

UPGRADE INTERNATIONAL CORP /FL/
Form 10KSB
January 17, 2002

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-KSB

FOR ANNUAL AND TRANSITION REPORTS
PURSUANT TO SECTIONS 13 OR 15(D) OF THE
SECURITIES EXCHANGE ACT OF 1934

[X] ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE
ACT OF 1934

FOR THE FISCAL YEAR ENDED SEPTEMBER 30, 2001

[] 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 0-27649

UPGRADE INTERNATIONAL CORPORATION
(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

WASHINGTON
(STATE OR OTHER JURISDICTION OF
INCORPORATION OR ORGANIZATION)

58-2441311
(I.R.S. EMPLOYER
IDENTIFICATION NO.)

1411 FOURTH AVE., SUITE 629; SEATTLE, WASHINGTON
(ADDRESS OF PRINCIPAL EXECUTIVE OFFICES)

98101
(ZIP CODE)

REGISTRANT'S TELEPHONE NUMBER, INCLUDING AREA CODE: (206) 903-3116

SECURITIES REGISTERED PURSUANT TO SECTION 12(B) OF THE ACT: NONE

TITLE OF EACH CLASS NAME OF EACH EXCHANGE ON WHICH REGISTERED

SECURITIES REGISTERED PURSUANT TO SECTION 12(G) OF THE ACT:
COMMON STOCK, PAR VALUE \$0.001 PER SHARE

(TITLE OF CLASS)

(TITLE OF CLASS)

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

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

The registrant's revenues for the fiscal year ended September 30, 2001 were \$-0-.

The aggregate market value as of January 8, 2002 of the voting and non-voting common equity held by non-affiliates of the registrant computed by reference to the closing price on January 8, 2002, was \$38,643,026.

There were issued and outstanding 41,282,802 shares of the Registrant's common stock as of January 8, 2002.

DOCUMENTS INCORPORATED BY REFERENCE: NONE

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UPGRADE INTERNATIONAL CORPORATION AND SUBSIDIARIES

FORM 10-KSB

SEPTEMBER 30, 2001

INDEX

PART I

| | |
|--------|--------------------------------------------------------------|
| Item 1 | Business |
| Item 2 | Properties |
| Item 3 | Legal Proceedings. |
| Item 4 | Submission of Matters to a Vote of Security Holders. |

PART II

| | |
|--------|------------------------------------------------------------------------------------------------|
| Item 5 | Market for Registrant's Common Equity and Related Stockholder Matters. |
| Item 6 | Management's Discussion and Analysis of Financial Condition and Results of Operations. |
| Item 7 | Financial Statements and Supplementary Data. |
| Item 8 | Changes in and Disagreements with Accountants on Accounting and Financial Disclosure |

PART III

| | |
|---------|----------------------------------------------------------------------------------------|
| Item 9 | Directors Executive Officers Promoters and Control Persons of the Registrant |
| Item 10 | Executive Compensation |
| Item 11 | Security Ownership of Certain Beneficial Owners and Management |
| Item 12 | Certain Relationships and Related Transactions |
| Item 13 | Exhibits and Reports on Form 8-K. |

PART 1

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ITEM 1. BUSINESS

GENERAL

Upgrade International Corporation (the "Company") is a Washington corporation was originally incorporated in Florida in 1997 reincorporated into Washington in 2000, that intends to be a fully integrated smart card solutions provider. The business is centered on developing and marketing a patented data storage technology that incorporates hard drive type of memory storage into a standard credit card format.

Upgrade is a development stage company. It is devoting its present efforts into establishing its business in the information technology industry, and is currently in the process of identifying markets and establishing applications for its technologies. The development of the technology is conducted through its subsidiaries, which are all development stage companies that have neither commenced their respective planned principal operations nor generated any revenue.

Upgrade's operations, and those of its subsidiaries, to date have consumed substantial and increasing amounts of cash. Upgrade's negative cash flow from operations is expected to continue and to accelerate in the foreseeable future. The expenditures of Upgrade's subsidiaries are comprised of both direct research and development expenditures, and the acquisition of in-process research and development.

Upgrade generates the funds provided to its subsidiaries by the sale of common stock, and long term debt arrangements. The ongoing ability of Upgrade to maintain the funding requirements of its subsidiaries is dependent upon its ability to raise additional debt or equity capital. In the event that Upgrade is unable to do so, the working capital requirements of the subsidiary companies may be met by others. This may cause substantial dilution to the interest of Upgrade in its subsidiary companies or, if they are unable to raise financing independently, they may not be capable of carrying on the development of their operations.

Upgrade's primary assets are through its subsidiaries' ownership of patented, licensed, and proprietary intellectual property, facilities, and equipment.

The ULTRACARD technology will provide increased data storage that enables a combination of high security, privacy and a greater amount of personal, transportable data storage-at the lowest cost in the industry. ULTRACARD will operate in conjunction with a read/write device and operating software that the Company is also developing. In addition, Upgrade may acquire and develop application software and systems for specific applications of the ULTRACARD technology, as well as conventional smart card solutions.

Upgrade intends to first complete the commercialization process of its core patented technology through its UltraCard, Inc. subsidiary. In conjunction with the completion of this commercialization, the Company intends to leverage off this technology through its ownership interest in:

- CQUE CORPORATION (formerly Centurion Technologies, Inc.), a planned smart card application provider for the medical, educational and governmental industries.
- The GLOBAL CYBERSYSTEMS group of companies which will provide European smart card sales and marketing in Europe and select markets in the United States.

And by pending acquisition of an ownership interest in:

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- ROCKSTER INC., a software and marketing company whose primary focus is digital distribution and acquisition of intellectual properties.

These companies are developing applications software and systems for specific applications of the UltraCard technology as well as conventional smart card solutions. The acquisition and development of existing smart card solutions to be provided by these groups represent a market strategy designed to accelerate the effective integration of UltraCard technology into newly developing and existing markets.

Upgrade intends to further leverage off its technology platform by making additional acquisitions that will horizontally integrate its technology into numerous business applications. This tracks with Upgrade's goal to become the high capacity transportable data storage standard.

BUSINESS STRATEGY

Upgrade intends to first complete the commercialization process of its core patented technology through its UltraCard, Inc. subsidiary. In conjunction with the completion of this commercialization, the Company intends to leverage off this technology through its ownership interest in cQue Corporation (formerly Centurion Technologies, Inc.), a smart card application will provide for the medical industry, and the Global Cybersystems companies, which provide European smart card sales and marketing. In addition, Upgrade has entered into a letter of intent with Rockster Inc., a software and marketing company whose primary focus is digital distribution and acquisition of intellectual properties. The family of companies is developing applications software and systems for specific applications of the UltraCard technology as well as conventional smart card solutions. The development of solutions to be provided by these entities is an integral part the Company's market strategy and is designed to accelerate the integration of UltraCard technology into newly developing and existing markets.

Upgrade intends to further leverage off its technology platform by making additional acquisitions that will horizontally integrate its technology into numerous business applications. This tracks with Upgrade's goal to become the high capacity transportable data storage standard, and then to leverage off of that platform.

SUBSIDIARIES

Upgrade owns a controlling interest in the following companies:

- ULTRACARD, INC.-a 53% subsidiary holding the patented technology that is Upgrade's core technological platform. UltraCard is developing and marketing ultra high capacity data storage and retrieval in a credit card format, a read/write device, and a supporting operating system.
- CQUE CORPORATION (formerly Centurion Technologies, Inc.)-a 51% subsidiary of Upgrade that is developing a medical card on a smart card platform capable of providing a host of interrelated services on line for the medical industry including such services as pharmacology conflict analysis.
- EFORNET CORPORATION-a wholly-owned subsidiary of Upgrade that is intended to be a research and development resource to the Upgrade group of companies. EforNet will provide alternative smart card solutions for specific markets in addition to the conventional smart card and the high memory capacity UltraCard. EforNet's operations are currently dormant.
- GLOBAL CYBERSYSTEMS INC. (a U.S. corporation), GLOBAL CYBERSYSTEMS

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S.A. (a Swiss corporation), and GLOBAL CYBERSYSTEMS PLC (a U.K. corporation) will provide marketing and sales for the products developed by the Upgrade group of companies in Europe and select markets in the United States.

Upon completion of the pending acquisition, Upgrade will own approximately 57% of the following company:

- ROCKSTER, INC.- Rockster's primary focus is digital distribution and acquisition of intellectual properties. The underlying technology applied to distribute and acquire content is a magnet to both artists and consumers. It protects and creates revenues for the artist and allows

consumers to pay for materials exchanged among themselves. The Rockster technology enables such transactions to be done securely, anonymously, and most importantly, conveniently. Its peer-to-peer dynamic allows for fast dissemination of Rockster's technologies and content. Rockster's model is to build assets and generate income concurrently.

Rockster has been structured to be a full service distribution entity incorporating new technologies, a record label, Rockster Records, a music publishing division, and a production company.

Upgrade provides its subsidiaries with strategic direction, financial and financing services, administrative and investor relations services, and additional services facilitating the development of each business unit's operating plans. Upgrade intends to hold substantial interests in, and maintain an active involvement with the companies and technologies it has developed.

ULTRACARD, INC.

THE COMPANY

UltraCard, Inc. (also referred to as our "Memory Card Subsidiary") is the developer of the UltraCard technology for high security, high capacity, portable data storage in existing and future market sectors. The business is centered on developing and marketing a patented data storage technology that incorporates hard drive type of memory storage into a standard credit card format. The UltraCard technology is designed to provide increased data storage to enable a combination of high security, privacy, and a greater amount of personal, transportable data storage-at the lowest cost in the industry. Our Memory Card Subsidiary will operate in conjunction with an Ultra Drive read/write device and operating software that the company is also developing. This technology will combine hard disk drive technology, magnetic stripe technology, smart card "chip" technology and UltraCard patented technology to achieve a new platform in data storage which allows the portable sharing, exchange, archiving and transport of large amounts of data storage.

UltraCard is a Nevada corporation, which was formed in 1997. It is headquartered in Los Gatos, California. UltraCard's principal assets are patented, licensed and proprietary intellectual property. UltraCard is a development stage company; therefore, its operations to date have principally been limited to research and development of the company's platform technology.

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RECENT DEVELOPMENTS

In October of 2001, UltraCard formed a new wholly-owned US subsidiary, UltraCard China, Inc., a Nevada corporation ("UltraCard China") to conduct its operation in China, and will form a Chinese corporate entity to conduct its operations in Shanghai. In November 2001, our Memory Card Subsidiary completed a technology demonstration to Shanghai G-Pro Technology Co., Ltd. Shanghai G-Pro Technology Co., Ltd. is a procurement company for the Shanghai government,

which has issued a purchase order to implement a pilot program consisting of two million UltraCards and ten thousand UltraDrive reader/writers. The US \$15 million purchase order is subject to delivery of the UltraCards and UltraDrives, conforming to mutually agreeable specifications and will include the 5 1/4" half-high UltraDrive with USB interface and triple read capability.

UltraCard is currently completing the tasks necessary to complete this order. The overall project includes approximately 26 individual tasks, which, when completed we expect will also position the Company not only to deliver upon the Shanghai purchase order, but market the technology on a wide-range basis.

The tragedy of September 11, 2001 has altered the attitudes of our nation, our government, and ultimately our world. It is painfully obvious that SAFETY and SECURITY have become immediate priorities. Businesses and governments alike are now re-evaluating security systems.

In the past, the industry has resisted the change to higher levels of security in exchange for convenience and speed. In one day, that attitude abruptly changed. UltraCard has been developing the technology that may solve the safety/security challenge through a combination of multiple biometric recognition programs and embedded storage capacity that can accommodate FBI-level fingerprints, handprints, iris scans, photographs, x-rays, voiceprints and more. UltraCard's technology will deliver authentication, security and personal privacy. The smart card industry is essentially in its infancy and has been stymied for years by a lack of sufficient data storage capacity. The smart cards being highly advertised and promoted on the market today are really not that "smart". Their limited capacity for data storage supports very limited applications and almost no enhancement of the security issues becoming so prevalent in the consumers' and businesses' minds. UltraCard will provide this industry the opportunity to do today what they have only talked about possibly doing in the future.

HISTORICAL TIMELINE OF ULTRACARD

- AUGUST 1998, successfully demonstrated the "Proof of Concept" for its core technology by setting up a working model of the card and read/write systems. This model demonstrated the capability of placing 5,000,000 bytes of information on the magnetic stripe card and then reading from, writing, erasing and replacing data on that card.
- NOVEMBER 1999, demonstrated the technology in Las Vegas, Nevada during Comdex trade show.
- NOVEMBER 1999, licensed from Ampex Corporation the right to use the patented Kepered media technology on magnetic cards.
- FEBRUARY 2000, entered into a cooperative affiliation with SciVac to produce a computerized sputtering system, for their advanced memory card technology. The sputtering equipment places the magnetic memory capacity on the card insert.

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- MAY 2000, entered into an agreement with Pemstar, Inc. for development of the reader/writer unit. UltraCard's in-house staff of engineers provided the core technology; Pemstar's expertise was to accelerate the design processes. Pemstar refined and repackaged the original read/write unit for a range of applications.
- AUGUST 2000, demonstrated high capacity card at the Democratic National Convention using the "Iceberg V" reader/writer prototype. "Iceberg V" is our Memory Card Subsidiary's fully-functional reader/writer unit.
- OCTOBER 2000, announced the signing of a "card substrate supply agreement", with Komag Incorporated. Komag was founded in 1983, and has produced over 480 million thin-films disks, the primary storage medium for digital data used in computer disk drives. Through its advanced development and high volume production facilities in the United States and overseas, Komag provides high quality, leading-edge disk products at a low overall cost to its customers. These attributes enable Komag to partner with customers in the execution of their time-to-market design and time-to-volume manufacturing strategies.
- JANUARY 2001, Pemstar Inc. completes design and development of the Iceberg V reader/writer prototype. 10 units are built for demonstration purposes.
- MAY 2001, the UltraCard technology is demonstrated in Las Vegas, Nevada during the Card Tech/Secure Tech Show.
- JUNE 2001, our UltraCard's Research and Development team begins development of the Iceberg VI prototype unit reducing the form factor to a 5 half high unit (CD Rom size).
- JULY 2001, announcement that an agreement to supply two million UltraCards, and ten thousand UltraDrives to the Chinese government for a pilot program in Shanghai. The business opportunity represents, an opportunity through a Shanghai-based joint venture that is being set up to accommodate manufacturing and distribution of the UltraCard and the UltraDrive throughout China.
- SEPTEMBER 2001, following the tragic events of September 11th, UltraCard executives meet with government officials in Washington, D.C. to demonstrate UltraCard technology and discuss a variety of personal identification, airline security, and biometric applications that would offer a solution to the government's efforts to find security technologies that are effective, but that also ensure individual rights and privacy.
- OCTOBER 2001, our Memory Card Subsidiary and their technology is featured in the article Feds Consider New Antiterrorist Smart-Card Technology in Computerworld Magazine.
- OCTOBER 2001, formed a strategic alliance with Wynnewood Technologies, Inc. a prime contractor for the Pentagon Renovation Program. Wynnewood Technologies Inc. has an established history of successful US government contracts for database management. The UltraCard/Wynnewood Technologies team will work together to solve the database management and security card issues for both the Pentagon and China Programs.
- OCTOBER 2001, formed a wholly-owned subsidiary UltraCard China and names Dan Kehoe, Chief Executive Officer, Arthur Zheng, President, and Oran Chang, Vice President. UltraCard China will be a strong and reliable source for sales of applications utilizing UltraCard technology in China.

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- NOVEMBER 2001, Research and Development team begins development of the Iceberg VII prototype unit that continues to refine form factor and electronics.
- NOVEMBER 2001, successfully completed its technology demonstration in Shanghai that resulted in Shanghai G-Pro Technology Co., Ltd., a procurement company for the Shanghai Government issuing a \$15 Million purchase order to implement a pilot program in Shanghai. This purchase order is subject to delivery of the two million UltraCards, and ten thousand UltraDrives.

WHAT IS ULTRACARD?

- We use a variety of patented, licensed and proprietary technologies to provide a reliable, secure reader/writer and a secure and private data storage card.
- Our product line will start with 20 MB of data on a "credit card" sized media - a form factor that is widely used today and is familiar and highly accepted by consumers.
- We have developed a way to use hard disk drive media technology in a credit card form factor with a reader/writer that is designed to interface with computers, hand held devices, ATM terminals, cash registers and other devices.
- Our technology enables, for the first time, high capacity re-writeable credit card-sized memory cards with enough capacity to store powerful error protection schemes, redundant data areas, high-resolution biometric information and sophisticated encryption and privacy schemes. Because of the increased storage capacity of the UltraCard, invisible card watermarking, several biometric recognition programs, FBI-level fingerprints, handprints, iris scans, photographs, x-rays, voiceprints, can all be accommodated on the UltraCard.
- Our technology will also eliminate fraud and skimming which is a major problem with current credit cards and smart cards. Because of the increased storage capabilities, several encryption libraries can reside on the card at the same time. The UltraCard high capacity memory, the magnetic stripe, the smart card chip and a PIN or biometric can all be mathematically tied together with encryption technology to validate the card and user 4 ways. That means it's secure, and private, not public. The card itself will also provide the biometric recognition program and a digital signature in order to deliver a "non-repudiatable" transaction and faultless authentication.

THE SMART CARD MARKET

A smart card is a plastic credit card with an embedded microchip. It can pick up, store, process, and secure data. The chip can process different kinds of information, and therefore, various industries use them in different ways. These cards can have multiple applications operating on them at one time. For

instance, you could have a frequent flyer program working on the same card as your debit or credit account - so anytime you use the card, you earn points in your favorite program. Other services allow you to participate in loyalty programs with merchants, including storing travel preferences on your smart card. Financial institutions have partnerships with local mass transit systems so you can pay for public transit with your smart card in various cities

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throughout the world.

