross profit	108,576	91,676
Operating expenses		
Research and development	13,364	11,873
Sales and marketing	34,379	34,775
General and administrative	253,848	212,273
Total operating expenses	301,591	258,921
Operating loss	(193,015)	(167,245)
Other Income (expense)		
Interest income	39	1,286
Interest expense (Note 5)	(5,855)	(5,180)
Other	742	37
Net loss	$ (198,089)	$ (171,102)

	2001	2000
Basic and diluted loss per common share	$ (0.03)	$ (0.02)
Weighted average common shares outstanding-basic and diluted	7,447,085	7,020,833

See Notes to Financial Statements

SURG II, INC. (Formerly known as Surgidyne, Inc.)
STATEMENTS OF STOCKHOLDERS' EQUITY (DEFICIT)

Years Ended December 31, 2001 and 2000

	Preferred Stock	Common Stock Shares	Common Stock Amount	Accumulated Deficit	Total
Balance, December 31, 1999	$400,000	7,017,085	$4,472,042	$(4,683,933)	$ 188,109
Issuance of Common Stock, (net of expenses of $1,500)	-	430,000	41,500	-	41,500
Issuance of Warrants for Services (Note 11)	-	-	92,724	-	92,724
Net Loss	-	-	-	(171,102)	(171,102)
Balance, December 31, 2000	$400,000	7,447,085	$4,606,266	$(4,855,035)	$ 151,231
Net Loss	-	-	-	$ (198,089)	$(198,089)
Balance, December 31, 2001	$400,000	7,447,085	$4,606,266	$(5,053,124)	$ (46,858)

See Notes to Financial Statements.

SURG II, INC. (Formerly known as Surgidyne, Inc.)
STATEMENTS OF CASHFLOWS

Years Ended December 31,	2001	2000
Cash Flows from Operating Activities		
Net loss	$ (198,089)	$ (171,102)
Adjustments to reconcile net loss to net		
Cash used in operating activities:		
Depreciation and amortization	10,314	5,707
Amortization of prepaid consulting expenses	38,635	54,089
Changes in assets and liabilities:		

Accounts receivable	(13,732)	19,665
Inventories	35,975	21,623
Prepaid expenses and other assets	3,199	14,404
Accounts payable and accrued expenses	108,057	(13,555)
Net cash used in operating activities	(15,641)	(69,169)
Cash Flows from Investing Activities		
Additions to patents and trademarks	-	(1,544)
Purchase of Furniture and Equipment	-	(1,030)
Net cash used in investing activities	-	(2,574)
Cash Flows from Financing Activities		
Payments on capital lease obligation	(4,587)	(4,397)
Payments on notes payable	(5,546)	(1,526)
Proceeds from issuance of common stock	-	41,500
Net cash provided by (used in) financing activities	(10,133)	35,577
Decrease in cash	(25,774)	(36,166)
Cash:		
Beginning	33,924	70,090
Ending	$ 8,150	$ 33,924
Supplemental Disclosures of Cash Flow Information		
Cash payments for interest	$ 7,587	$ 3,150
Supplemental Non Cash Investing and Financing Activities		
Conversion of accounts payable to a note payable	$ 20,000	
Equipment acquired under capital lease	-	$ 19,491
Warrant issued for prepaid consulting services (Note 11)	-	$ 92,724

See Notes to Financial Statements.

Note 1. Nature of Business and Significant Accounting Policies

Nature of Business: Immediately following the asset sale, see Note 2, the Company changed its name from Surgidyne, Inc. to Surg II, Inc. (Company). The Company designs, develops, manufactures and markets specialty medical and surgical wound drainage products. The Company sells its products primarily on a credit basis throughout the United States and Europe.

A summary of the Company's significant accounting policies follows:

Revenue Recognition: The Company recognizes revenue upon shipment of the product to the customer, FOB shipping point. Shipping and handling charges billed to customers are included in net sales, and shipping and handling costs incurred by the Company are included in cost of goods sold.

Recent Pronouncements: In July 2001 FAS 141, Business Combinations, and FAS 142 Goodwill and Other Intangible Assets, were issued. These pronouncements provide that all business combinations initiated after June 30, 2001 be accounted for using the purchase method and that goodwill be reviewed for impairment rather than amortized, beginning on January 1, 2002. The Company does not believe that the adoption of these pronouncements will have a material effect on its financial statements. Any business combination transactions in the future would be accounted for under this new guidance.