In 1997, 920 million smart cards were sold worldwide. The major end-user market segments in terms of units were: phone cards, banking, digital mobile phones (GSM), pay TV, health ID and transportation. Although sources vary, it is estimated that North America accounted for 10% of the worldwide distribution of smart cards in the year 2000. Most North America smart card applications use higher priced microprocessor cards for multi-applications and multi-purse requirements, and use very few low cost pay phone cards.

Additional requirements include hardware (readers/writers, kiosks, etc.), software and system support, and ongoing infrastructure services primarily IT services, transaction processing and recharging services. For the year 2000, the Killen & Associates report forecasts the market for software support at \$3.8 billion, recharging smart cards at \$3.5 billion, and the dedicated equipment market at \$3.8 billion. Our Memory Card Subsidiary recognizes these tremendous revenue growth opportunities and is preparing to meet them in the areas of smart card sales, reader/writer sales, technology licensing, smart card application solutions, and transaction processing.

PRODUCTS

The first generation UltraCard will enter the market with 20 MB (20 million bytes) of interactive, re-writable, encrypted data storage. This translates into approximately 10,000 pages of text. As a comparison, today's common credit card with a magnetic stripe installed across its back can hold 256 bytes of data. This amounts to no more than a cardholder's name, credit card number, and authorization codes. The newer smart cards on the market utilize an integrated circuit (IC) chip imbedded in a credit card, which creates an average memory capacity of approximately 2 KB of data (2,000 bytes). That capacity is enough to store about one page of text. Some (IC) chip cards in development are projected to have up to 64 KB of memory, but are expensive, reaching in excess of \$20 per card with limited read/write capability.

The next generation of cards will be expected to carry enormous amounts of secure portable data that can be used across a wide variety of applications: biometrics for authentication, medical images, passport data, e-commerce payments, access controls, global business activity, and complex financial transactions. UltraCard is that next generation.

UltraCard's credit card sized data storage devices are being developed along with a series of card readers/writers Ultra Drive that will compliment future product introductions leading up to low GB storage capacity. With such dramatic increases in data storage capabilities, soon a person will be able to carry a personal computer hard drive in their wallet, thus, total access to all of their records on any computer located anywhere in the world without the need for online access. UltraCard allows decentralized databases and simultaneously offers a very high security and privacy level for the cardholder.

UltraCard will provide the necessary operating systems, application programming interfaces and toolkits such that card issuers and card users can take full advantage of the huge application potential of UltraCard. Full "end-to-end" solutions will be provided that to take full advantage of the new potential of this innovative technology.

APPLICATIONS

Practically any application requiring data that can be transported easily and accessed inexpensively can use UltraCard technology.

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| MARKET | APPLICATIONS | EXAMPLE OF POTENTIAL CUSTOMERS |
|-------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Banking & Finance | <ul style="list-style-type: none"> - e-Commerce, - business-to-business, - purse-to-purse, - stored value cards | <ul style="list-style-type: none"> - VISA, - MasterCard, - American Express - Europay |
| Communications/Wireless | <ul style="list-style-type: none"> - Cell phones, - PDAs, - universal phone cards, - access control, - web access | <ul style="list-style-type: none"> - Nokia, - Ericsson, - Sagem, - Motorola |
| Government | <ul style="list-style-type: none"> - Access control, - bill of lading shipping cards, - criminal record files, - all agency interoperability | <ul style="list-style-type: none"> - General Services Administration, - Department of Defense, - Veterans Administration, |
| ID Systems | <ul style="list-style-type: none"> - Passports/immigrations, - multi-biometrics, - multiple operating systems, - multiple security protocols | <ul style="list-style-type: none"> - General Services Administration, - Department of Defense |
| Travel & Entertainment | <ul style="list-style-type: none"> - retail store, - valued customer, - frequent flyer programs | <ul style="list-style-type: none"> - All airline carriers - Theme parks - Hotel, Travel agencies |
| Healthcare Industry | <ul style="list-style-type: none"> - patient record cards, - x-rays, - insurance records & pharmacy transaction cards, - maternity & family care cards | <ul style="list-style-type: none"> - HMO & PPO programs - All hospital systems |
| The Internet | <ul style="list-style-type: none"> - Personal preferences card, - transaction card, - privacy plus security for all transactions | <ul style="list-style-type: none"> - Hard Rock International, - Amazon, - VISA |
| Transportation Industry | <ul style="list-style-type: none"> - Mass transit payment cards, - QC/Process control records, parts lists, - maintenance records, - RF entry cards | <ul style="list-style-type: none"> - All Airlines carriers - Public Transit systems - Airport security systems |

COMPETITION

The main competitive products of the UltraCard include magnetic stripe cards, IC smart cards, optical cards, magnetic cards, and flash cards. Below is a breakdown of their memory capacity, common uses/features, and their inherent weaknesses.

| PRODUCT | MEMORY CAPACITY | WEAKNESSES |
|---------|-----------------|------------|
| | | |

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| | | |
|-------------------------------------------------------------------------------------------------------------------------------------------|-----------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| MAGNETIC STRIPE CARD | 256 K | low memory and prone to wear and accidental erasure |
| ----- | | |
| - ATM cards, - POS readers, - door entry, - phone cards | | |
| IC SMART CARDS | 2 K to 64 K | more memory capacity than magnetic stripe cards but expensive, require a special card reader, m fragile, and negatively affected by shortage of silicone |
| ----- | | |
| - also with magnetic stripe; - look like credit cards | | |
| OPTICAL CARDS | 4.1 MB to 40 MB | memory capacity competes with magnetic media, but only available with WORM (Write Once, Read Many) capability; lasercard time to read and w is slow and prone to deterioration with high humidity; trimmed optical discs unconventional and hardware to write on disc is expensive |
| ----- | | |
| - lasercards with proprietary readers, or - trimmed discs with standard CD-ROM readers | | |
| MAGNETIC CARDS | 2 KB | slightly higher storage than magnetic stripe, b significant compared to smart cards, optical ca and flash cards and need different readers than magnetic stripe |
| ----- | | |
| - magnetically treated plastic card | | |
| FLASH CARDS | 2 MB to 128 MB | fast and versatile, but very expensive to manufacture and prone to damage at connectors and breaking in field use |
| ----- | | |
| - portable, removable and interchangeable memory chips (similar to computer chip); - cell phones, - digital cameras, - MP3 audio | | |

THE TECHNOLOGY

The UltraCard technology is an innovative system for high capacity data storage and retrieval using hard disk media in a credit card format. The product and technology held by our Memory Card Subsidiary will offer the consumer a combination of features not currently available in any existing data storage medium. The first generation UltraCard product is positioned for immediate acceptance in the existing and rapidly growing smart card market.

- 20 MB CARD ENTRY-LEVEL PRODUCT. UltraCard will offer more memory than any of the current credit card sized cards including (IC) chip and magstripe, 20,000 times the capacity of magnetic stripe cards, and 10,000 times the capacity of smart cards (2KB).
- FULLY EDITABLE. The UltraCard may be written on, edited and read just like the hard disk on your computer or partitioned into non-cross-accessible zones. UltraCard is not limited by WORM (Write Once, Read Many) technology inherent in other smart cards.
- A PATENTED METHOD OF CARD PROTECTION. The UltraCard will ensure magnetic data is not vulnerable to accidental erasure, tampering, fraud, or damage from normal consumer use. Proprietary magnetic layers over the media further enhance magnetic fields from being detected. This raises the bar in security, privacy, and personal protection. UltraCard will allow the consumer to control how, when and from where the data is put on and taken

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off the card.

- COMPATIBILITY WITH EXISTING SMART CARD AND MAGNETIC STRIPE TECHNOLOGY. As a result, UltraCard technology will integrate existing technologies, is backwards compatible with conventional card readers and offers a clear migration path to increased capabilities. UltraCard technology is the only technology that offers diversity and backwards compatibility with existing technologies.
- RUGGED. Because of a patented design, UltraCard holds up to the "torturous" environment of the consumer wallet and daily abuse that may leave a credit card inoperable.
- DESIGNED FOR HIGH VOLUME MASS PRODUCTION. At the same time that UltraCard represents a ramping up of capacity, security and privacy, it represents a downward spiral of cost. It will use high volume, high-throughput sputter technology that's a mature, proven production process already cost-reduced substantially.
- SCALABLE. The technology allows smooth transition to larger memory capacity as needs and technology expands. Our Memory Card Subsidiary entry product is based on technology developed by IBM in 1953. It has great growth potential and 20 MB is just the beginning.

INTELLECTUAL PROPERTY

UltraCard relies primarily on a combination of patents, trademarks, copyright and trade secret laws and employee and third-party non-disclosure agreements to protect its intellectual property assets.

PATENTS

UltraCard holds, through its exclusive license with CardTech, Inc., a patent on its Magnetic Card Reader and Method. This patent includes the apparatus and method for a magnetic storage memory and readout for a credit card sized memory. UltraCard also holds, through CardTech, Inc., a Continuation in Part on that patent which includes optical recording, oscillating recording and various types of card substrates. UltraCard has also purchased patents pertaining to memory storage modules for applications of the Personal Computer Memory Card International Association (commonly known as "PCMCIA").

PATENTS PENDING

UltraCard has pending two patent applications for a linear and high speed rotary portable storage apparatus and methods for using the apparatuses. These patents include optical, magneto-optical, near field, far field, vertical and other modern recording technologies, all contained on a credit card-like portable memory. These two patent applications are very broad and our Memory Card Subsidiary's patent counsel believes that the United States Patent Office may break them up into at least 20 separate patents. UltraCard also has pending a patent application for a data storage unit with an embedded but accessible storage member including the read/write apparatus and methods for using the unit. This patent application is also very broad and our Memory Card Subsidiary's patent counsel believes that it may result in 10 to 12 separate patents.

FINANCIAL DATA

Revenues are expected to be derived in the following areas:

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1. Production and sale of UltraCards.
2. Production and sale of UltraDrive reader/writers.
3. Licensing of the technology.
4. Revenues from smart card application solution providers.
5. Licensing (OEM) and customization of application interfaces, toolkits, operating systems and applications.
6. System integration and professional services.
7. Transaction based pricing.
8. Per certificate, user, server, card, application, service and memory property pricing.

STEPS IN THE COMMERCIALIZATION PROCESS

UltraCard intends to first complete the commercialization process of its core, patented technology. Through strategic partnerships and licensing of its proprietary technology, UltraCard plans its revenue streams based on the following model. UltraCard product development strategy is guided by the tactic to accumulate and retain ownership of as broad and comprehensive an intellectual property package as possible in order to retain as much ownership of intellectual property as possible, all R&D activities are funded and controlled in house by UltraCard.

The steps to commercialization are the ability to produce the card body with our Memory Card Subsidiary patented process of hard drive technology on a shim in a credit card format. This process starts with the manufacture of the shim itself, which, by using exacting standards established by our Memory Card Subsidiary, has allowed for the extraction and retraction of the shim within the card body. The shim, after cut to exacting standards, is run through a process called sputtering. Sputtering is a process of layering the shim with magnetics that later can be read from and written to by magnetic heads located within the UltraDrive reader/writer.

The UltraDrive is essential. It is the only drive or reader/writer that works with the total patented system. The UltraCard is inserted into the card slot on the front of the UltraDrive and the card mechanism within the drive accepts the card and extracts the shim. Next the IC chips, one with in the UltraDrive and one present in the card body validates the authenticity of the UltraCard. This

process of communication is handled by what is called middleware. Middleware is software used within the system for internal communications between working mechanisms. At this point, the heads within the drive can read information previously written on the shim. If this information has been placed onto the shim in an area of high encrypted security known as a vault area, it is possible that this area could be designated a write once read only area. This is where the biometrics can be stored and accessed to verify the identity of the user. After the user's identity has been verified, the remaining areas of data storage can be accessed.

Within seconds of performing the above validation process, the card is ready to perform the application architected by its issuer. Because of the 20-megabyte data storage capacity on the introductory card, the operating program or software can be more diverse than that which resides on a chip only card (Smartcard). The additional storage capacity allows for many applications beyond that which can only be imagined. The ability of the UltraCard to be read from and written to, with such great data storage capacity, creates what we believe to be a revolutionary product in the data storage industry allowing for individual and personal control over highly sensitive information.

The IC chip residing on the card itself classifies the UltraCard as a smartcard and with proper programming can be used in the many smartcard readers already in

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place around the world. The magstripe on the rear of the card gives the UltraCard the ability to be read by all of the magstripe readers around the world. These additional abilities are what makes the UltraCard backward compatibility and it can be used the world over by existing readers, until the implementation of UltraDrives occurs allowing for a more secure use.

The ability of UltraCard to partner with other manufacturers of the above items is a direct and logical track for UltraCard to follow. The more outsourcing the less internal funding is required.

MANUFACTURING STRATEGY

UltraCard intends to use contract manufacturing and other disk drive companies to produce its products. Because we believe there is excess manufacturing capacity in the disk drive industry today, the contract manufacturing approach should result in lower short term investment, maximum ability to vary production levels to meet demand and lower risk of early manufacturing start-up problems. In addition, we expect contract manufacturing to dramatically reduce UltraCard's required headcount which would result in better return on assets than would be possible if our Memory Card Subsidiary were to build its own manufacturing facility.

IC's or chip manufacturers are readily available, and with the low memory capacity needed for the UltraCard solution, many could be chosen, some of which have already entered into technology partner relationships with our Memory Card Subsidiary.

However, UltraCard does intend to maintain absolute control over manufacturing from the perspectives of manufacturing process and inventory exposure. Our Memory Card Subsidiary also intends to control the quality processes in the plant including all incoming inspection procedures, in-cycle quality assurance and final burn-in and test. UltraCard also will set up an ongoing reliability inspection of its products to fully meet specifications and reliability goals before they are shipped.

CURRENT STATUS

- The reader/writer is in the final R&D stage.
- Card interchangeability and interoperability are currently undergoing test and refinement for maximum reliability
- Reader/writer units for initial pilot tests and demonstration have been completed by the Research and Development team.

DESIGN COMPLETION

The next step will be to refine the R&D units based on test results and definitive market information into a product specific design for a specific customer. This first take place followed by hard tooling the pilot production (China), after which full scale production can begin.

MEDIA

The magnetic recording media is the most critical component in the UltraCard intellectual property package. Full control of the media from R&D through full scale production will be maintained by our Memory Card Subsidiary. This includes process and quality control of the substrate, the sputter deposition equipment, the magnetic film, the protective overcoats and inspection equipment and material handling and automation technology for high volume production. The volume production goal from day one has been to achieve one million "shims" or

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media inserts per day. The Company has a supply agreement with Komag Incorporated is an important step towards meeting the manufacturing goal.

Komag, founded in 1983, is the world's largest independent supplier of disks and has produced over 480 million thin-film disks, the primary high-capacity storage medium for digital data in computers. Through its advanced development and high volume production facilities in the United States and abroad, Komag provides high quality, leading edge data storage products at a low overall cost to its customers.

CARD BODIES

UltraCard is currently exploring establishing partnerships with several vendors including Orga and Giesecke & Devrient, Inc. to provide card body development, manufacturing and supply the card bodies to UltraCard specifications.

CQUE CORPORATION

cQue Corporation (formerly Centurion Technologies, Inc.), (a development stage company), is a systems and communications developer that has created a database and secure network that services the medical, educational and government markets. The Company was formed in November 1996 in Redmond, Washington.

cQue has designed a Web-based software application called iQue Rx(TM) that manages data stored on a smart card and has the capability of disseminating private electronic information securely, easily, and efficiently. iQue Rx(TM) currently uses the available smart card technology and it is being upgraded to the new UltraCard platform. The application can be accessed through any dial up, dedicated, hard-wired, (Ethernet) or wireless connection running over a Virtual Private Network or Windows 2000, Web or LAN Server.

The primary market focus of this technology is in the medical industry, travel and government markets. One of the core features is providing medical and other vital information on a smart card platform capable of providing a host of interrelated services online including such things as pharmacology conflict analysis. The company was formed in November 1996 in Redmond, Washington. The flagship product, iQue Rx(TM) is ready for final commercial site testing. Following programming and control function updates after testing, the product will be market-ready for commercialization.

ELECTRONIC MEDICAL RECORDS - POWERED BY INTELLIQUE(TM) SMART SUITE

The United States federal government is actively involved in electronic digital record programs, including eMR (electronic medical records). In fact, the US Department of Defense is involved in the largest known as GCPR in the history of digital records, with over \$2.5 billion dollars allocated to convert the US Department of Defense paper based record systems into a digital record exchange system. These federal government initiatives, including: the GSA Smart Common ID Program (smart card ID) and Department of Defense (D/SIDDOMS) eMR Programs are significant both in concept and budget commitment. UltraCard & cQue coupled with cQue team partner administrators - Litton/PRC, Logicon. SAIC, and Schlumberger Technologies are in the right place at the right time. It will take a concerted effort to accomplish established goals.

A news article published by the Washington Post (November 30, 1999) reads, "As many as 98,000 Americans die unnecessarily every year from medical mistakes made by physicians, pharmacists and other health care professionals, according to an independent report released that calls for a major overhaul of how the nation addresses medical errors. More Americans die from medical mistakes than from breast cancer, highway accidents, or Aids, according to the report from the

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Institute of Medicine. That costs the nation almost \$9 billion a year." cQue intends to provide a solution to this problem on an international scale.

Computerized prescribing is long overdue in the United States. Virtually all prescriptions are still handwritten or even worse, verbally called into the pharmacy. cQue's web-based software application permits both offline and online access to portable smart card data, local client server, and national repository (cQue global server). iQue Rx(TM) uses SmartCheck, an interactive medical advisory database. Every MD Rx order is carefully reviewed for potential conflicts or interactions with over-the-counter products, foods, herbals, and other medications in use. A medical alert is displayed and sent directly to the appropriate physician and pharmacist.

IQUE(TM) RX IS AN AMBULATORY AND EMERGENCY PATIENT CARE RECORD MANAGEMENT AND

CONTROLLED RX ORDER SYSTEM

The iQue Rx(TM) software is an integrated system for secured access, transfer, and storage of cumulative patient healthcare data in a real-time on-line environment. The system uses smart cards, biometrics, and other forms of secured access to insure complete patient and provider confidentiality consistent with the latest proposed HIPAA standards. The system also provides complete portability of patient medical information in a customized, highly flexible format, thereby creating a fully electronic ambulatory record of relevant encounters and episodic and longitudinal care elements.

IQUEACCESS(TM) PORTABLE MEDICAL RECORD

The iQue(TM) Rx system provides dual access to records. Patient medical records stored on a smart card provide portability. At the same time, the smart card provides controlled PKiQue(TM) access to detailed records over a secured socket layers (SSL) internet channel.

IQUEVIEW(TM) DETAILED MEDICAL RECORD ACCESS

Through the use of our Access Profile Control Interface (APCI) the iQue(TM) Rx environment provide quick, real-time access to vital medical data stored on a Primary Institutional Site (PIS) Server located at the patients primary physician's office.

IQUEORDER(TM) ONLINE MEDICATION ORDERING

An additional feature of the iQue(TM) Rx system is web-enabled medication ordering. This permits doctors to send a digital prescription order directly to a selected pharmacy that includes vital patient health information with the order (script).

IQUELOGIC(TM) DRUG INTERACTION INTERVENTION

The built-in Rx screening software is designed, to reduce most identified drug interactions and conflicts. To accomplish this, iQueLogic(TM) looks at all orders checking them against meds to meds, meds to allergies, meds to immunizations, meds to herbals, and soon to follow meds to foods and meds to over-the-counters (e.g. Rogaine).

INSURANCE FORMULARY CONTROL

The built-in intelligent interface alerts the doctor when attempts are made to place medication orders that are not covered under the patient's insurance plan.

IQUECONNECT(TM) TWO-WAY CONTACT MANAGER.

Allows two-way text communication to take place between healthcare professionals, either in real-time or synchronized delayed communication.

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iQue(TM)Rx monitors the user on-line activities through the smart card login process and routes messages to them remotely.

iQue Rx(TM) is designed to connect any person around the globe with real-time encrypted data transfer instantaneously. The smart card is a key component in a system that uses iQue Rx, (TM) because it provides off-line record access and provides the security link to the database by keeping the passwords or other

biometric access controls on a computer chip embedded on a plastic card. cQue believes that it makes patient and client data readily available in a secure, universally accessible, portable, nonproprietary, digital format, using a smart card integrated into iQue Rx(TM) application software that provides a real-time, universal, online, interactive, MD-based order entry system.

The iQue Rx(TM) workstation application manages the patient's data through various screens. The entrance into a patient's data is through a "profile" screen that shows all of the data. The profile screen displays a summary of the information stored on a User's card in a flexible and intuitive manner. The information is grouped by category into a series of boxes, which the access user can arrange and resize to their liking. The profile screen arrangement is stored on the access user's card—their preferences are present on whatever workstation they use.

iQue Rx(TM) stores a patient profile that consists of several blocks of information including prescription medications, over-the-counter medications, allergies, immunizations, foods, herbals and insurance coverage as well as other patient information specific to the application. For example, Rx SmartCheck is a component of iQue Rx(TM) that can alert physicians and pharmacists to possible conflicts, drug interactions or medical insurance coverage qualification.

THE INTELLIQUE(TM) SYSTEM IS A SMART CARD ENABLED SECURED RECORD MANAGEMENT FRAMEWORK.

PKIQUE(TM) SMART CARD SECURED LOGIN SCHEMA

By using the PKIQUE(TM) solution, digital certificates can be access through the smart card and facilitate the transfer of private and public keys to the server. This method can also be used to create a smart card secured website access.

BIOIQUE: USER AUTHENTICATION BIOMETRIC INTERFACE

Using fingerprint verification, any new fingerprint scan sample can be compared to the stored fingerprint template (386 bytes) held on the card. This method provides 1 to 1 verification and eliminates the need to store prints on a centralized server, protecting individual's personal identities.

CONTROLIQUE: SYSTEM ADMINISTRATOR CARD TYPE DEPLOYMENT

Different card types create multiple gateways into the software, allowing controlled, and/or restricted access to sensitive information. As an added benefit, the interface can turn off features and procedures that are not relevant to the card user, reducing the software's complexity and technical support requirements.

APCIQUE: INFORMATION DATABASE PROFILING

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Using the Access Profile Control Interface (APCI) the IntelliQue(TM) environment can easily be configured to provide quick, real-time access to any database. The APCI environment creates a very flexible and GUI design method for view, editing and browsing important information.

CASHIQUE: E-PURSE WITH BACK-END PROCESSING & CARD MANAGEMENT SOLUTION

IntelliQue(TM) utilizes an e-purse solution that is CEPS compliant, allowing multiple purses and currencies to be stored on the same card. A complete on-line or off-line back-end settlement system supports the loading and exchange of funds. Their card issuance program is support by a 24/7 customer support team, which handles any card tracking problems and card re-issuance concerns.

The ability to provide proper identification of the patient is important. The iQue Rx(TM) system provides alternative identification options, including: voice print, fingerprint and photo identification. Two different photo resolution versions could be created at patient registration. The higher quality, size, and larger digital file size photo would be stored either on the workstation or server and the thumbprint (e.g., drivers license size) could be stored on the smart card.

Keeping a patient's medical history safe from computer intruders can be accomplished by having them carry their personal health records in a wallet or purse on smart cards or the new UltraCard. cQue believes that new media will change the way people think about prescription orders and medical records. Using secure encrypted data, smart cards (and soon UltraCards) allow physicians and other healthcare providers to create, maintain and update standardized patient medical information for use throughout the whole medical community on a tightly controlled "right-to-know" basis. This is accomplished through individual patient, pharmacist and physician personal smart cards (and soon UltraCards), read/write card terminals and high security cryptographic software globally tied together with the use of Internet and interlinked networks.

The smart card (and soon the UltraCard) contains the patient's emergency health details, established in compliance with most generally accepted American medical standards. The patient's general practitioner, who possesses a professional's card, may update the medical file, as permitted by legal standards. Read and write access to the patient's card is protected by the card-bearer's confidential code. The card also contains the name and address of the patient and even details of insurance coverage, if necessary. A special smart card reader (soon to be an UltraDrive) reads the card via the software application program.

Data storage space on the smart card is very limited, unlike the relatively larger storage capacity of the new UltraCard. Using existing smart cards, in order to use the space effectively and efficiently, literal data (text) is used sparingly. The Schlumberger 8K Cyberflex card, as an example, has only 8192 bytes of available EEPROM (non-volatile storage space). Such a card will only hold approximately 1-1/2 typewritten pages. The alternative to storing literal data, such as a personal physician's demographic information, is to provide a database table populated with this information for all relevant physicians and a reference number, or "key" for each one stored. This method requires much less space on the smart card than the literal data. A problem associated with this method occurs when the database is stored on a server. A connection to the server is required or some alternative method must be used to retrieve the literal data associated with a key. With the introduction of the UltraCard, the medical industry will be able to make portable in the form of literal data much more of the patient information, while also using additional UltraCard space to enhance data security.

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EFORNET CORPORATION

EforNet Corporation, a wholly-owned subsidiary of Upgrade, is a software and hardware development company focused upon the commercialization of smart card initiatives.

EforNet's objective has been to extend the high capacity, hard disk storage technology of the UltraCard by incorporating this technology into a new innovative smart card solution. Currently activities at EforNet are dormant.

GLOBAL CYBERSYSTEMS COMPANIES

Global Cybersystems Inc. is a Nevada Corporation which has licensed the sales and marketing rights to the UltraCard technology in the United States for retail and convenience applications, as well as banking. In addition the Company has been licensed the worldwide gaming applications.

Global Cybersystems PLC is a privately owned company based in London, England which is wholly owned by Global Cybersystems SA, a Swiss Company. The Companies have the exclusive rights to commercialize the UltraCard technology in Europe. The purpose of the company is to provide a variety of services including the distribution, trade and licensing of electronic data storage media, hardware, and software. Currently activities at Global Cybersystems are dormant.

ROCKSTER, INC. (TRANSACTION IN-PROCESS)

Rockster and Upgrade entered into a letter of intent dated December 11, 2000 pursuant to which Upgrade agreed to purchase 57% of Rockster's the outstanding capital stock. On March 6, 2001, the Company also entered into a letter of intent with Rockster Records, Inc. (Rockster Records) to acquire 10% of Rockster Records for total purchase price of \$2,000,000. The payments were to be made on or before April 30, 2001. No definitive agreement has been entered into by the parties. Upgrade has made substantial non-secured advances to Rockster there can be no assurance that the transaction will be consummated or that Upgrade will recover the advances made to Rockster.

ROCKSTER's primary focus is digital distribution and acquisition of intellectual properties. The underlying technology applied to distribute and acquire content is a magnet to both, artists and consumers. It protects and creates revenues for the artist and allows consumers to pay for materials exchanged among themselves. And all this can be done securely, anonymously, and most importantly, conveniently. Its peer-to-peer dynamic allows for fast dissemination of Rockster's technologies and content. Rockster's model is to build assets and generate income concurrently.

ROCKSTER has been structured to be a full service distribution entity incorporating new technologies, a record label, a music publishing division, and a production company.

THE TECHNOLOGY - Rockster has four products that when deployed will create a methodology for a complete solution of intellectual property distribution system. The products are: WebBouncer, WebCard, RightTrack and DEEVA.

WEBBOUNCER can catalogue every Web user in the world that's not unique for a Proxy Server. But, what's unique to WebBouncer is its Extra Intelligence that

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can encrypt this database and do 3 things with it:

BI-DIRECTIONAL SECURITY

Allows parents to prevent their kids from being exposed to undesirable materials that can be downloaded to their PCs. But, also it allows employers to control what goes out of their network and into the hands of the competition or strangers that have no business acquiring such information. It's an intelligent filter that works in both directions with data coming in and data going out.

BROWSE WITH COMPLETE ANONYMITY

Once your personal information is encrypted, no one can learn anything about you anymore, and you can choose to browse the web with complete anonymity. Your Internet pseudonym, say John Doe or Marie Jane, is all the Data Miners can collect on you. There is absolutely no footprints left behind your journey on the web - it's zero knowledge about what you do. If you don't break any laws, no one will ever know what you do or what you buy or what sites you visit when you browse the net.

INTERFACE WITH WEBCARD

The WebCard lies on top of your real information on the WebBouncer Server, but like WebBouncer, it allows you to go out click and buy without leaving any information behind for the digital vultures. Moreover, it makes the online shopping faster and more pleasant - you find a song (single track), a book, a shampoo, or whatever, just click and go. All the information that you need to buy is pre-set on the anonymous card, and therefore you no longer need to fill out forms, give credit card numbers, mother's maiden name, social security, etc.

RIGHTTRACK - a very significant technology. RightTrack embeds code (not fingerprint or watermark) into digital files. It does not matter if it is a song, an article, a music sheet, a video game, etc. Once encoded with this technology, such a file can be tracked on the web for various purposes. For example, a song can allow WebBouncer to collect money for the artist who wrote the song or for the writer of an article, and so on.

DEEVA - is an acronym for Dynamic Efficient E-commerce Virtual Agent. It causes every computer on the Internet to look and feel like a directory on your own computer. That's called a peer-to-peer network. Do you want to buy a rare stamp? Just fill out a simple form with specifics about the stamp, and how much you want to pay for it, and submit it. Anyone in the world selling that stamp will find you within seconds - voila you got your stamp. No more useless trips to e-bay, Yahoo!, or stamp sites on the Internet. And guess what? If the seller is a WebBouncer member with a WebCard you don't even have to talk money. His WebCard will be credited the amount upon which you both agreed, and your WebCard will be debited the same amount.

FOREIGN OPERATIONS

The Company does not engage in any operations in foreign countries.

PERSONNEL

As of September 30, 2001, the Company and its subsidiaries had 35 full time employees. The Company from time-to-time will contract with outside programmers, engineers and other data processing professionals, rather than hiring full-time staff. The employees are not represented by a collective bargaining unit, and the Company considers its relationship with its employees to be good. Rockster, Inc on September 30, 2001 had 3 full time equivalent

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employees.

ITEM 2. PROPERTIES

The following table sets forth information relating to each of the Company's offices as of September 30, 2001. The total net book value of the Company's premises and equipment (including land, building and leasehold improvements and furniture, fixtures and equipment) at September 30, 2001 was \$2.1 million.

PRINCIPAL BUSINESS OFFICE:

1411 Fourth Avenue, Suite 629, Seattle, Washington 98101

SUBSIDIARY OFFICES:

Ultracard, Inc.

980 University Ave., Los Gatos, California 95032 (effective January 11, 2001)

4101 Westerly Place, Suite 108, Newport Beach, California 92660

2220 Eastman, Suite 106, Ventura, California 93003 (closed October 2001)

cQue Corporation

10900 NE 8th Street, Suite 900, Bellevue, Washington 98004

EforNet

1411 Fourth Avenue, Suite 629, Seattle, Washington 98101

Rockster, Inc. (Transaction In-Process)

8820 Wilshire Blvd., Beverly Hills, California 90211

Upgrade and all its subsidiaries lease their facilities for various terms. Ultracard also owns a residence near the company's office which is used by management when necessary. The Company believes that all of its properties and equipment are well maintained, in good operating condition and adequate for all present and anticipated needs of the Company. The premises are adequately insured against perils consistent with industry standards.

ITEM 3. LEGAL PROCEEDINGS

Upgrade, its president, Daniel S. Bland, and Chief Operating & Financial Officer, Howard Jaffe, are defendants in The Pathways Group, Inc. v. Upgrade

International Corporation et al., Superior Court of the State of California in

for the County of Sonoma. The complaint, filed August 3, 2001, alleges breach of merger and collateral agreements between Upgrade and plaintiff, breach of oral agreement, fraud, and negligent material misrepresentation, and seeks specific performance of the agreements, and an injunction against exercising provisions pursuant to the merger agreement whereby Upgrade could obtain control of Pathways. Specifically, the complaint alleges that Upgrade failed to provide interim financing to Pathways pending consummation of the proposed merger transaction, and prevented Pathways from obtaining alternate sources of financing. Upgrade believes that the plaintiff's allegations are without legal

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or factual basis and intends to vigorously defend the lawsuit. Upgrade filed a

counterclaim against Pathways, its Board of Directors and executive officers, for moneys due and owing from funds advanced, fraud in the inducement as well as other misrepresentations made by Pathways to Upgrade. As a result, Upgrade recorded a provision for the advances made to Pathways in the event those amounts prove to be uncollectible.

Upgrade, its president, Daniel S. Bland, and Chief Operating & Financial Officer, Howard Jaffe, are defendants in Kenneth Donnelly v. Upgrade

International Corporation et al., Superior Court of the State of California in

for the County of Santa Clara, Cause No. CV801537. The complaint, filed September 18, 2001, alleges breach of employment contract, breach of oral argument, and false representations to induce relocation. Specifically, plaintiff alleges that Upgrade has failed to pay him employment wages. Upgrade believes that the plaintiff's allegations are without legal or factual basis and intends to vigorously defend the lawsuit.

Pursuant to a court order dated May 26, 2000, the three actions previously filed against Upgrade and its president, Daniel S. Bland, have been consolidated into one action, In Re Upgrade International Corporation Securities Litigation, U.S. District Court, Western District of Washington at Seattle, c/a #C00-0298. A Consolidated and Amended Class Action Complaint was filed July 24, 2000. Six minority shareholders are named as lead plaintiffs. The complaint alleges that material misrepresentations and omissions were made by Upgrade and Mr. Bland in violation of the Securities Exchange Act of 1934. Specifically, the complaint alleges that Upgrade and Mr. Bland made false statements regarding market readiness and technological capabilities of its UltraCard technology, thereby artificially inflating Upgrade's stock. The consolidated complaint seeks class certification and payment of unspecified damages and attorneys fees. Upgrade filed a motion to dismiss the complaint, which was affirmed by the court on February 9, 2001. Plaintiffs appealed the court's order to dismiss, and the defendants filed a cross appeal seeking sanctions. The parties entered into a stipulated agreement to dismiss their appeals; which closed this case.