In September 2001, the FASB issued Statement 143, Asset Retirement Obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. The Statement will be effective for the Company's fiscal year ending December 2003. The Company does not believe that the adoption of this pronouncement will have a material effect on its financial statements.

In August 2001, the FASB issued Statement 144, Accounting for Impairment or Disposal of Long-Lived Assets. This Statement addresses financial accounting and reporting for the impairment or disposal of long-lived assets. The Statement will be effective for the Company's fiscal year ending December 2002. The Company does not believe that the adoption of this pronouncement will have a material effect on its financial statements.

Inventories: Inventories are stated at the lower of cost (first-in, first-out method) or market.

Patents and Trademarks: Patent and trademark costs are included in other assets and are being amortized over 17 years using the straight-line method.

Furniture and Equipment: Depreciation is provided on the straight-line method over estimated useful lives of three to five years.

Research and Development Costs: Expenditures for research and development activities, whether performed by the Company or performed by outside parties under contract, are charged to operations as incurred.

Accounting of Long-Lived Assets: The Company reviews its furniture and equipment and other long-lived assets periodically to determine potential impairment by comparing the carrying value of the assets with the estimated future net undiscounted cash flows expected to result from the use of the assets, including cash flows from disposition. Should the sum of the expected future net cash flows be less than the carrying value, the Company would recognize an impairment loss at that date. An impairment loss would be measured by comparing the amount by which the carrying value exceeds the fair value (estimated discounted future cash flows or appraised value) of the long-lived assets.

Income Taxes: Deferred taxes are provided on an asset and liability method whereby deferred tax assets are recognized for deductible temporary differences and operating loss and tax credit carry forwards and deferred tax liabilities are recognized for taxable temporary differences. Temporary differences are the differences between the reported amounts of assets and liabilities and their tax bases. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or all of the tax assets will not be

realized. Deferred tax assets and liabilities are adjusted for the effects of changes in tax laws and rates on the date of enactment.

Fair Value of Financial Instruments: The fair value of the notes payable are estimated based on interest rates for the same or similar debt having the same or similar remaining maturities and collateral requirements. The carrying amount of these obligations approximates fair value.

Management Estimates: The preparation of 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 financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Basic and Diluted Income (Loss) per Share: Basic per-share amounts are computed, generally by dividing net income or loss by the weighted average number of common shares outstanding. Diluted per-share amounts assume the conversion, exercise or issuance of all potential common stock instruments unless their effect is anti-dilutive thereby reducing the loss or increasing the income per common share. Basic and diluted loss per share are the same in each year presented as the inclusion of the warrants to purchase common stock (see Note 7) would have an anti-dilutive effect.

Note 2. Subsequent Event and Going Concern Considerations:

On January 22, 2002, pursuant to an agreement, the Company closed on the sale of substantially all of its net operating assets. The sale resulted in gross proceeds of $200,000 and a gain of approximately $13,000 after considering total transaction costs of $70,000 including $55,000 that were incurred and expensed in 2001. After the sale the Company has no sources of revenue as the net operating assets sold represent substantially all of its operations. The Company believes that the asset sale will enable the Company to seek a business combination or other transaction with an opportunity that will be more attractive than the Company's former wound drainage business. The Company hopes to utilize its remaining capital structure to attract a business opportunity that will maximize potential value to shareholders. On March 21, 2002 the Company signed a non-binding letter of intent with Metaclad Corporation to sell a majority ownership in the Company's commons stock. However, there can be no assurance that this transaction will occur. Moreover, without a source of revenues, the Company's ability to continue as a going concern is dependent on a business combination, additional equity or debt financing, or other transaction occurring. The financial statements do not reflect any adjustments that might be necessary should the Company not remain as a going concern.

Pro Forma assets and liabilities at December 31, 2001, assuming the asset sale had been completed at that date, not reflecting the subsequent payments made on the remaining liabilities using the cash received, would be as follows (In thousands):

		Unaudited	
	Actual	Pro Forma Adjustments	Pro Forma
Cash	$ 8	$ 200	$ 208
Accounts receivable	45	(45)	-

Inventories	125	(125)	-
Other current assets	12	-	12
Current assets	190	30	220
Other assets	3	(3)	-
Furniture and equipment, net	16	(16)	-
	209	11	220
Current maturities of long-term debt and notes payable	75	(5)	70
Other current liabilities	176	(47)	129
	251	(52)	199
Long-term debt	5	(5)	-
Total liabilities	256	(57)	199
Stockholders'equity (deficit)	(47)	68	21
	$ 209	$ 11	$ 220

Because the Company sold all of its net operating assets, on a pro forma basis there would have been no sales in either 2001 or 2000, assuming the transaction had been effective January 1, 2000.