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

On March 27, 2001, the Company held its Annual Meeting of Shareholders. The shareholders voted on and approved the following matters, with the voting results indicated:

Issue 1: Election of Directors:

| | | |
|--------------------------------------------------|------------|------------------------|
| Daniel S. Bland, Class 3 (term expiring 2004) | | |
| For: | 11,273,980 | Withheld Vote: 123,068 |
| Malcolm P. Burke, Class 3 (term expiring 2004) | | |
| For: | 11,277,580 | Withheld Vote: 119,468 |
| Ronald P. Erickson, Class 2 (term expiring 2003) | | |
| For: | 11,132,474 | Withheld Vote: 264,574 |
| Howard A. Jaffe, Class 2 (term expiring 2003) | | |
| For: | 11,271,930 | Withheld Vote: 125,118 |

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Issue 2: For approval of the Company's 2000 Omnibus Stock Option Plan:

| For | Against | Abstain | Broker Non-Votes |
|-----------|---------|---------|------------------|
| --- | ----- | ----- | ----- |
| 7,127,515 | 63,314 | 60,055 | 4,146,164 |

Issue 3: The appointment of Grant Thornton, L.L.P. as the Company's independent auditors for the fiscal year 2001:

| For | Against | Abstain | Other Non-Votes |
|------------|---------|---------|-----------------|
| --- | ----- | ----- | ----- |
| 11,353,455 | 13,801 | 29,792 | 9,758,113 |

PART II

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

The Company's common stock is traded on the OTC Bulletin Board Market under the symbol "UPGD" as well as the Frankfort Stock Exchange. The approximate number of stockholders of record of common stock as of January 8, 2002 was 388. Certain shares of the Company are held in "nominee" or "street" name and accordingly, the number of beneficial owners of such shares are not known or included in the foregoing number. Such shares are not separated to count actual beneficial owners. As of January 8, 2002 there were 41,282,802 shares of common stock outstanding. The following table presents quarterly market information for the Company's common stock for the fiscal year ended September 30, 2001:

| | MARKET LOW | PRICE HIGH | RANGE CLOSING |
|----------------------------------|---------------|---------------|------------------|
| ----- | ----- | ----- | ----- |
| FISCAL YEAR 2001 | | | |
| ----- | | | |
| Quarter ended September 30, 2001 | \$.57 | \$ 2.89 | \$ 1.37 |
| ----- | ----- | ----- | ----- |
| Quarter ended June 30, 2001 | \$ 2.20 | \$ 3.34 | \$ 2.31 |
| ----- | ----- | ----- | ----- |
| Quarter ended March 31, 2001 | \$ 1.63 | \$ 4.84 | \$ 3.34 |
| ----- | ----- | ----- | ----- |
| Quarter ended December 31, 2000 | \$ 2.38 | \$11.00 | \$ 2.66 |
| ----- | ----- | ----- | ----- |
| FISCAL YEAR 2000 | | | |
| ----- | | | |
| Quarter ended September 30, 2000 | \$ 9.13 | \$20.25 | \$ 9.91 |
| ----- | ----- | ----- | ----- |
| Quarter ended June 30, 2000 | \$ 8.00 | \$27.50 | \$ 14.88 |
| ----- | ----- | ----- | ----- |
| Quarter ended March 31, 2000 | \$ 17.50 | \$89.88 | \$ 23.94 |
| ----- | ----- | ----- | ----- |
| Quarter ended December 31, 1999 | \$ 3.00 | \$52.25 | \$ 40.50 |
| ----- | ----- | ----- | ----- |

During fiscal year 2001, the Company sold unregistered securities that have not previously been disclosed in its filings on Form 10-QSB as follows:

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On December 28, 2000, the Company granted to an officer/director of the Company options to purchase 575,000 shares of common stock at an exercise price of \$2.50 per share, 375,000 of which were exercisable immediately and the remaining 200,000 were to vest over a three-year period in equal increments of 8.33% every three months commencing on March 28, 2001. The options expire ten years from the date of grant.

In January, Upgrade issued 3,872 shares of common stock at a price of \$2.60 per share, warrants to purchase 4,840 shares of common stock at a price of \$2.60 per share, and warrants to purchase 7,744 shares of common stock at a price of \$3.00 per share as loan penalty fees. The issuances were exempt under Regulation S of the Securities Act of 1933 (the "Act").

In January, Upgrade issued 7,744 shares of common stock at a price of \$2.60 per share, warrants to purchase 9,680 shares of common stock at a price of \$2.60 per share, and warrants to purchase 15,488 shares of common stock at a price of \$3.00 per share as loan penalty fees. The issuances were exempt under Regulation S of the Act.

In January, Upgrade issued 3,872 shares of common stock at a price of \$2.60 per share, warrants to purchase 4,840 shares of common stock at a price of \$2.60 per share, and warrants to purchase 7,744 shares of common stock at a price of \$3.00 per share as loan penalty fees. The issuances were exempt under Regulation S of the Act.

In February, Upgrade issued 3,904 shares of common stock at a price of \$2.60 per share, warrants to purchase 4,880 shares of common stock at a price of \$2.60 per share, and warrants to purchase 7,808 shares of common stock at a price of \$3.00 per share as loan penalty fees. The issuances were exempt under Regulation S of the Act.

In February, Upgrade issued 7,422 shares of common stock at a price of \$2.74 per share, warrants to purchase 9,278 shares of common stock at a price of \$2.74 per share, and warrants to purchase 14,844 shares of common stock at a price of \$3.00 per share as loan penalty fees. The issuances were exempt under Regulation S of the Act.

In February, Upgrade issued 3,904 shares of common stock at a price of \$2.60 per share, warrants to purchase 4,880 shares of common stock at a price of \$2.60 per share, and warrants to purchase 7,808 shares of common stock at a price of \$3.00 per share as loan penalty fees. The issuances were exempt under Regulation S of the Act.

On March 27, 2001, the Company granted to officers and to board members options to purchase 600,000 shares of common stock at an exercise price of \$3.19, 400,000 of which vested immediately with the remaining options vesting in equal increments every three months commencing on June 30, 2001. The options expire ten years from the date of grant.

In March, Upgrade issued 5,754 shares of common stock at a price of \$1.78 per share, warrants to purchase 7,193 shares of common stock at a price of \$1.78 per share, and warrants to purchase 11,508 shares of common stock at a price of \$3.00 per share as loan penalty fees. The issuances were exempt under Regulation S of the Act.

In March, Upgrade issued 11,508 shares of common stock at a price of \$1.78 per share, warrants to purchase 14,386 shares of common stock at a price of \$1.78 per share, and warrants to purchase 23,017 shares of common stock at a price of \$3.00 per share as loan penalty fees. The issuances were exempt under Regulation S of the Act.

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In March, Upgrade issued 5,754 shares of common stock at a price of \$1.78 per share, warrants to purchase 7,193 shares of common stock at a price of \$1.78 per share, and warrants to purchase 11,508 shares of common stock at a price of \$3.00 per share as loan penalty fees. The issuances were exempt under Regulation S of the Act.

In April, Upgrade issued 4,448 shares of common stock at a price of \$2.32 per share, warrants to purchase 5,560 shares of common stock at a price of \$2.32 per share, and warrants to purchase 8,897 shares of common stock at a price of \$3.00 per share as loan penalty fees. The issuances were exempt under Regulation S of the Act.

In April, Upgrade issued 8,300 shares of common stock at a price of \$2.49 per share, warrants to purchase 10,375 shares of common stock at a price of \$2.49 per share, and warrants to purchase 16,600 shares of common stock at a price of \$3.00 per share as loan penalty fees. The issuances were exempt under Regulation S of the Act.

In April, Upgrade issued 4,448 shares of common stock at a price of \$2.32 per share, warrants to purchase 5,560 shares of common stock at a price of \$2.32 per share, and warrants to purchase 8,897 shares of common stock at a price of \$3.00 per share as loan penalty fees. The issuances were exempt under Regulation S of the Act.

In May, Upgrade issued 3,991 shares of common stock at a price of \$2.61 per share, warrants to purchase 4,989 shares of common stock at a price of \$2.61 per share, and warrants to purchase 7,982 shares of common stock at a price of \$3.00 per share as loan penalty fees. The issuances were exempt under Regulation S of the Act.

In May, Upgrade issued 8,669 shares of common stock at a price of \$2.40 per share, warrants to purchase 10,836 shares of common stock at a price of \$2.40 per share, and warrants to purchase 17,337 shares of common stock at a price of \$3.00 per share as loan penalty fees. The issuances were exempt under Regulation S of the Act.

In May, Upgrade issued 3,991 shares of common stock at a price of \$2.61 per share, warrants to purchase 4,989 shares of common stock at a price of \$2.61 per share, and warrants to purchase 7,982 shares of common stock at a price of \$3.00 per share as loan penalty fees. The issuances were exempt under Regulation S of the Act.

In June, Upgrade issued 4,667 shares of common stock at a price of \$2.25 per share, warrants to purchase 5,833 shares of common stock at a price of \$2.25 per share, and warrants to purchase 9,333 shares of common stock at a price of \$3.00 per share as loan penalty fees. The issuances were exempt under Regulation S of the Act.

In June, Upgrade issued 9,361 shares of common stock at a price of \$2.24 per share, warrants to purchase 11,701 shares of common stock at a price of \$2.24 per share, and warrants to purchase 18,722 shares of common stock at a price of \$3.00 per share as loan penalty fees. The issuances were exempt under Regulation S of the Act.

In June, Upgrade issued 4,667 shares of common stock at a price of \$2.25 per share, warrants to purchase 5,833 shares of common stock at a price of \$2.25 per share, and warrants to purchase 9,333 shares of common stock at a price of \$3.00 per share as loan penalty fees. The issuances were exempt under Regulation S of the Act.

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In July, Upgrade issued 6,412 shares of common stock at a price of \$2.08 per share, warrants to purchase 8,015 shares of common stock at a price of \$2.08 per share, and warrants to purchase 12,824 shares of common stock at a price of \$3.00 per share as loan penalty fees. The issuances were exempt under Regulation S of the Act.

In July, 2001, Upgrade issued 11,457 units at a price of \$1.76 per share as a loan penalty fee. Each unit contained one share and one warrant to acquire one additional share of common stock at the same price. In addition, as part of the loan penalty fee, Upgrade issued warrants to purchase 22,914 shares of common stock at a price of \$6.00 per share. The issuances were exempt under Regulation S of the Act.

In July, Upgrade issued 6,412 shares of common stock at a price of \$2.08 per share, warrants to purchase 8,015 shares of common stock at a price of \$2.08 per share, and warrants to purchase 12,824 shares of common stock at a price of \$3.00 per share as loan penalty fees. The issuances were exempt under Regulation S of the Act.

In July, Upgrade issued 17,599 shares of common stock at a price of \$1.88 per share, warrants to purchase 22,000 shares of common stock at a price of \$1.88 per share, and warrants to purchase 35,199 shares of common stock at a price of \$3.00 per share as loan penalty fees. The issuances were exempt under Regulation S of the Act.

In July, 2001, Upgrade issued 2,864 units at a price of \$1.76 per share as a loan penalty fee. Each unit contained one share and one warrant to acquire one additional share of common stock at the same price. In addition, as part of the loan penalty fee, Upgrade issued warrants to purchase 5,729 shares of common stock at a price of \$3.00 per share. The issuances were exempt under Regulation S of the Act.

In July, 2001, Upgrade issued 14,321 units at a price of \$1.76 per share as a loan penalty fee. Each unit contained one share and one warrant to acquire one additional share of common stock at the same price. In addition, as part of the loan penalty fee, Upgrade issued warrants to purchase 28,643 shares of common stock at a price of \$6.00 per share. The issuances were exempt under Rule 506 and Section 4(2) of the Act.

In July, Upgrade completed a private placement offering of 37,000 shares of its common stock at a price of \$2.00 per share for total proceeds of \$74,000. The offer and sale of securities was made pursuant to an exemption from registration under Regulation S of the Act, due to the foreign nationality of the investor.

In July, 2001, Upgrade issued 14,322 shares of its common stock at a price of \$1.56 per share as a loan penalty fee. The issuance was exempt under Rule 506 and Section 4(2) of the Act.

In August, 2001, Upgrade issued 23,534 shares of its common stock at a price of \$.96 per share as a loan penalty fee. The issuance was exempt under Rule 506 and Section 4(2) of the Act.

In August, Upgrade issued 15,316 shares of common stock at a price of \$1.27 per share, warrants to purchase 19,145 shares of common stock at a price of \$1.27 per share, and warrants to purchase 30,632 shares of common stock at a price of \$3.00 per share as loan penalty fees. The issuances were exempt under Regulation S of the Act.

In August, Upgrade issued 31,583 shares of common stock at a price of \$1.13 per share, warrants to purchase 39,479 shares of common stock at a price

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of \$1.13 per share, and warrants to purchase 63,167 shares of common stock at a

price of \$3.00 per share as loan penalty fees. The issuances were exempt under Regulation S of the Act.

In August, Upgrade issued 15,316 shares of common stock at a price of \$1.27 per share, warrants to purchase 19,145 shares of common stock at a price of \$1.27 per share, and warrants to purchase 30,632 shares of common stock at a price of \$3.00 per share as loan penalty fees. The issuances were exempt under Regulation S of the Act.

In August, 2001, Upgrade issued 20,312 units at a price of \$1.09 per share as a loan penalty fee. Each unit contained one share and one warrant to acquire one additional share of common stock at the same price. In addition, as part of the loan penalty fee, Upgrade issued warrants to purchase 45,624 shares of common stock at a price of \$6.00 per share. The issuances were exempt under Regulation S of the Act.

In August, 2001, Upgrade issued 23,242 units at a price of \$1.09 per share as a loan penalty fee. Each unit contained one share and one warrant to acquire one additional share of common stock at the same price. In addition, as part of the loan penalty fee, Upgrade issued warrants to purchase 46,483 shares of common stock at a price of \$6.00 per share. The issuances were exempt under Rule 506 and Section 4(2) of the Act.

In August, 2001, Upgrade issued 5,078 units at a price of \$1.09 per share as a loan penalty fee. Each unit contained one share and one warrant to acquire one additional share of common stock at the same price. In addition, as part of the loan penalty fee, Upgrade issued warrants to purchase 10,156 shares of common stock at a price of \$3.00 per share. The issuances were exempt under Regulation S of the Act.

In September, 2001, Upgrade issued 8,143 units at a price of \$.72 per share as a loan penalty fee. Each unit contained one share and one warrant to acquire one additional share of common stock at the same price. In addition, as part of the loan penalty fee, Upgrade issued warrants to purchase 16,285 shares of common stock at a price of \$3.00 per share. The issuances were exempt under Regulation S of the Act.

In September, Upgrade issued 44,333 shares of common stock at a price of \$.72 per share, warrants to purchase 55,416 shares of common stock at a price of \$.72 per share, and warrants to purchase 88,665 shares of common stock at a price of \$3.00 per share as loan penalty fees. The issuances were exempt under Regulation S of the Act.

In September, Upgrade issued 20,649 shares of common stock at a price of \$.81 per share, warrants to purchase 25,812 shares of common stock at a price of \$.81 per share, and warrants to purchase 41,299 shares of common stock at a price of \$3.00 per share as loan penalty fees. The issuances were exempt under Regulation S of the Act.

In September, 2001, Upgrade issued 40,712 units at a price of \$0.72 per share as a loan penalty fee. Each unit contained one share and one warrant to acquire one additional share of common stock at the same price. In addition, as part of the loan penalty fee, Upgrade issued warrants to purchase 81,426 shares of common stock at a price of \$6.00 per share. The issuances were exempt under Rule 506 and Section 4(2) of the Act.

In September, Upgrade issued 20,649 shares of common stock at a price of \$.81 per share, warrants to purchase 25,812 shares of common stock at a price

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of \$.81 per share, and warrants to purchase 41,299 shares of common stock at a price of \$3.00 per share as loan penalty fees. The issuances were exempt under Regulation S of the Act.

In September, 2001, Upgrade issued 32,571 units at a price of \$.72 per share as a loan penalty fee. Each unit contained one share and one warrant to acquire one additional share of common stock at the same price. In addition, as part of the loan penalty fee, Upgrade issued warrants to purchase 65,140 shares of common stock at a price of \$6.00 per share. The issuances were exempt under Regulation S of the Act.

In September, 2001, Upgrade completed a private placement offering of 1,600,000 shares of its common stock at a price of \$.70 per share for total proceeds of \$1,120,000. The offer and sale of securities was made pursuant to an exemption from registration under Regulation S of the Act, due to the foreign nationality of the investor.

In September, 2001, Upgrade issued 563,080 shares of its common stock at a price of \$.54 per share pursuant to the conversion of debentures. The issuance was exempt under Rule 506 and Section 4(2) of the Act.

In September, 2001, Upgrade issued 284,042 shares of its common stock at a price of \$.60 per share pursuant to the conversion of debentures. The issuance was exempt under Rule 506 and Section 4(2) of the Act.

In September, 2001, Upgrade issued 124,721 shares of its common stock at a price of \$1.30 per share as a penalty for failure to file a registration statement registering shares underlying warrants. The issuance was exempt under Rule 506 and Section 4(2) of the Act.

In September, 2001, Upgrade issued 7,126 shares of its common stock at a price of \$2.90 per share as a loan penalty fee. The issuance was exempt under Rule 506 and Section 4(2) of the Act.

In September, 2001, Upgrade issued 7,362 shares of its common stock at a price of \$2.83 per share as a loan penalty fee. The issuance was exempt under Rule 506 and Section 4(2) of the Act.

In September, 2001, Upgrade issued 9,052 shares of its common stock at a price of \$2.32 per share as a loan penalty fee. The issuance was exempt under Rule 506 and Section 4(2) of the Act.

In September, 2001, Upgrade issued 7,570 shares of its common stock at a price of \$2.73 per share as a loan penalty fee. The issuance was exempt under Rule 506 and Section 4(2) of the Act.

In September, 2001, Upgrade issued 8,573 shares of its common stock at a price of \$2.43 per share as a loan penalty fee. The issuance was exempt under Rule 506 and Section 4(2) of the Act.

In September, 2001, Upgrade issued 7,807 shares of its common stock at a price of \$2.69 per share as a loan penalty fee. The issuance was exempt under Rule 506 and Section 4(2) of the Act.

In September, 2001, Upgrade issued 1,000,000 shares of its common stock at a price of \$1.50 per share as prepayment of a financing fee; the share issuance is subject to cancellation in the event the financing does not close. The issuance was exempt under Rule 506 and Section 4(2) of the Act.

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In September, 2001, Upgrade completed a private placement offering of 200,000 shares of its common stock at a price of \$1.00 per share for total proceeds of \$200,000. The offer and sale of securities was made pursuant to an exemption from registration under Regulation S of the Act, due to the foreign nationality of the investor.

In September, 2001, Upgrade completed a private placement offering of 1,000,000 shares of its common stock at a price of \$.50 per share for total proceeds of \$500,000. The offer and sale of securities was made pursuant to an exemption from registration under Regulation S of the Act, due to the foreign nationality of the investor.

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

OF OPERATION

The following is a discussion and analysis of the Company's financial position and results of operation and should be read in conjunction with the information set forth under "General" in Item 1 and the consolidated financial statements and notes thereto appearing elsewhere in this report. Certain statements contained in this Annual Report on Form 10-KSB, including without limitation, statements containing the words "believes," "anticipates," "estimates," "expects," and words of similar import, constitute "forward looking statements." You should not place undue reliance on these forward looking statements. Our actual results could differ materially from those anticipated in these forward looking statements for many reasons, including the risks faced by us described in the Annual Report and in other documents we file with the Securities and Exchange Commission.

GENERAL

The Company is a development stage enterprise. The Company is devoting its present efforts into establishing a new business in the information technology industry and, is currently in the process of identifying markets and establishing applications for its technologies. The process of commercialization of the Company's core technology is focused upon the development of that core technology, the UltraCard and read/write device. In addition, the Company is in the process of acquiring strategically aligned businesses to facilitate certain applications of the Company's core technology. To date, no operating revenues have been generated. The Company's operations to date have consumed substantial and increasing amounts of cash. The Company's negative cash flow from operations is expected to continue and to accelerate in the foreseeable future. The development of the Company's technology and potential products will continue to require a commitment of substantial funds. The Company will need to raise substantial additional capital to fund its operations and may seek such additional funding through public or private equity or debt financing.

During 2001, equity investments has been increasing difficult reflecting the marketplace; therefore the Company has incurred a great deal of debt financing to meet its obligations during the year.

The Company's continued existence as a going concern is ultimately dependent upon its ability to secure additional funding for completing and marketing its technology and the success of its future operations. There can be no assurance that such additional funding will be available on acceptable terms, if at all.

Year ended September 30, 2001 compared to year ended September 30, 2000.

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Net losses aggregated \$30.2 million in the fiscal year ending September 30, 2001 compared with an \$17.4 million net loss for prior fiscal year. This increase in net loss reflects a continued and growing level of investment into the Company's technology, production processes and the development of commercialization of the Company's core technology. Research and development expenditures were approximately the same in the current fiscal year, \$6.4 million, compared to the prior year, \$6.8 million, indicating the continuing technology investment as the Company nears the completion of a

production ready product. The majority of the research and development expenses occurred at UltraCard in a concentrated effort to complete a commercialized version of its high memory capacity UltraCard and read write device. These expenditures reflect the Company's focused efforts upon completing its research and development initiatives, while at the same time, establishing production processes and specifications to facilitate the Company to engage others to produce the UltraCard and its read write device.

The other significant operating subsidiary cQue (formerly Centurion) contributed approximately 7% of the total loss reflecting both the allocation of limited resources along with the focus of the consolidated groups efforts to complete the UltraCard technology. All of the Company's research and development costs have been expensed as incurred.

As a result of the significant increase in debt financing to the Company, interest expense increased to \$5.7 million in the current fiscal year compared to \$1.0 million the previous year. The impact of higher costing funds to the Company is a reflection of the capital markets and resulting lack of investment activity that took place in 2001. As future investments in the Company permit, it is the intention of the Company to paydown on its high cost financings and debt.

During the fiscal year the Company announced that it had terminated the merger agreement with The Pathways Group. Advances to Pathways of over \$3.0 million were deemed potentially uncollectible and accordingly the Company has provided an allowance for collection of the amount due. The Company's advance to Pathways is collateralized by way of a general security over the Pathways assets. The Company plans to actively pursue collection.

Sales and marketing expenditures were \$1.6 million in the current fiscal year compared to \$2.0 million the previous year. Albeit modest, sales and marketing expenditures are associated with the Company's attendance at trade shows and industry awareness programs to enable the Company to build market awareness and to establish and develop new markets in preparation for an effective product launch when the Company completes the commercialization phase of development.

Year ended September 30, 2000 compared to year ended September 30, 1999.

Net losses from operations totaled \$17.4 million for the fiscal year ended September 30, 2000. This compares to a net loss of \$10.6 million for the year ended September 30, 1999. The loss reflects the Company's continuously growing level of investment into the Company's subsidiaries technologies, production processes and industrialization opportunities. The increase in the net loss as compared to the prior year is also attributable to the operations of the Company's subsidiaries whose operating results were included, primarily, using equity accounting prior to September 30, 1999. In addition, due to continuous losses incurred by the subsidiaries, the Company's minority interest was

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eliminated and all losses are now included in the net loss of the Company. The losses for the year ended September 30, 2000 borne by each subsidiary are as follows: Ultracard 42%, cQue Corporation (formerly Centurion) 15%, EforNet 11% and 32% the Company itself.

For all expense categories, changes are largely attributable to the aforementioned differences in inclusion of subsidiaries operating results and minority interest allocations in the fiscal year 2000 as compared to the fiscal year 1999. Other specific explanations by expense categories follow.

Direct research and development expenditures increased by \$5.7 million as compared to the fiscal year 1999. This increase is due primarily to costs incurred in developing UltraCard's technology. A significant portion of the increase was due to the addition of new personnel, prototype development and contracts with external research and development personnel.

All of the Company's research and development costs are expensed as incurred except for capitalized cost of research and development equipment that has alternative future uses. Research and development costs are expected to accelerate in order to meet anticipated market opportunities.

In an effort to establish the Company's market for UltraCard's technology and related products, and in order to augment internally developed research and development initiatives, the Company anticipates licensing technology from others, engaging others to develop components and/or acquiring other businesses with similar strategic focus.

General and administrative expenses have increased from \$2.0 to \$8.8 million. Included in expenses incurred during the year ended September 30, 2000, was a noncash compensation of approximately \$1 million in legal expenses incurred in connection with defending the Company against the outstanding class action lawsuit and approximately \$0.5 million in other contract costs. In addition, fiscal year 2000 general and administrative expenses include approximately \$1 million in legal and other professional costs incurred in conjunction with occurred and pending acquisitions. General and administrative costs are expected to continue to grow in the foreseeable future.

Sales and marketing expenditures increased to approximately \$2.0 million or 21% reflecting Company's trade show attendances and efforts to increase market awareness in anticipation of product launches.

In process research and development decreased in the fiscal year 2000 and compared to 1999 as majority of the acquisitions occurred during the year ended September 30, 1999.

Liquidity and Capital Resources

At September 30, 2001, cash and cash equivalents were approximately \$2.6 when compared to \$0.4 million as of September 30, 2000. However the increase in cash is reflective of the timing of a closing of a financing. The US and international economy, conditions of world capital markets, and other external factors impact the ability of the Company to raise capital. During the last year the capital markets willingness to invest in development companies has become more restrictive and limited the Company's ability to fund the financing agreements of the subsidiaries resulting in increased accounts payable balances. However the Company was able to secure other forms of financings rather than equity investment to meet its obligations throughout the year. During the year ended September 30, 2001, the Company did raise approximately \$15 million in privately placed equity, debt and other forms of financings. The Company's

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negative cash flow from operations is expected to continue. The Company does expect that its existing and expected financings will be adequate to satisfy the requirements of its current and planned operations until the end of the fiscal year 2002.

Subsequent to September 30, 2001, the Company raised an additional \$2.2 million through \$1.7 million in equity placements and \$.5 million in debt and convertible debenture placements.

The Company continues to devote extensive efforts in its ability to raise capital, including the identification of a significant number of new sources of capital.

Subsequent Events

Subsequent to the year end the Company has continued to fund operations through the issuance of both equity and debt securities. During the period October to December, 2001 the Company received \$1,108,705 from foreign investors in transactions exempt from registration under Regulation "S", private placement offering documents for the issuance of 2,217,410 shares at a price of \$0.50 per share. In addition warrants to acquire 1,567,410 shares at \$0.50 per share were issued in conjunction with the offerings.

Between September through November 2001 the Company received proceeds aggregating \$618,734 from a number of investors pursuant to both Regulation "S" and Rule 506 private placement offering documents for the issuance of 680,608 shares at a price of \$0.91 per share. The Regulation "S" offerings represent 66,275 shares with the balance of 614,333 being issued pursuant to Rule 506. In addition warrants to acquire an equal number of shares at \$0.91 per share were issued in conjunction with the offering.

During the period October to December 2001 the Company received proceeds pursuant to notes payable aggregating \$488,500. The notes have a term of 30 days, and bear interest at a rate of 10% per annum. In the event that the loans are not repaid on the maturity date, a penalty charge will be due and payable as follows;

10% of the unpaid principal and interest at the maturity date will be issued in common stock to the lender, calculated based upon the average trading price of the common stock of the Company on the loan maturity date.

Warrants to acquire common stock will be issued equal to 10% of the unpaid principal and interest at the loan maturity date issued at a strike price of the average trading price of the Company's common stock on the maturity date.

Additional warrants to acquire common stock will be issued equal to 20% of the unpaid principal and interest at the loan maturity date calculated at the current market issued at a strike price of \$3.00.

In the event that the loan principal and interest is not repaid, an additional penalty will become due and payable every 30 days following the maturity date.

This disclosure is not an offer to sell securities or a solicitation of an offer to buy securities. No money or other consideration is being solicited or will be accepted by way of this disclosure. Any public offer of the Company's common stock will be made only by means of a prospectus filed with the SEC.

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FORWARD LOOKING STATEMENTS

Statements made about the Company's future economic performance, strategic plans or objectives, revenues or earnings projections, or other financial items and similar statements are not guarantees of future performance, but are forward looking statements. By their nature, these statements are subject to numerous uncertainties that could cause actual results to differ materially from those in the statements. Important factors that might cause the Company's actual results to differ materially include, but are not limited to, the following:

- The Company's ability to continue the development of its products and services in a timely manner;
- The Company's ability to adapt successfully to technological changes;
- The Company's ability to access cost effective funding; and
- Changes in financial markets and general economic conditions.

SELECTED FINANCIAL DATA

The following table sets forth certain consolidated financial and other data of the Company at the dates and for the periods indicated. The information is derived in part from and should be read in conjunction with the Company's consolidated financial statements and notes thereto (dollars in thousands, except common share data):

| | YEAR ENDED SEPTEMBER, | | | | |
|-----------------------------------------------|-----------------------|----------|----------|---------|----------|
| | 2001 | 2000 | 1999 | 1998 | 1997 (1) |
| STATEMENT OF OPERATIONS DATA: | | | | | |
| Costs and expenses: | | | | | |
| Research and development | \$ 6,382 | \$ 6,834 | \$ 1,108 | \$ 209 | |
| Purchased in-process research and development | -0- | 426 | 5,122 | 424 | |
| Sales and marketing | 1,624 | 1,973 | 1,642 | -0- | |
| General and administrative | 11,783 | 8,771 | 1,972 | 404 | |
| | 19,789 | 18,004 | 9,844 | 1,037 | |
| Other expenses: | | | | | |
| Equity in losses of Ultracard | -0- | -0- | 1,088 | 177 | |
| Interest expense | 5,758 | 953 | 11 | -0- | |
| Other, net | 5,076 | 206 | 36 | (1) | |
| | 10,834 | 1,159 | 1,135 | 176 | |
| Minority interest in losses of subsidiaries | (453) | (1,759) | (356) | -0- | |
| Net Loss | \$30,170 | \$17,404 | \$10,624 | \$1,213 | |
| COMMON SHARE DATA: | | | | | |
| Basic and diluted loss per common | \$ 1.35 | \$ 0.93 | \$ 0.79 | \$ 0.15 | |

share

1. Upgrade commenced operations February 5, 1997, the results of operations during 1997 were negligible.

ITEM 7. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

Consolidated Financial Statements and Report of
Independent Certified Public Accountants

UPGRADE INTERNATIONAL CORPORATION AND
SUBSIDIARIES

(A development stage enterprise)

September 30, 2001 and 2000

C O N T E N T S

| | Page |
|----------------------------------------------------|------|
| STATEMENT OF MANAGEMENT RESPONSIBILITY | 2 |
| REPORT OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS | 2 |
| FINANCIAL STATEMENTS | |
| CONSOLIDATED BALANCE SHEETS | 2 |
| CONSOLIDATED STATEMENTS OF OPERATIONS | 2 |
| CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY | 2 |
| CONSOLIDATED STATEMENTS OF CASH FLOWS | 3 |
| NOTES TO CONSOLIDATED FINANCIAL STATEMENTS | 3 |

Statement of Management Responsibility

Upgrade International's management is responsible for the preparation, integrity and fair presentation of its published financial statements. The consolidated financial statement have been prepared in accordance with generally accepted accounting principles and, as such, include amounts based on judgments and estimates made by management. Management also prepared other information included in the annual report and is responsible for its accuracy and consistency with the consolidated financial statements.

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The consolidated financial statements have been audited by an independent accounting firm, Grant Thornton, LLP, which has been given unrestricted access to all financial records and related data, including minutes of all meetings of shareholders, the Board of Directors and committees of the Board. Management believes that representations made to the independent auditors during their audit were valid and appropriate.

Management maintains a system of internal controls over the preparation of its published financial statements, which is intended to provide reasonable assurance to the Company's Board of Directors and officers regarding preparation of financial statements presented fairly in conformity with generally accepted accounting principles.

Management has long recognized its responsibility for conducting the Company's affairs in a manner, which is responsive to the interest of employees, stockholders, investors and society in general. This responsibility is included in the statement of policy on ethical standards, which provides that the Company will fully comply with laws, rules and regulations of every community in which it operates and adhere to the highest ethical standards. Officers, employees and agents of the Company are expected and directed to manage the business of the Company with complete honesty, candor and integrity.

The Board, operating through its audit committee, which is composed entirely of directors who are not officers or employees of the Company, provides oversight to the financial reporting process.

Even effective internal controls, no matter how well designed, have inherent limitations, such as the possibility of human error or of circumvention or overriding of controls, and the consideration of cost in relation to benefit of a control. Further, the effectiveness of an internal control can change with circumstances.

Upgrade International's management periodically assesses the internal controls for inadequacy. Based upon these assessments, Upgrade International's management believes that, in all material respects, its internal controls relating to the preparation of the consolidated financial statements as of September 30, 2001 functioned effectively during the year ended September 30, 2001.

Daniel S. Bland
Chief Executive Officer

Howard A. Jaffe
Chief Financial Officer

Report of Independent Certified Public Accountants

Board of Directors
Upgrade International Corporation

We have audited the accompanying consolidated balance sheets of Upgrade International Corporation and Subsidiaries (a development stage enterprise) as of September 30, 2001 and 2000, and the related consolidated statements of operations, stockholders' equity (deficit) and cash flows for the years then ended and for the period from inception (February 5, 1997) to September 30, 2001. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these

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financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Upgrade International Corporation and Subsidiaries as of September 30, 2001 and 2000, and the results of their operations and their cash flows for the years then ended and for the period from inception (February 5, 1997) to September 30, 2001, in conformity with accounting principles generally accepted in the United States of America.

The accompanying financial statements have been prepared using generally accepted accounting principles assuming that the Company will continue as a going concern. As discussed in note B to the financial statements, the Company has incurred substantial losses in each of the two years ended September 30, 2001 which raises substantial doubt about its ability to continue as a going concern. Management's plans in regards to their planned financings and other matters are also described in note B. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

/s/ Grant Thornton LLP

Seattle, Washington
January 7, 2002

Upgrade International Corporation and Subsidiaries (A development stage enterprise)

CONSOLIDATED BALANCE SHEETS

| | September 30, | |
|---------------------------------------------------------|---------------|------------|
| | 2001 | 2000 |
| CURRENT ASSETS | | |
| Cash | \$ 2,551,465 | \$ 398,989 |
| Restricted deposit | 300,000 | 805,687 |
| Subscriptions receivable | 500,000 | 32,725 |
| Note receivable from related party | 135,243 | - |
| Prepaid expenses, deposits and other | 110,022 | 121,491 |
| Total current assets | 3,596,730 | 1,358,892 |
| PROPERTY AND EQUIPMENT - AT COST, | | |
| less accumulated depreciation and amortization | 2,071,663 | 1,791,257 |
| SPUTTERING MACHINE, held for sale at September 30, 2001 | 2,000,000 | 3,301,625 |

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| | | |
|-----------------------------------------------------------------|---------------|--------------|
| ADVANCES TO THE PATHWAYS GROUP, INC. | - | 1,900,825 |
| ADVANCES TO ROCKSTER GROUP | 1,084,000 | - |
| OTHER ASSETS | | |
| Intangible and deferred assets, net of accumulated amortization | 466,256 | 370,206 |
| Acquisition deposits | 1,820,715 | - |
| Other deposits | 194,128 | 328,051 |
| | ----- | ----- |
| Total assets | \$ 11,233,492 | \$ 9,050,856 |
| | ===== | ===== |
| LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIT) | | |
| CURRENT LIABILITIES | | |
| Accounts payable | \$ 3,853,950 | \$ 1,993,796 |
| Payable to related parties | 5,503,022 | 175,240 |
| Accrued liabilities | 2,972,713 | 733,241 |
| Bridge loans | - | 799,177 |
| Notes payable | 1,717,231 | - |
| Equipment purchase contract payable | 2,024,748 | 2,307,025 |
| Royalty fee payable to Card Tech, Inc. | 1,161,873 | 487,500 |
| | ----- | ----- |
| Total current liabilities | 17,233,537 | 6,495,979 |
| CONVERTIBLE DEBENTURES, net of unamortized discount | 2,004,488 | 809,043 |
| MINORITY INTEREST | 1,473,179 | - |
| COMMITMENTS AND CONTINGENCIES | - | - |
| STOCKHOLDERS' EQUITY (DEFICIT) | | |
| Common stock - \$.001 par value, 100,000,000 shares authorized | 24,524 | 20,341 |
| Stock subscriptions | 2,742,586 | 323,640 |
| Additional paid in capital | 53,947,618 | 36,925,837 |
| Deferred compensation | (498,559) | - |
| Receivable from stockholders of subsidiary | (266,621) | (266,621) |
| Accumulated development stage deficit | (65,427,260) | (35,257,363) |
| | ----- | ----- |
| | (9,477,712) | 1,745,834 |
| | ----- | ----- |
| Total liabilities and stockholders' equity (deficit) | \$ 11,233,492 | \$ 9,050,856 |
| | ===== | ===== |

The accompanying notes are an integral part of these statements.