Note 3. Inventories

Inventories consisted of the following:

	2001	2000
Component parts and subassemblies	$ 64,218	$ 75,780
Work-in-Process	11,007	17,617
Finished Goods	59,487	77,290
Less Obsolescence Reserve	(10,000)	(10,000)
	$124,712	$160,687

Note 4. Furniture and Equipment

Furniture and equipment cost consists of the following:

	2001	2000
Furniture, fixtures and equipment	$251,735	$251,735
Tooling and Molds	102,182	102,182
	$353,917	$353,917

Note 5. Notes Payable

Notes Payable to Related Parties: The Company has short-term notes payable outstanding with a certain officer and director which bear interest at 10%.

The principal is due in annual installments limited to 50% of the audited net income each year until paid in full. Related party interest expense was approximately $1,000 for both 2001 and 2000. This note was paid-off in full in February 2002.

Other Notes Payable: In January 2002, the Company converted a portion of an accounts payable balance to a demand note payable of $20,000, which has been reflected as a note payable at December 31, 2001. In 1995, the Company converted an accounts payable balance of $35,546 into a non-interest bearing unsecured note payable due in a single installment on January 1, 1997. The Company did not pay off the note on January 1, 1997 and as a result the note is due on demand. $5,546 was paid on this note April 2001 leaving a balance of $30,000. The Company also has a 12% demand note payable for $11,646. All of these notes, with the exception of $20,000 note, were paid-off in full during February 2002.

Note 6. Series A Preferred Stock

On December 1, 1993, certain debenture holders elected to convert the face value of the debentures into 1,600,000 shares of unregistered Series A preferred stock at $.25 per share. The preferred shareholders are entitled to a dividend equal to 3% of net sales. The dividend in a given year is limited to 50% of the Company's net income. Cumulative dividends cannot exceed $210,000. In 1999, 1998 and 1995, the Company accrued $19,008, $884 and $437 respectively for dividends on net income. Accrued liabilities at both December 31, 2001 and 2000 include $20,329 of dividends payable under the preferred stock.

The preferred shares are convertible into common shares on a one for one basis, subject to certain anti-dilutive adjustments. The preferred stock is automatically convertible into common stock upon the occurrence of any of the following:

* The Company's common stock price is traded at a bid price of $.50 or more for thirty consecutive trading days:

* The preferred shareholders have received the cumulative dividends specified above.

* Two-thirds of the preferred shareholders elect to convert their preferred stock.

Subsequent to year-end, the Board of Directors have approved a plan whereby the current preferred shareholders may be accorded the right to convert each share of preferred stock into two shares of common stock instead of the current conversion rights of one to one.

Note 7. Stock Warrants

Warrants: The Company has granted warrants for the purchase of shares of the Company's common stock to directors, medical advisors, employees and certain debt and equity holders. The warrants are fully exercisable upon issuance and expire in varying amounts through 2005. Information with respect to warrant activity is summarized as follows:

	Shares	Weighted Average Exercise Price
Outstanding at December 31, 1999	40,000	$0.12
Granted	1,080,000	$0.17

Outstanding at December 31, 2000	1,120,000	$0.17
Granted	35,000	$0.08
Expired	(10,000)	$0.07
Outstanding at December 31, 2001	1,145,000	$0.17

Option and warrant grants to employees and directors are accounted for following APB Opinion No. 25 and related interpretations. For 2001 and 2000, there was no compensation expense recorded on the issuance of warrants to employees/officers/directors as they were issued at or above the Company's quoted market price.