Upgrade International Corporation and Subsidiaries
(A development stage enterprise)

CONSOLIDATED STATEMENTS OF OPERATIONS

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| | Year ended September 30, | | Cumulative results of operations since inception |
|-----------------------------------------------|--------------------------|--------------|--------------------------------------------------|
| | 2001 | 2000 | (February 5, 1997) |
| Costs and expenses | | | |
| Research and development | \$ 6,381,731 | \$ 6,834,508 | \$ 14,532,403 |
| Purchased in-process research and development | - | 425,800 | 5,971,603 |
| Sales and marketing | 1,623,842 | 1,972,838 | 5,238,805 |
| General and administrative | 11,782,650 | 8,770,862 | 22,930,657 |
| | 19,788,223 | 18,004,008 | 48,673,468 |
| Other expenses | | | |
| Equity in losses of UltraCard | - | - | 1,264,316 |
| Interest expense | 5,758,307 | 953,286 | 6,722,301 |
| Loss on advances to Pathways | 3,549,780 | | 3,549,780 |
| Other, net | 1,526,252 | 205,787 | 1,768,400 |
| | 10,834,339 | 1,159,073 | 13,304,797 |
| Minority interest in losses of subsidiaries | (452,665) | (1,759,091) | (2,567,800) |
| NET LOSS | \$30,169,897 | \$17,403,990 | \$ 59,410,465 |
| LOSS PER COMMON SHARE-BASIC AND DILUTED | \$ 1.35 | \$ 0.93 | \$ 4.53 |

The accompanying notes are an integral part of these statements.

Upgrade International Corporation and Subsidiaries
(A development stage enterprise)

STATEMENT OF STOCKHOLDERS' EQUITY (DEFICIT)

Since inception through September 30, 2001

| | Voting common stock | | Common stock subscribed | | Additional paid-in capital |
|--------------------------------------------------------------------------------|---------------------|--------|-------------------------|--------|----------------------------|
| | Shares | Amount | Shares | Amount | |
| Balance at February 5, 1997 | - | \$ - | - | \$ - | - |
| Issuance of founder's shares at \$.03 per share in February 1997 adjusted for | | | | | |

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| | | | | | |
|-----------------------------------------------------------------------------------------------------------------|------------|--------|-------------|-----------|----------|
| December 1997 1:2 reverse stock split | 500,000 | 500 | - | - | 29,500 |
| Issuance of common stock in February 1997 at \$.10 per share adjusted for December 1997 1:2 reverse stock split | 29,000 | 29 | - | - | 5,771 |
| Issuance of common stock at \$.0025 per share in December 1997 Reg. D Rule 504 offering | 4,000,000 | 4,000 | - | - | 6,000 |
| Issuance of common stock in December 1997 to an officer in exchange for property contribution | 4,000,000 | 4,000 | - | - | 47,250 |
| Sale of common stock at \$.50 per share in January 1998 Reg. D Rule 504 offering | 1,680,988 | 1,681 | - | - | 838,813 |
| Common stock subscribed in September 1998 at \$.065 per share | - | - | 2,250,000 | 146,250 | - |
| Net loss for the year ended September 30, 1998 | - | - | - | - | - |
| Balances at September 30, 1998 | 10,209,988 | 10,210 | 2,250,000 | 146,250 | 927,334 |
| Issuance of subscribed shares in November 1998 Reg. D Rule 504 offering | 2,250,000 | 2,250 | (2,250,000) | (146,250) | 144,000 |
| Issuance of common stock in January 1999 to satisfy trade liabilities | 437,500 | 438 | - | - | 103,312 |
| Issuance of common stock warrants at \$.25 per share in January 1999 | - | - | - | - | 221,000 |
| Common stock subscribed at \$1.80 per share in February 1999 private placement | - | - | 999,999 | 1,799,998 | - |
| Issuance of common stock warrants for services in August 1999 | - | - | - | - | 64,155 |
| Common stock subscribed at \$.25 per share in August 1999 through exercise of common stock warrants | - | - | 27,500 | 71,030 | (64,155) |
| Issuance of common stock warrants and options at exercise prices of \$.25 and \$2.50 per share in | | | | | |

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| | | | | | |
|---------------------------------------------------------------------------------------------------------------------|--------|-------------|---|---|---------|
| September 1999 for services | - | - | - | - | 671,893 |
| Issuance of common stock at \$.25 per share in September 1999 through exercise of employee stock options | 60,000 | 60 | - | - | 14,940 |
| | Total | | | | |
| | ----- | | | | |
| Balance at February 5, 1997 | \$ | - | | | |
| Issuance of founder's shares at \$.03 per share in February 1997 adjusted for December 1997 1:2 reverse stock split | | 30,000 | | | |
| Issuance of common stock in February 1997 at \$.10 per share adjusted for December 1997 1:2 reverse stock split | | 5,800 | | | |
| Issuance of common stock at \$.0025 per share in December 1997 Reg. D Rule 504 offering | | 10,000 | | | |
| Issuance of common stock in December 1997 to an officer in exchange for property contribution | | 51,250 | | | |
| Sale of common stock at \$.50 per share in January 1998 Reg. D Rule 504 offering | | 840,494 | | | |
| Common stock subscribed in September 1998 at \$.065 per share | | 146,250 | | | |
| Net loss for the year ended September 30, 1998 | | (1,213,530) | | | |
| | ----- | | | | |
| Balances at September 30, 1998 | | (129,736) | | | |
| Issuance of subscribed shares in November 1998 Reg. D Rule 504 offering | | - | | | |
| Issuance of common stock in January 1999 to satisfy trade liabilities | | 103,750 | | | |
| Issuance of common stock warrants at \$.25 per share in | | | | | |

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| | |
|-------------------------------------------------------------------------------------------------------------------------------|-----------|
| January 1999 | 221,000 |
| Common stock subscribed at \$1.80 per share in February 1999 private placement | 1,799,998 |
| Issuance of common stock warrants for services in August 1999 | 64,155 |
| Common stock subscribed at \$.25 per share in August 1999 through exercise of common stock warrants | 6,875 |
| Issuance of common stock warrants and options at exercise prices of \$.25 and \$2.50 per share in September 1999 for services | 671,893 |
| Issuance of common stock at \$.25 per share in September 1999 through exercise of employee stock options | 15,000 |

Continued

Upgrade International Corporation and Subsidiaries
(A development stage enterprise)

CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY (DEFICIT) - Contin

Since inception through September 30, 2001

| | Voting common stock | | Common stock subscribed | | Additional paid-in capital | Defe Comp sati |
|-----------------------------------------------------------------------------------------------------------------------------|---------------------|--------|-------------------------|------------|----------------------------|----------------------|
| | Shares | Amount | Shares | Amount | | |
| Common shares subscribed at \$2.50 per share in September 1999 | - | - | 4,189,434 | 10,473,585 | - | |
| Receivable from UltraCard stockholders for payroll taxes and related charges inconnection with stock issued by UltraCard as | | | | | | |

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| | | | | | |
|---------------------------------------------------------------------------------------------------------------------------------------------------------------|------------|--------|-------------|--------------|------------|
| compensation | - | - | - | - | - |
| Net loss for the year ended September 30, 1999 | - | - | - | - | - |
| Balances at September 30, 1999 | 12,957,488 | 12,958 | 5,216,933 | 12,344,613 | 2,082,479 |
| Common shares subscribed by a broker at \$2.50 per share in October 1999 in connection with placement of \$1 million in convertible debentures | - | - | 16,000 | 40,000 | (40,000) |
| Issuance of common stock warrants with a strike price of \$.25 per share in October 1999 | - | - | - | - | 339,500 |
| Issuance of subscribed Shares in November 1999 | 999,999 | 1,000 | (999,999) | (1,799,998) | 1,798,998 |
| Issuance of common shares , including shares subscribed, in November 1999 at \$2.50 per share, net of expenses | 4,652,281 | 4,652 | (4,045,583) | (10,113,957) | 11,521,038 |
| Common shares subscribed by a broker at \$2.50 per share in November 1999 in connection November 1999 private placements | - | - | 24,000 | 60,000 | (60,000) |
| Issuance of common stock at \$.25 per share in December 1999 through exercise of employee stock options | 90,000 | 90 | - | - | 22,410 |
| Common shares issued for services in December 1999 | 70,000 | 70 | - | - | 242,830 |
| Allocation of debenture proceeds to beneficial conversion feature | - | - | - | - | 676,360 |
| Allocation of debenture proceeds to stock warrants | - | - | - | - | 323,640 |
| Issuance of common stock at \$44 per share in January 2000 through a private placement, net of expenses | 100,000 | 100 | - | - | 4,289,900 |

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| | | | | | |
|---------------------------------------------------------------------------------------------------------------------------------------------------------------|---------|-----|---|--------------|------------|
| Issuance of common stock at \$.25 and \$2.50 per share in February 2000 through exercise of stock warrants | 294,449 | 295 | - | - | 304,046 |
| | | | | Total | |
| | | | | ----- | |
| Common shares subscribed at \$2.50 per share i September 1999 | | | | | 10,473,585 |
| Receivable from UltraCard stockholders for payroll taxes and related charges inconnection with stock issued by UltraCard as compensation | | | | (400,000) | |
| Net loss for the year ended September 30, 1999 | | | | (10,623,048) | |
| | | | | ----- | |
| Balances at September 30, 1999 | | | | | 2,203,472 |
| Common shares subscribed by a broker at \$2.50 per share in October 1999 in connection with placement of \$1 million in convertible debentures | | | | | - |
| Issuance of common stock warrants with a strike price of \$.25 per share in October 1999 | | | | | 339,500 |
| Issuance of subscribed Shares in November 1999 | | | | | - |
| Issuance of common shares , including shares subscribed, in November 1999 at \$2.50 per share, net of expenses | | | | | 1,411,733 |
| Common shares subscribed by a broker at \$2.50 per share in November 1999 in connection November 1999 private placements | | | | | - |
| Issuance of common stock at \$.25 per share in December 1999 through exercise of | | | | | |

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| | |
|------------------------------------------------------------------------------------------------------------|-----------|
| employee stock options | 22,500 |
| Common shares issued for services in December 1999 | 242,900 |
| Allocation of debenture proceeds to beneficial conversion feature | 676,360 |
| Allocation of debenture proceeds to stock warrants | 323,640 |
| Issuance of common stock at \$44 per share in January 2000 through a private placement, net of expenses | 4,290,000 |
| Issuance of common stock at \$.25 and \$2.50 per share in February 2000 through exercise of stock warrants | 304,341 |

Continued

Upgrade International Corporation and Subsidiaries
(A development stage enterprise)

CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY (DEFICIT) - Continued

Since inception through September 30, 2001

| | Voting common stock | | Common stock subscribed | | Additional paid-in capital | Deferr compen sation |
|------------------------------------------------------------------------------------------------------------------|---------------------|--------|-------------------------|----------|----------------------------|----------------------------|
| | Shares | Amount | Shares | Amount | | |
| Issuance of common stock in February 2000 subscribed to in August 1999 through exercise of common stock warrants | 27,500 | 27 | (27,500) | (71,030) | 71,003 | |
| Issuance of common stock in April 2000 in connection with reverse acquisition of Second CMA, Inc. | 45,000 | 45 | - | - | 1,155 | |
| Issuance of common stock options with a strike price of \$10.00 per share | | | | | | |

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| | | | | | |
|--------------------------------------------------------------------------------------------------------------|---------|-----|-----------|-----------|-----------|
| in April 2000 for legal services | - | - | - | - | 1,047,670 |
| Issuance of common stock at \$10 per share in April 2000 through a private placement, net of expenses | 50,000 | 50 | - | - | 449,950 |
| Issuance of common stock at \$11.31 per share in May 2000 through a private placement, net of expenses | 80,000 | 80 | - | - | 859,480 |
| Common shares subscribed to through a cashless exercise of common stock warrants in May 2000 | - | - | 102,609 | 323,640 | (323,640) |
| Issuance of common stock at \$2.50 per share in June 2000 through exercise of stock warrants | 91,878 | 92 | - | - | 229,603 |
| Issuance of common stock at \$10.48 per share in July 2000 through a private placement | 160,000 | 160 | - | - | 1,676,640 |
| Issuance of common stock at \$.25 and \$2.50 per share in July 2000 through exercise of stock warrants | 130,000 | 130 | - | - | 156,120 |
| Distribution of common stock warrants on August 16, 2000 | - | - | - | - | 6,016,795 |
| Issuance of common stock at \$12.25 per share in September 2000 through a private placement, net of expenses | 408,164 | 408 | - | - | 4,899,301 |
| Issuance of common stock in September 2000 subscribed in September 1999 | 143,851 | 144 | (143,851) | (359,628) | 359,484 |
| Issuance of common stock in September 2000 subscribed in October and November of 1999 | 40,000 | 40 | (40,000) | (100,000) | 99,960 |
| Adjustment to market of options granted for services in April 2000 | - | - | - | - | (118,885) |
| Adjustment to receivable from subsidiary's | | | | | |

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| | | | | | |
|---------------------------------------------------------------------------------------------------------------------------------|------------|-----------|---------|---------|------------|
| stockholders | - | - | - | - | - |
| Net loss for the year ended September 30, 2000 | - | - | - | - | - |
| Balances at September 30, 2000 | 20,340,610 | \$ 20,341 | 102,609 | 323,640 | 36,925,837 |
| | Total | | | | |
| | ----- | | | | |
| Issuance of common stock in February 2000 subscribed to in August 1999 through exercise of common stock warrants | - | | | | |
| Issuance of common stock in April 2000 in connection with reverse acquisition of Second CMA, Inc. | 1,200 | | | | |
| Issuance of common stock options with a strike price of \$10.00 per share in April 2000 for legal services | 1,047,670 | | | | |
| Issuance of common stock at \$10 per share in April 2000 through a private placement, net of expenses | 450,000 | | | | |
| Issuance of common stock at \$11.31 per share in May 2000 through a private placement, net of expenses | 859,560 | | | | |
| Common shares subscribed to through a cashless exercise of common stock warrants in May 2000 | - | | | | |
| Issuance of common stock at \$2.50 per share in June 2000 through exercise of stock warrants | 229,695 | | | | |
| Issuance of common stock at \$10.48 per share in July 2000 through a private placement | 1,676,800 | | | | |
| Issuance of common stock at \$.25 and \$2.50 per share in July 2000 through | | | | | |

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| | |
|--------------------------------------------------------------------------------------------------------------|--------------|
| exercise of stock warrants | 156,250 |
| Distribution of common stock warrants on August 16, 2000 | - |
| Issuance of common stock at \$12.25 per share in September 2000 through a private placement, net of expenses | 4,899,709 |
| Issuance of common stock in September 2000 subscribed in September 1999 | - |
| Issuance of common stock in September 2000 subscribed in October and November of 1999 | - |
| Adjustment to market of options granted for services in April 2000 | (118,885) |
| Adjustment to receivable from subsidiary's stockholders | 133,379 |
| Net loss for the year ended September 30, 2000 | (17,403,990) |
| | ----- |
| Balances at September 30, 2000 | 1,745,834 |

Upgrade International Corporation and Subsidiaries
(A development stage enterprise)

STATEMENT OF STOCKHOLDERS' EQUITY (DEFICIT)

Year ended September 30, 2001

| | Voting common stock | | Common stock subscribed | | Additional paid-in Capital |
|-----------------------------|---------------------|----------|-------------------------|------------|----------------------------|
| | Shares | Amount | Shares | Amount | |
| Balances at October 1, 2000 | 20,340,610 | \$20,341 | 102,609 | \$ 323,640 | \$36,925,837 |
| Issuance of shares in | | | | | |

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| | | | | | |
|-----------------------------------------------------------------------------------------------------------|---------|-----|-----------|-----------|-----------|
| October 2000 subscribed to shares in May 2000 | 102,609 | 102 | (102,609) | (323,640) | 323,538 |
| Issuance of common shares at \$10.50 per share in October 2000, net of costs | 142,860 | 143 | - | - | 1,349,857 |
| Shares subscribed to at \$3.12 and \$6.00 per share in October 2000, net of costs | - | - | 258,333 | 1,070,000 | (100,000) |
| Allocation of debenture proceeds to common stock | 167,768 | 168 | - | - | 444,435 |
| Allocation of debenture proceeds to common stock warrants | - | - | - | - | 829,551 |
| Allocation of debenture proceeds to beneficial conversion feature | - | - | - | - | 1,051,096 |
| Allocation of promissory note proceeds to common stock | 40,000 | 40 | - | - | 136,167 |
| Common stock subscribed to at \$4.00 per share in December 2000 | - | - | 125,000 | 500,000 | - |
| Common shares subscribed at \$2.00 per share in December 2000, net of issuance costs | - | - | 389,129 | 778,257 | (102,208) |
| Common shares subscribed in December 2000 at \$0.25 through the exercise of stock warrants | - | - | 20,000 | 5,000 | - |
| Issuance of common shares at \$2.02 per share pursuant to conversion of debenture | 107,981 | 108 | - | - | 218,014 |
| Issuance of common shares subscribed pursuant to warrant exercise at \$0.25 per share | - | - | 200,000 | 50,000 | - |

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| | | | | | |
|-----------------------------------------------------------------------------------------------------------|---------|-----|-----------|-----------|-----------|
| Shares subscribed to at \$2.50 per share in January 2001, net of costs | - | - | 200,000 | 500,000 | (50,000) |
| Modification of warrants | - | - | - | - | 2,414,000 |
| Issuance of common shares at \$1.43 per share pursuant to conversion of debentures | 307,509 | 307 | - | - | 438,049 |
| Shares subscribed to at \$2.50 per share in February 2001 net of costs | - | - | 80,000 | 200,000 | (20,000) |
| Common shares subscribed at \$3.75 per share as additional consideration on debt | - | - | 16,267 | 61,001 | - |
| Common shares subscribed at \$3.31 as additional consideration on debt | - | - | 18,429 | 61,001 | - |
| Common stock issued in March 2001 for shares previously subscribed | 253,334 | 254 | (253,334) | (925,000) | 924,746 |
| Warrants issued with a strike price of \$6.00 per share as additional compensation on debt | - | - | - | - | 7,708 |
| Warrants issued with a Strike price of \$3.75 per share as additional compensation on debt | - | - | - | - | 14,659 |
| Warrants issued with a Strike price of \$3.31 per share as additional compensation on debt | - | - | - | - | 12,715 |
| Issuance of common shares subscribed at \$2.00 per share net of financing costs | - | - | 806,073 | 1,612,146 | (5,000) |