Had compensation expense for the warrants to purchase shares of common stock granted to employees/officers/directors been determined based on the fair market value at the dates of grants consistent with the provisions of SFAS No. 123, the Company's net loss and basic and diluted loss per share would have been changed to the following pro forma amounts:

	2001	2000
Net loss - as reported	$ (198,089)	$ (171 102)
Net loss - pro forma	$ (200,800)	$ (248,564)
Basic and diluted net loss per share as reported	$ (.03)	($.02)
Basic and diluted net loss per share pro forma	(.03)	($.04)

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions used for grants in 2001 and 2000:

	2001	2000
Expected dividend yield	0%	0%
Expected stock price volatility	225%	190%
Risk-free interest rate	4.8%	5.4%
Expected life of options (years)	4	4
Weighted average fair value of options granted	$0.08	$.16

Option and warrant grants to non-employees are accounted for under FASB Statement No. 123 based on the grant date fair values.

The following table summarizes information about warrants outstanding as of December 31, 2001:

Exercise Price	Number Of Units Outstanding	Weighted Average Remaining Contractual Life(Years)	Weighted Average Exercise Price
.07	20,000	1.5	.07
.08	35,000	4.5	.08
.17	1,080,000	3.5	.17
.08	10,000	2.5	.08

1,145,000

Of the warrants issued in 2000, 480,000 were issued to Directors/Officers with the remaining being issued pursuant to a consulting agreement (see Note 11). All outstanding warrants are exercisable as of December 31, 2001 and 2000.

On January 22, 2002, the Company granted warrants to its legal counsel to purchase a total of 200,000 shares of Company common stock. The warrants are immediately exercisable at an exercise price of $0.04 per share and have a five-year life. These warrants were granted for services performed during January 2002 in connection with the sale of net assets (see Note 2). Therefore, the Company will recognize an expense in that period for approximately $10,000, the estimated fair value of warrants using the Black-Scholes pricing model.

Note 8. Income Taxes

Deferred tax assets consist of the following:

	2001	2000
Allowance for inventory Obsolescence	$ 2,000	$ 2,000
Other	7,000	2,000
Net Operating Loss Carry forwards (NOL's)	1,390,000	1,640,000
Tax credit carry forwards	41,000	41,000
Gross deferred tax assets	1,440,000	1,685,000
Less valuation allowance	1,440,000	1,685,000
Net deferred tax assets	$ -	$ -

The Company has federal net operating loss and tax credit carry forwards which are available to reduce taxable income as income taxes payable in future years, subject to potential limitations due to changes in ownership and will be further limited if the future sale of stock to Metaclad occurs, see Note 2. These carry forwards and credits will expire as follows:

Year	Net Operating Loss Carry-Forwards	Tax Credit Carry-Forwards
2002	$1,128,000	-
2003	995,000	-
2004	407,000	-
2005	144,000	-
2006	4,000	-
2007	-	-
2008	164,000	-
2009	187,000	-
2010	21,000	-
2011	3,000	-
2012	72,000	-

2015	173,000	-
2016	180,000	-
	$3,478,000	$41,000

Note. 9 Leases

Operating: The Company leases its office and warehouse facilities under an operating lease which is on a month to month basis. The lease requires monthly payments of $3,100. The Company also leases certain equipment under operating leases. Total rent expense was approximately $38,000 in both 2001 and 2000.

Capital: The Company leases its computer equipment under a capital lease agreement. As of December 31, 2001, the assets capitalized under the capital lease and related accumulated amortization were approximately $19,500 and $4,400 respectively.

Approximate annual future minimum lease payments under the capital lease at December 31, 2001 are as follows:

2002	$ 5,760
2003	5,760
Total Minimum lease payments	11,520
Less amount representing interest	1,013
Present value of minimum lease payments using a discount rate of 9.0 percent.	10,507
Less: current maturities	(5,000)
Long-term portion	$ 5,507

Note 10. Major Customers, Suppliers and Export Sales

The Company operates in one business segment, the manufacture and sales of specialty medical and surgical wound drainage products. Major customers: Net Sales for the year ended December 31, 2001 and 2000 include sales to major customers as follows:

	Sales Percentage	
Company	2001	2000
A*	21%	29%
B	16%	12%
C	-	12%

	Year End Receivable Balances	
Company	2001	2000
A*	$ -	$ -
B	13,574	4,855
C	-	5,314

*International customer, representing 48% and 62% of export sales in 2001 and 2000, respectively.

Major Suppliers: The Company purchases all components for its products from outside suppliers and has some components manufactured to its specification. The Company is dependent upon such suppliers for a readily available supply of necessary components.

The Company has single sources of supply for some of its critical components. Management has determined that developing and maintaining additional sources for critical components is not cost effective.