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| | | | | | |
|-----------------------------------------------------------------------------------------------------------------------------------|-----------|-------|-------------|-------------|-----------|
| Placement fees accrued on prior financings | | | | | (831,133) |
| Allocation of debenture Proceeds to beneficial Conversion feature | - | - | - | - | 790,369 |
| Adjustment to remeasurement of attorney stock options | - | - | - | - | (510,315) |
| Issuance of common Stock in April for shares previously subscribed | 1,606,721 | 1,607 | (1,606,721) | (3,703,442) | 3,701,835 |
| Common stock subscribed at \$2.00 per share in April | - | - | 15,000 | 30,000 | - |
| Common stock subscribed at \$1.74 per share pursuant to conversion of debentures in June 2001 | - | - | 12,784 | 22,203 | - |
| Common stock subscribed at \$2.70 per share in connection with debt in June 2001 | - | - | 50,000 | 106,299 | - |
| Common stock subscribed at \$2.32 to \$2.83 per share from April through June 2001 as Additional financing fees | - | - | 47,490 | 125,000 | - |
| Shares issued pursuant to conversion of debentures at \$1.25 per share | 82,000 | 82 | - | - | 102,418 |
| Shares issued pursuant to conversion of debentures at \$1.74 | 115,606 | 116 | - | - | 200,692 |
| Shares issued pursuant to conversion of debentures at \$1.00 | 29,433 | 29 | - | - | 29,404 |
| Shares issued in April, 2001 for \$2.00 per share pursuant to private placement net of stock issue costs | 375,000 | 375 | - | - | 649,625 |

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| | | | | | |
|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------|-----|-----------|-----------|-----------|
| Issuance of warrants issued at \$2.03 to \$3.75 as additional financing fees | - | - | - | - | 1,383,353 |
| Allocation of debenture proceeds to beneficial conversion feature | - | - | - | - | 281,843 |
| Allocation of debenture proceeds to cashless exercise warrants | - | - | - | - | 48,487 |
| Common stock subscribed in lieu of loan origination fees | - | - | 50,000 | 145,000 | - |
| Common stock issued at \$3.19 per share from April through June 2001 as additional financing fees | 53,185 | 53 | - | - | 169,474 |
| Common stock subscribed at \$0.54 per share pursuant to conversion of debentures in September 2001 | - | - | 563,080 | 304,063 | - |
| Common stock subscribed at \$0.60 per share pursuant to conversion of debentures in September 2001 | - | - | 284,042 | 170,425 | - |
| Common stock subscribed at \$1.30 in September 2001 to satisfy penalty on late filing of the Registration Statement with the SEC for conversion shares in connection with convertible debt agreements dated November 2000. | - | - | 124,721 | 162,141 | - |
| Common stock issued in July 2001 for shares previously subscribed | 262,784 | 263 | (262,784) | (178,506) | 178,243 |
| Common stock issued at \$2.70 per share in June 2001 in lieu of loan origination fee | 50,000 | 50 | - | - | 134,950 |
| Common stock subscribed At \$2.00 per share in July 2001 | - | - | 37,000 | 74,000 | - |
| Common stock subscribed At \$1.00 per share in September 2001 | - | - | 200,000 | 200,000 | - |
| Common stock subscribed At \$0.50 per share in | | | | | |

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| | | | | | |
|------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------|----------|-----------|--------------|--------------|
| September 2001 | - | - | 1,000,000 | 500,000 | - |
| Common stock issued at \$0.72 to \$2.08 per share from July through September 2001 as additional finance fees | 363,432 | 363 | - | - | 361,774 |
| Common stock issued in September 2001 for shares Previously subscribed | 82,186 | 82 | (82,186) | (247,002) | 246,920 |
| Common stock issued at \$1.98 per share in July 2001 for late issuance of debt converted in June 2001 | 2,649 | 3 | - | - | 5,242 |
| Common stock issued at \$1.56 per share in July 2001 for prepaid debt penalty | 14,322 | 14 | - | - | 22,328 |
| Common stock issued at \$0.96 per share in August 2001 as prepaid debt penalty | 23,534 | 24 | - | - | 22,569 |
| Warrants issued between July and September 2001, with exercise price from \$0.72 to \$6.00, as additional financing fees | - | - | - | - | 828,602 |
| Adjustment of warrants Issued between January and June 2001 as a result of Settlement agreement dated June 2001 regarding Additional finance fees | - | - | - | - | (559,273) |
| Warrants issued in August 2001 with exercise price of \$1.00 in connection with debt | - | - | - | - | 114,484 |
| Stock option issued to Employees below fair Market value on March 27, 2001 | - | - | - | - | 1,762,563 |
| Common stock subscribed On September 26, 2001 At \$0.70 per share | - | - | 1,600,000 | 1,120,000 | - |
| Net loss for the year ended September 30, 2001 | - | - | - | - | - |
| | ----- | ----- | ----- | ----- | ----- |
| Balances September 30, 2001 | 24,523,523 | \$24,524 | 3,892,323 | \$ 2,742,586 | \$53,947,618 |
| | ===== | ===== | ===== | ===== | ===== |

Accumulated

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| | Development stage deficit | Total |
|-----------------------------------------------------------------------------------------------------------|---------------------------------|-----------|
| | ----- | ----- |
| Balances at October 1, 2000 | \$(35,257,363) | 1,745,834 |
| Issuance of shares in October 2000 subscribed to shares in May 2000 | - | - |
| Issuance of common shares at \$10.50 per share in October 2000, net of costs | - | 1,350,000 |
| Shares subscribed to at \$6.00 per share in October 2000, net of costs | - | 970,000 |
| Allocation of debenture proceeds to common stock | - | 444,603 |
| Allocation of debenture proceeds to common stock warrants | - | 829,551 |
| Allocation of debenture proceeds to beneficial conversion feature | - | 1,051,096 |
| Allocation of promissory note proceeds to common stock | - | 136,207 |
| Common stock subscribed to at \$4.00 per share in December 2000 | - | 500,000 |
| Common shares subscribed at \$2.00 per share in December 2000, net of issuance costs | - | 676,049 |
| Common shares subscribed in December 2000 at \$0.25 through the exercise of stock warrants | - | 5,000 |
| Issuance of common shares at \$2.02 per | | |

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| | | |
|--------------------------------------------------------------------------------------------|---|-----------|
| share pursuant to conversion of debenture | - | 218,122 |
| Issuance of common shares pursuant to warrant exercise at \$0.25 per share | - | 50,000 |
| Shares subscribed to at \$2.50 per share in January 2001, net of costs | - | 450,000 |
| Modification of warrants | - | 2,414,000 |
| Issuance of common shares at \$1.43 per share pursuant to conversion of debentures | - | 438,356 |
| Shares subscribed to at \$2.50 per share in February 2001 net of costs | - | 180,000 |
| Common shares subscribed at \$3.75 per share as additional consideration on debt | - | 61,001 |
| Common shares subscribed at \$3.31 as additional consideration on debt | - | 61,001 |
| Common stock issued in March 2001 for shares previously subscribed | - | - |
| Warrants issued with a strike price of \$6.00 per share as additional compensation on debt | - | 7,708 |
| Warrants issued with a Strike price of \$3.75 per share as additional compensation on debt | - | 14,659 |
| Warrants issued with a Strike price of \$3.31 per share as | | |

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| | | |
|-----------------------------------------------------------------------------------------------------------------------------------|---|-----------|
| additional compensation on debt | - | 12,715 |
| Issuance of common shares at \$2.00 per share net of financing costs | - | 1,607,146 |
| Placement fees accrued on prior financings | - | (831,133) |
| Allocation of debenture Proceeds to beneficial Conversion feature | - | 790,369 |
| Adjustment to remeasurement of attorney stock options | - | (510,315) |
| Issuance of common Stock in April for shares previously subscribed | - | - |
| Common stock subscribed at \$2.00 per share in April | - | 30,000 |
| Common stock subscribed at \$1.74 per share pursuant to conversion of debentures in June 2001 | - | 22,203 |
| Common stock subscribed at \$2.70 per share in connection with debt in June 2001 | - | 106,299 |
| Common stock subscribed at \$2.32 to \$2.83 per share from April through June 2001 as Additional financing fees | - | 125,000 |
| Shares issued pursuant to conversion of debentures at \$1.25 per share | - | 102,500 |
| Shares issued pursuant to conversion of debentures at \$1.74 | - | 200,808 |

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| | | |
|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---|-----------|
| Shares issued pursuant to conversion of debentures at \$1.00 | - | 29,433 |
| Shares subscribed in April, 2001 for \$2.00 per share pursuant to private placement net of stock issue costs | - | 650,000 |
| Issuance of warrants issued at \$2.03 to \$3.75 as additional financing fees | - | 1,383,353 |
| Allocation of debenture proceeds to beneficial conversion feature | - | 281,843 |
| Allocation of debenture proceeds to cashless exercise warrants | - | 48,487 |
| Common stock subscribed in lieu of loan origination fees | - | 145,000 |
| Common stock issued at \$3.19 per share from April through June 2001 as additional financing fees | - | 169,527 |
| Common stock subscribed at \$0.54 per share pursuant to conversion of debentures in September 2001 | - | 304,063 |
| Common stock subscribed at \$0.60 per share pursuant to conversion of debentures in September 2001 | - | 170,425 |
| Common stock subscribed at \$1.30 in September 2001 to satisfy penalty on late filing of the Registration Statement with the SEC for conversion shares in connection with convertible debt agreements dated November 2000. | - | 162,141 |
| Common stock issued in July 2001 for shares previously subscribed | - | - |
| Common stock issued at \$2.70 per share in June 2001 in lieu of loan origination fee | - | 135,000 |
| Common stock subscribed | | |

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| | | |
|------------------------------------------------------------------------------------------------------------------------------------------------------------------|---|-----------|
| At \$1.00 per share in July 2001 | - | 74,000 |
| Common stock subscribed At \$1.00 per share in September 2001 | - | 200,000 |
| Common stock subscribed At \$0.50 per share in September 2001 | - | 500,000 |
| Common stock issued at \$0.72 to \$2.08 per share from July through September 2001 as additional finance fees | - | 362,137 |
| Common stock issued in September 2001 for shares Previously subscribed | - | - |
| Common stock issued at \$1.98 per share in July 2001 for late issuance of debt converted in June 2001 | - | 5,245 |
| Common stock issued at \$1.56 per share in July 2001 for prepaid debt penalty | - | 22,342 |
| Common stock issued at \$0.96 per share in August 2001 as prepaid debt penalty | - | 22,593 |
| Warrants issued between July and September 2001, with exercise price from \$0.72 to \$6.00, as additional financing fees | - | 828,602 |
| Adjustment of warrants Issued between January and June 2001 as a result of Settlement agreement dated June 2001 regarding Additional finance fees | - | (559,273) |
| Warrants issued in August 2001 with exercise price of \$1.00 in connection with debt | - | 114,484 |
| Stock option issued to Employees below fair Market value on March 27, 2001 | - | 1,264,004 |
| Common stock subscribed On September 26, 2001 At \$0.70 per share | - | 1,120,000 |
| Net loss for the year | | |

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| | | |
|--------------------------|-----------------|----------------|
| ended September 30, 2001 | (30,169,897) | (30,169,897) |
| | ----- | ----- |
| Balances | | |
| September 30, 2001 | \$ (65,427,260) | \$ (9,477,712) |
| | ===== | ===== |

The accompanying notes are an integral part of this statement.

UPGRADE INTERNATIONAL CORPORATION AND SUBSIDIARIES
(A DEVELOPMENT STAGE ENTERPRISE)

CONSOLIDATED STATEMENTS OF CASH FLOWS

| | YEAR ENDED SEPTEMBER | |
|-----------------------------------------------------------------------------|----------------------|-------------|
| | 2001 | 2000 |
| | ----- | ----- |
| INCREASE (DECREASE) IN CASH | | |
| CASH FLOWS FROM OPERATING ACTIVITIES | | |
| NET LOSS | \$ (30,169,897) | \$ (17,403) |
| ADJUSTMENTS TO RECONCILE NET LOSS TO NET CASH USED IN OPERATING ACTIVITIES: | | |
| DEPRECIATION AND AMORTIZATION | 888,758 | 289 |
| AMORTIZATION OF BENEFICIAL CONVERSION FEATURE AND DEBENTURE DISCOUNT | 2,989,150 | 809 |
| LOSS ON SALE OF PROPERTY AND EQUIPMENT | 26,021 | |
| ADJUSTMENT TO RECEIVABLES FROM SUBSIDIARY'S | - | 133 |
| WRITE OFF OF UNCOLLECTIBLE ADVANCES | 3,549,780 | |
| IMPAIRMENT WRITE OFF | 1,054,125 | |
| WRITE OFF OF OPTION COST | - | |
| EQUITY IN LOSS OF ULTRACARD | - | |
| PURCHASED IN PROCESS RESEARCH & DEVELOPMENT | - | 425 |
| WARRANTS AND OPTIONS ISSUED FOR SERVICES | 1,903,685 | 1,268 |
| SHARES ISSUED FOR SERVICES | 190,000 | 242 |
| EMPLOYEE STOCK OPTIONS ISSUED BELOW FAIR VALUE | 1,264,004 | |
| COMMON STOCK ISSUED IN SATISFACTION OF INTEREST PENALTIES | 990,983 | |
| WARRANTIES ISSUED IN SATISFACTION OF INTEREST PENALTIES | 1,687,763 | |
| EXPENSES INCURRED THROUGH LOAN ASSUMPTION | - | |
| STOCK OF SUBSIDIARY ISSUED IN EXCHANGE FOR INTELLECTUAL PROPERTY | - | |
| MINORITY INTEREST | (452,665) | (1,759) |
| CHANGES IN ASSETS AND LIABILITIES: | | |
| PREPAID EXPENSES, DEPOSITS AND OTHER | 145,392 | 244 |
| PAYABLES, ACCRUED LIABILITIES AND OTHER | 6,510,957 | 1,382 |
| | ----- | ----- |
| NET CASH USED IN OPERATING ACTIVITIES | (9,421,944) | (14,366) |
| CASH FLOWS FROM INVESTING ACTIVITIES | | |
| ADVANCES TO THE PATHWAYS GROUP, INC. | (1,648,955) | (1,885) |
| ADVANCES TO ROCKSTER GROUP | (1,084,000) | |
| PAYMENTS ON EQUIPMENT UNDER CONSTRUCTION | - | (1,200) |
| ACQUISITION OF PROPERTY AND EQUIPMENT | (630,476) | (1,000) |
| ACQUISITION OF CENTURION TECHNOLOGIES, INC., NET OF CASH | - | (350) |

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| | | |
|---------------------------------------------------------|--------------|---------|
| ACQUISITION OF ULTRACARD, INC., NET OF CASH ACQUIRED | - | (260) |
| ACQUISITION OF EQUITY INTEREST IN EFORNET | - | (200) |
| ADDITIONS TO NOTE RECEIVABLE FROM RELATED PARTY | (130,000) | |
| ACQUISITION DEPOSIT | (62,500) | |
| ADDITIONS TO INTANGIBLE ASSETS | (78,009) | (117) |
| | | |
| NET CASH USED IN INVESTING ACTIVITIES | (3,633,940) | (5,013) |
| | | |
| CASH FLOWS FROM FINANCING ACTIVITIES | | |
| PROCEEDS FROM SALE OF COMMON STOCK | 9,206,768 | 13,720 |
| BORROWINGS, NET OF LOAN COSTS | 6,481,082 | 3,453 |
| PRINCIPAL PAYMENTS ON BORROWINGS | (1,040,177) | (2,082) |
| RELEASE OF COLLATERAL | - | 505 |
| PURCHASE OF COLLATERAL ON SUBSIDIARY'S LETTER OF CREDIT | - | (805) |
| PROCEEDS FROM EXERCISE OF STOCK OPTIONS AND WARRANTS | 55,000 | 712 |
| | | |
| NET CASH PROVIDED BY FINANCING ACTIVITIES | 15,208,360 | 14,997 |
| | | |
| NET INCREASE (DECREASE) IN CASH | 2,152,476 | (4,382) |
| CASH AT THE BEGINNING OF THE PERIOD | 398,989 | 4,781 |
| | | |
| CASH AT THE END OF THE PERIOD | \$ 2,551,465 | \$ 398 |
| | | |
| | | |
| SUPPLEMENTARY INFORMATION: | | |
| INTEREST PAID | \$ 27,664 | \$ 54 |
| | | |

SEE NOTE E FOR NONMONTARY EXCHANGES AND TRANSACTIONS.

THE ACCOMPANYING NOTES ARE AN INTEGRAL PART OF THESE STATEMENTS.

Upgrade International Corporation and Subsidiaries
(A development stage enterprise)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2001 and 2000

NOTE A - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Upgrade International Corporation (the "Company" or "Upgrade") is a development stage company incorporated on February 5, 1997 (inception) in the State of Florida and currently headquartered in Seattle, Washington. In April 2000 Upgrade issued 45,000 shares of its common stock in exchange for all the outstanding shares of common stock of Second CMA, Inc., a Colorado corporation, pursuant to an Agreement and Plan of Merger dated as of April 4, 2000 between Upgrade and Second CMA. The transaction was accounted for as a reverse

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acquisition. In August 2000, Upgrade reincorporated in the State of Washington. The Company is active in the acquisition and development of proprietary hardware and software in the information technology industry. Its primary business focus has been the acquisition, development and commercial exploitation of the UltraCard technology, a super high capacity data storage and retrieval device. The aforementioned activities are conducted through its subsidiary, UltraCard, Inc. (UltraCard). In addition, the Company has invested in technology companies, developing application software and "know-how" in a focused effort to commercialize the Company's base technology.

1. Basis of Presentation

The Company consolidates all companies in which it invests when the Company has a controlling financial interest in the investee. This generally occurs when the Company owns more than 50% of the outstanding voting shares of the investee. The Company also consolidates 50%-owned companies in which it has voting control through agreements with other shareholders. Investments in companies where the Company has significant influence through ownership of 20% to 50% of the investors voting shares or contractual arrangements are accounted for by the equity method.

The balance sheet, statement of operations and statements of cash flows as of September 30, 2001 and 2000, and for the years then ended, reflect the consolidated financial position and results of the Company and its subsidiaries (Subsidiaries) as follows: UltraCard, Inc. (UltraCard), Cque Corporation (formerly known as Centurion Technologies, Inc.) (Centurion), CTI Acquisition Corporation (CTI), Global CyberSystems, Inc. (Global), Global CyberSystems PLC (Global PLC), Global CyberSystems SA (Global SA), and EforNet Corporation (EforNet). All significant intercompany balances and transactions have been eliminated in consolidation. Minority interest represents the minority stockholders' proportionate share in the equity of the Company's consolidated Subsidiaries. The losses incurred by a subsidiary are allocated on a proportionate basis to minority interest until the carrying amount of minority interest is eliminated. Further losses are then included in the net loss of the Company.

2. Property and Equipment

Property and equipment are stated at cost. Depreciation expense is charged to operations using the straight-line depreciation method over the estimated useful life of the assets ranging as follows:

| | |
|------------------------|----------------------------------------------------------------------------|
| Equipment | 3-5 years |
| Software | 3 years |
| Office Furniture | 10 years |
| Corporate Condominium | 30 years |
| Leasehold Improvements | Over the term of the related lease or life of assets, whichever is shorter |

The Company uses accelerated depreciation methods for tax purposes, when allowable.

3. Intangible and Deferred Assets

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Intangible assets consist of capitalized license fees, patent and trademark costs, and loan fees. Intangible assets are amortized using the straight-line method over seven years, the estimated useful life of the underlying technology. Loan fees are amortized using effective interest method over the life of the underlying borrowing.

4. Accounting for the Impairment of Long-Lived Assets and for Long-Lived ----- Assets to be Disposed of -----

The Company follows SFAS No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of, which addresses accounting for impairment of long-lived assets. SFAS No. 121 requires assets to be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable.

The sputtering machine is classified as an asset held for sale as of September 30, 2001, and recorded at the lower of cost or estimated fair value. Fair value was determined by management and included an estimate of expected cash flows and of the assets method and likelihood of disposition.

5. Research and Development -----

Research and development costs are expensed as incurred.

6. Software Development Costs -----

Statement of Financial Accounting Standards No. 86, Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed, requires capitalization of certain software developments costs subsequent to the establishment of technological feasibility. The Company considers technological feasibility to be established upon completion of a working model. The Company estimates that costs incurred between completion of a working model and the point at which the product will be ready for general release will be insignificant. As a result, all product development costs have been expensed as incurred.

7. Cash Equivalents -----

For purposes of the statement of cash flows, the Company considers all highly liquid debt instruments purchased with a maturity of three months or less to be cash equivalents. As of September 30, 2001 and 2000, the Company had no cash equivalents.

The Company and its subsidiaries maintain their bank accounts with a number of financial institutions. At September 30, 2001 and 2000, the balances in some of these accounts were in excess of the \$100,000 federally insured limit. The Company has not experienced any losses with these cash accounts.

8. Financial Instruments -----

The Company's financial instruments consist of cash, restricted deposit, receivables, advances, acquisition deposits, accounts payable, accrued liabilities, payable to related parties, contract payables, royalty payable, bridge loans, notes payable, and convertible debentures. The Company believes that the fair value of these financial instruments approximates their carrying

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amounts based on their short-term nature or current market indicators such as prevailing interest rates.

9. Loss per Common Share

Basic loss per share is computed by dividing the net loss by the weighted average number of common shares outstanding during the period. The weighted average number of shares outstanding was 22,426,612 and 18,635,082 for the years ended September 30, 2001 and 2000, respectively, and 13,110,531 since inception (February 5, 1997) through September 30, 2001. Diluted loss per share for all periods presented equaled basic loss per share due to antidilutive effect of the potentially dilutive securities. As of September 30, 2001 and 2000, total warrants and options of 8,346,042 and 3,908,476, respectively, were not included in diluted loss per share computations due to their antidilutive effect.

10. Use of Estimates

In preparing the Company's financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets, liabilities and equity, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

Significant estimates used in preparing the accompanying financial statements include the estimates used to determine the fair value of the sputtering machine and the recoverability of other long-lived assets. It is reasonably possible that the proceeds from the sale will differ materially from the carrying amount and a loss may be recognized.

11. Reclassifications

Certain reclassifications were made to prior year balances to conform to current year presentation.

12. New Authoritative Pronouncements

In June 2001, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 141 (SFAS 141), Business Combinations. SFAS 141 applies to all business combinations initiated after June 30, 2001. The Statement also applies to all business combinations accounted for using the purchase method for which the date of acquisition is July 1, 2001, or later. The Company is currently evaluating the potential effect of the initial application of the SFAS 141 on its consolidated financial statements.

In June 2001, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 142 (SFAS 142), Goodwill and Other Intangible Assets. The provisions of SFAS 142 are required to be applied starting with fiscal years beginning after December 15, 2001 with earlier application permitted for entities with fiscal years beginning after March 15, 2001 provided that the first interim financial statements have not been previously issued. The statement is required to be applied at the beginning of the entity's fiscal year and to be applied to all goodwill and other intangible assets recognized in its financial statements to that date. The Company is currently evaluating the potential effect of the initial application of the SFAS 142 on its consolidated financial statements.

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In October 2001, the Financial Accounting Standards Board issued Statement of Financial Accounting Standard (SFAS) 144, Accounting for the Impairment or Disposal of Long-Lived Assets. SFAS 144 supersedes SFAS 121, Accounting for the Impairment of Long-Lived Assets and Long-Lived Assets to Be Disposed Of, and APB Opinion 30, Reporting the Results of Operations - Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions, for segments of a business to be disposed of. SFAS 144 is effective for fiscal years beginning after December 15, 2001. The Company is currently evaluating the potential effect of the initial application of the SFAS 144 on its consolidated financial statements.

NOTE B - MANAGEMENT PLANS

The Company is a development stage enterprise as defined under Statement of Financial Accounting Standards No. 7. The Company is devoting its present efforts into establishing a new business in the information technology industry and, is currently in the process of identifying markets and establishing applications for its technologies. Accordingly, no operating revenues have been generated. The Company's operations to date have consumed substantial and increasing amounts of cash. The Company's negative cash flow from operations is expected to continue but is expected to decrease as the Company commences revenue generating activities through the sale of its products. The continued development of the Company's technology and products will continue to require a commitment of substantial funds. Management believes that its existing and expected financings in addition to planned revenue generating activities will be adequate to satisfy the requirements of its current and planned operations until the end of the fiscal year 2002. However, the rate at which the Company expends its resources is variable, may be accelerated, and will depend on many factors.

Subsequent to the year end the Company has continued to fund operations through the issuance of both equity and debt securities. During the period October to December, 2001 the Company received \$783,705 from investors pursuant to Regulation "S", private placements of 1,567,410 shares of its common stock at \$0.50 per share and warrants to acquire 1,567,410 common stock shares at \$0.50 per share. In November 2001, the Company received a further \$25,000 from an investor pursuant to a Rule 506 offering memorandum for the issuance of 18,437 common stock shares at \$1.356 per share. In conjunction with the offering, the Company also issued a warrant to acquire 18,437 common stock shares at \$1.356 per share.

During the period September to November 2001, the Company received proceeds aggregating \$618,734 from a number of investors pursuant to both Regulation "S" and Rule 506 private placement offering documents for the issuance of 680,608 common stock shares at a price of \$0.91 per share. The Regulation "S" offerings contained 66,275 common shares, while 614,333 common stock shares were issued pursuant to Rule 506. In addition, as part of these offerings, the Company issued warrants to acquire an equal number of common stock shares at \$0.91 per share.

On November 26, 2001, the Company issued 100,000 shares to one of its legal counsels in settlement of \$100,000 in trade liabilities. During the period October to December 2001, the Company issued notes payable aggregating \$488,500. The notes mature in 30 days from their date of issuance, and bear interest at a rate of 10% per annum. In the event that the loans are not repaid on their maturity, the following penalties will be due and payable:

- 10% of the unpaid principal and interest at the maturity date payable in common stock, with the number of shares computed based upon the three lowest closing bid prices during the sixty trading days immediately preceding the maturity date.

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- Warrants to acquire common stock equaling 10% of the unpaid principal and interest at the maturity date with a strike price based upon the three lowest closing bid prices during the sixty trading days immediately preceding the maturity date (not to exceed \$1.40).
- Additional warrants to acquire the Company's common stock equaling twice the amount of warrants discussed above with a strike price of \$3.00.
- In the event that the loan principal and interest is not repaid, an additional penalty (payable in common stock and warrants to acquire common stock) will become due and payable every 30 days following the maturity date. The computations of this penalties are similar to the ones disclosed in the note M for June 2001 notes under provision (c).

The Company will need to raise substantial additional capital to fund its operations and may seek such additional funding through public or private equity or debt financing. Current financing activities in which the Company believes will be funded include; a \$9 million - \$15 million debt instrument, a \$12 million equity line-of-credit and \$5 million in privately placed equity. There can be no assurance that such additional funding will be available on acceptable terms, if at all. The Company's continued existence as a going concern is ultimately dependent upon its ability to secure additional funding for completing and marketing its technology and the success of its future operations.

NOTE C - INVESTMENTS

1. UltraCard, Inc. -----

The results of operations of the Company's subsidiary, UltraCard are consolidated with the Company's financial results from the time, the Company acquired controlling interest in this subsidiary on September 30, 1999. The purchase price totaling \$7,950,000 was allocated to the assets acquired and liabilities assumed based on their estimated fair values at the date of acquisition, which approximated the carrying amounts recorded by UltraCard. The remaining unallocated amount of purchase price was allocated to purchased in-process research and development (IPR&D). See Commitments and Contingencies footnote for additional information on acquisitions of additional equity interest during the year ended September 30, 2001. In connection with acquisitions of interest in UltraCard, during the years ended September 30, 2001 and 2000, and since inception through September 30, 2001, the Company recorded \$0, \$225,800, and \$4,843,527, respectively, of IPR&D.

On September 30, 1999, the Board of Directors of UltraCard approved an employee stock option plan, which authorized the issuance of up to three million shares (after the effect of 3:1 split) in the share capital of UltraCard to its directors, officers and employees. In order to avoid dilution of the 50% equity interest of Upgrade if these stock options are granted and exercised, the Company was issued an additional 3,000,000 shares. In addition, a stockholder of UltraCard had granted to the Company certain proxy rights that allow the Company to vote an additional 2% of the outstanding common stock of UltraCard. During the year ended September 30, 2000, the Company acquired an additional 1% interest in UltraCard from one of UltraCard's stockholders, increasing the Company's interest in UltraCard to approximately 55% as of September 30, 2000.

In order to permit UltraCard to explore strategic partnerships and other funding alternatives, some of which could include outside equity participation, on December 15, 2000, Upgrade waived certain provisions of the Funding Agreement including its non-dilution clause. As a result, the Company returned 3,000,000 shares of UltraCard originally issued in connection with implementation of

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UltraCard's stock option plan As of September 30, 2001, the Company owned 53% of UltraCard.

The Company has expressed an intention to acquire an additional interest in UltraCard and to continue funding its operations until UltraCard completes an anticipated IPO. Under terms of the Funding Agreement between the Company and UltraCard dated March 21, 2001, should UltraCard require additional financing prior to an IPO, the Company has agreed to provide sufficient funds on a firm commitment basis in an amount not to exceed \$20 million. All such funds advanced by the Company will be subject to a note payable agreement, the terms of which will require the accrual of interest at the bank's prime interest rate and repayment of principal and accrued interest on the earlier of the occurrence of the following events: the payment of dividends to stockholders; the completion of an IPO where the proceeds exceed \$35 million subject to the conversion provisions described below; or upon the occurrence of a change in control of UltraCard; but no later than March 31, 2004. Pursuant to the terms of the Funding Agreement, the unpaid principal and accrued interest is convertible into common stock of UltraCard at specified conversion rates upon the completion of an IPO. The graduated conversion rates range from \$0.63 to \$5.00 per share depending on the amount owed to the Company at the time of conversion. During the years ended September 30, 2001 and 2000, the Company loaned to UltraCard approximately \$5,482,000 and \$7,835,000 to fund its operations.

During the year ended September 30, 2001, the Company entered into agreements with two UltraCard's shareholders to acquire additional shares of UltraCard's stock (see note O for further information).

On October 2, 2001, the Company entered into an agreement with UltraCard to acquire 338,000 common stock shares at \$2.50 per share and a conversion of \$5,847,484 in intercompany borrowings into 2,000,000 shares of UltraCard. These transactions resulted in increase of the Company's interest in UltraCard to 55%.

2. EforNet Corporation

As of September 30, 2001 and 2000, Upgrade held a 100% and 54% voting interest in EforNet, a California corporation that was originally intended to develop an application for secure, anonymous electronic commerce of the internet, utilizing Ultracard technology and EforNet's proprietary switching software. On December 1, 2000, the Company suspended EforNet's operations. It is expected to recommence activities during the fiscal year 2002. Also, on December 1, 2000, the Company acquired all remaining outstanding shares of EforNet for a nominal consideration.

3. CTI Acquisition Corporation and cQue Corporation (formerly Centurion Technologies Inc.)

On May 12, 1999, the Company formed CTI Acquisition Corporation for the sole purpose of acquiring an equity interest in cQue Corporation (formerly Centurion Technologies, Inc.) (cQue), a development stage company headquartered in Redmond, Washington. cQue is developing a proprietary transaction processing software designed for the real-time transmission of encrypted data over the Internet with a business focus in the medical, educational and government market niches.

Two stockholders of cQue have granted to Upgrade certain proxy rights that allow Upgrade to vote an additional 1% of the outstanding common stock of the cQue. As of September 30, 2001 and 2000, Upgrade holds a 51% voting

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interest in cQue.

In November 2000, Centurion changed its name to cQue Corporation.

4. Global CyberSystems, Inc., Global CyberSystems PLC and Global

CyberSystems SA

Global CyberSystems Inc., was incorporated in Nevada on January 12, 1998. As part of the UltraCard acquisition agreement (see note C (1)), the Company received a 50% interest in the newly formed corporation with the remaining 50% being owned by UltraCard. On July 11, 1998, the Company entered into a master distribution agreement with UltraCard which provided Global with the exclusive distribution rights for the UltraCard products and technology in territories and applications as follows: (1) in the U.S., Global holds the exclusive distribution for banking applications and retail/convenience applications; and (2) worldwide, Global holds the exclusive rights to gaming applications for the UltraCard products and technology. As of September 30, 2001, Global had not commenced its operations and the carrying amounts of its assets, liabilities and stockholders' equity were nominal.

During the second quarter of the year ended September 30, 2000, the Company formed Global CyberSystems PLC (incorporated in the United Kingdom) and Global CyberSystems SA (incorporated in Switzerland). Global SA is 100% owned by Global CyberSystems, Inc. and Global PLC is an 80% owned subsidiary of Global SA. Both European companies had minimal operations during the year ended September 30, 2001 and 2000. These results of operations were consolidated with the Company's financial results for the year ended September 30, 2001 and resulted in minority interest of \$46,179.

5. Purchased In-Process Research and Development Costs

The purchased or contributed cost of in-process research and development (IPR+D) represents the value assigned in a purchase business combination to research and development projects of the acquired business that had commenced but had not yet reached technological feasibility at the date of the acquisition and have no future alternative use. In accordance with Statement on Financial Accounting Standards No. 2, Accounting for Research and Development Costs, as clarified by Financial Accounting Standards Board Interpretation No. 4, the amounts assigned to IPR&D meeting these criteria are charged to expense as part of the allocation of the purchase price of the business combination. A similar accounting was also utilized for the Company's investment in UltraCard accounted for under the equity method. Accordingly, charges totaling \$0, \$425,800, and \$5,971,603 were recorded as IPR&D during the years ended September 30, 2001 and 2000 and for the period from inception through September 30, 2001, respectively, as part of the allocations of purchase price and equity investment of the Subsidiaries.

Since all of the Subsidiaries are development stage companies, which had not commenced their respective planned principal operations nor generated any significant revenues, the entire amount of the excess of the purchase price or investment amount over the fair market value of the identifiable assets and liabilities of the investee, which approximated the carrying amount of these assets and liabilities, was allocated to IPR&D. As a result, no amount of the purchase prices or investment amounts were allocated to goodwill or other intangibles, except those already recorded by the investees.

On the dates of acquisition and consolidation of the Subsidiaries, as described in note C (1) through (4), the Subsidiaries had non-cash assets with an estimated fair value aggregating approximately \$2,000,000 and liabilities aggregating approximately \$1,300,000.

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NOTE D - RELATED PARTY TRANSACTIONS

On March 30, 2001, the Company loaned \$130,000 to a company controlled by one of the Company's shareholders (who also performs financial consulting services to the Company). The note matures on March 30, 2002 and bears 8% annual interest. As of September 30, 2001, the Company recorded \$5,243 in accrued interest receivable on the balance due.

Notes and other payables to related parties are comprised of the following as of September 30:

| | 2001 | | 2000 |
|-----------------------------------------------------------------------------------------------------------------------------|-------------|------|-----------|
| | ----- | | ----- |
| Payables in connection with acquisitions of additional interests from minority shareholders of UltraCard and CardTech, Inc. | \$1,758,215 | | \$ - |
| Short-term demand loan from an executive officer | 1,210,000 | * | - |
| Convertible debenture with an executive officer | 125,000 | ** | - |
| Shareholders advances | 894,606 | | - |
| Other payable to stockholders and officers | 794,727 | * | 27,740 |
| Loans from UltraCard's officers | 373,066 | *** | - |
| Loans from minority shareholders | 200,769 | **** | 147,500 |
| Payable to employees | 52,373 | * | - |
| Payable to UltraCard's employees | 67,596 | * | - |
| Payable to other related parties | 26,670 | * | - |
| | ----- | | ----- |
| | \$5,503,022 | | \$175,240 |
| | ===== | | ===== |