Export Sales: Net export sales to international customers were $192,400 and $197,020 in 2001 and 2000 respectively.

Note 11. Consulting Agreement

On June 2, 2000 the Company retained Equity Securities Investments, Inc. (the Consultant) to advise and assist the Company in evaluating strategic opportunities including a possible sale or merger. However, there can be no assurance that these activities will result in a proposal acceptable to the Company or that any transaction will be completed.

The consulting agreement had a term of one year and provided the Consultant with a warrant to purchase 600,000 shares of the Company common stock at a price of $0.17 per share. The Company valued this warrant using the Black-Scholes pricing model, which resulted in a value of approximately $93,000. The expense was recognized over the term of the agreement and $39,000 and $54,000 was reflected as an operating expense in 2001 and 2000 respectively.

ITEM 8. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE.

None.

PART III

ITEM 9. DIRECTORS, EXECUTIVE OFFICERS, PROMOTERS AND CONTROL PERSONS; COMPLIANCE WITH SECTION 16(a) OF THE EXCHANGE ACT.

Directors and Executive Officers

The following seven persons serve as directors and executive officers of the Company:

Name	Age	Position	Director Since
Charles B. McNeil 3115 Maplewood Road Wayzata, MN 55391	72	Director, Executive Vice President and Treasurer	1982
Theodore A. Johnson 825 Southgate Plaza	61	Chief Executive Officer, Chief Financial Officer	1985

5001 West 80th Street Bloomington, MN 55437		and Chairman of the Board	
David B. Kaysen 825 Southgate Plaza 5001 West 80th Street Bloomington, MN 55437	52	Director	1988
William F. Gearhart 825 Southgate Plaza 5001 West 80th Street Bloomington, MN 55437	54	Director and Secretary	1984
Arthur W. Schwalm 825 Southgate Plaza 5001 West 80th Street Bloomington, MN 55437	69	Director	1984
Vance D. Fiegel 2460 South Highway 100 St. Louis Park, MN 55416	48	Director	1995
David R. Knighton, M.D. 2460 South Highway 100 St. Louis Park, MN 55416	53	Director	1994

Charles B. McNeil, founder of the Company, has over 30 years experience in the health care industry. He served as President of the Company from its incorporation in 1982 until 1988. Since 1988 has served as Executive Vice President of the Company, and since its incorporation he has served as Treasurer of the Company. He previously served as Vice President and General Manager of the Inmed and Bittner Medical and Home Health Division of Inmed Corporation, Norcross, Georgia. Prior to joining Inmed, he was employed for 16 years by Davol, Inc., Providence, Rhode Island, where he directed product development for seven years. New products he successfully developed at Davol include numerous disposable surgical devices such as the Reliavac Closed Suction Device, surgical drains and disposable surgical suction devices.

Theodore A. Johnson, has served as Chairman of the Board and Chief Executive Officer since January 1995 and the Chief Financial Officer since 2001. Mr. Johnson also serves as President, CEO and Director of the Minnesota Cooperation Office for Small Business and Job Creation, Inc. (MCO), a non-profit corporation formed in 1979 to foster job creation through assisting the start-up and growth of innovative, technological ventures in Minnesota. Prior to joining MCO, Mr. Johnson spent eight years at Control Data Corporation and twelve years at DATA 100 Corporation in a number of different technical, marketing and management positions. He currently serves as Chairman of the Board of International Lottery and Totalizator Systems, Inc., a NASDAQ listed company in California. In addition, he serves on the boards of directors of three private companies and one venture capital fund and is also an active investor and advisor to a number of emerging companies around the United States.

Vance D. Fiegel, Director since January 1995, is also Chief Operating Officer and the Director of Research at Embro Corporation, a biomedical research and development company specializing in wound healing products and vascular devices. At Embro, he directs corporate operations and new product development. He is founder of Embro as well as the National Reparative Medicine Foundation where he serves as Director and Executive Vice President. Prior to founding Embro, Mr. Fiegel held various positions at the University

of Minnesota, ultimately directing research in the field of wound healing where he has published over fifty papers in national and international journals. Mr. Fiegel previously served as President of the Company from January 1995 through 2001.

David B. Kaysen, Director, is an experienced healthcare executive with over 20 years involvement in medical products sales and marketing. He is currently President, CEO and a Director of Rehabilicare, Inc., a NASDAQ listed company. He also serves as a board member of American Telecare, a private company, and ZEVOX International, Inc., a NASDAQ listed company. From 1991 to 1992 he served as Vice President of Emeritus Corporation. From 1989 to 1991 he served as Vice President of Sales and Marketing for VDM Corporation. From 1988 to 1989, he served as the President and CEO and Director of Surg II, Inc. From 1986 to 1988, Mr. Kaysen was Vice President of Marketing for Red Line/XVIIIB Medi Mart, Minneapolis, Minnesota.

William F. Gearhart, Director and Secretary, has been Vice President Sales and Marketing for Senorx, Inc. since 1999 and the Executive Vice President, Marketing and Sales, for Micro Therapeutics, Inc. since 1997. He also previously held positions as Vice President, Sales and Marketing for Interventional Technologies, Inc.; Vice President Sales and Marketing for Schneider (USA), Inc.; Director of Marketing for St. Jude Medical; and Director of Sales and Marketing for the clinical division of Sandoz Nutrition Corporation. Mr. Gearhart was President and COO of Med Ventures, Inc. from 1987 to 1990, and from 1985 to 1987 was Chairman and President of Competitive Business Strategies, a developer of strategic planning software, and Vice President of Alpha Business Group, Inc., a business consulting service to start-up medical companies.

Arthur W. Schwalm, Director, was founder of Cardiac Pacemakers, Inc. (CPI) in 1972 and served as President and Chief Executive Officer for 10 years. CPI was sold to Eli Lilly in 1978. Mr. Schwalm served as Chairman of the Board until 1983.

David R. Knighton, M.D., Director and Chairman of the Company's Medical/ Scientific Advisory Board, is currently a practicing vascular surgeon in the Twin Cities. He is also the Medical Director of the Institute for Reparative Medicine and President and CEO of Embro, Inc. Dr. Knighton founded Curative Technologies, Inc., an international wound healing company, which specializes in formation and management of Wound Care Centers. In addition to his recognized expertise in clinical wound care, Dr. Knighton is an experienced basic science researcher in the field of wound repair and wound healing angiogenesis.

Section 16(a) Beneficial Ownership Reporting Compliance

Section 16(a) of the Securities Exchange Act of 1934 requires the Company's directors and executive officers, and persons who own more than ten percent of a registered class of the Company's equity securities, to file the Securities and Exchange Commission (the "SEC") initial reports of ownership and reports of changes in ownership of common stock of the Company. Officers, directors and greater than ten-percent shareholders are also required by SEC regulation to furnish the Company with copies of all Section 16(a) reports they file. To the knowledge of the Company, during the fiscal year ended December 31, 2001, all Section 16(a) filing requirements applicable to the Company's directors, executive officers and greater than ten-percent beneficial owners were timely filed.

ITEM 10. EXECUTIVE COMPENSATION

Cash Compensation

The following table sets forth the annual compensation paid or accrued by the Company for services rendered during the years indicated to Charles B. McNeil, the executive officer serving in the capacity of the Company's chief executive officer (the "Named Executive Officer"). No executive officer of the Company, including the Named Executive Officer, had compensation in excess of $100,000 during any of the fiscal years for which information is provided.

SUMMARY COMPENSATION TABLE

	Annual Compensation				Long-Term Compensation			
Name and Principal Position	Year	Salary	Bonus	Other Annual Compen- Sation	Restricted Stock Award(s)	Securities Underlying Options/ SARs	LTIP Payouts	All Other Compen- sation
Charles B. McNeil (Executive Vice President and Treasurer.)	2001	$45,950	-	$4,800	-	-	-	-
	2000	$46,400	-	$5,000	-	-	-	-
	1999	$43,284	-	$4,800	-	-	-	-

Stock Options

No options were granted to or exercised by the Named Executive Officer in the year ended December 31, 2001.

Compensation of Directors

The Company does not provide cash remuneration to its directors.

ITEM 11. SECURITY OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

The following table presents certain information with respect to each shareholder known by the Company to own beneficially 5% or more of its outstanding common shares (which includes the assumed conversion of the Series A preferred stock) and for each Director and Officer as of March 29, 2002. Each shareholder has sole voting and investment power with respect to the shares shown as beneficially owned, except as otherwise indicated in a footnote.

Name and Address of Beneficial Owner	Amount and Nature of Beneficial Owner	Percent of Class
All Directors and Officers as a group	1,928,354	