ADVANTAGE MARKETING SYSTEMS INC/OK
Form 10-K
March 31, 2003

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

FORM 10-K

(Mark one)

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

For the fiscal year ended December 31, 2002

[ ] 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: 001-13343

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ADVANTAGE MARKETING SYSTEMS, INC.
(Exact name of registrant as specified in its charter)

| | |
|---|---|
| Oklahoma | 73-1016728 |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |

| | |
|---|---|
| 2601 Northwest Expressway, Suite 1210W Oklahoma City, Oklahoma | 73112 |
| (Address of principal executive offices) | (Zip code) |

REGISTRANT'S TELEPHONE NUMBER INCLUDING AREA CODE: (405) 842-0131

SECURITIES REGISTERED UNDER SECTION 12(b) OF THE EXCHANGE ACT:

| Title of each class | Name of each exchange on which registered |
|---|---|
| Common Stock, $0.0001 Par Value | American Stock Exchange |
| Redeemable Common Stock Purchase Warrants | American Stock Exchange |
| 1997-A Warrants | American Stock Exchange |

SECURITIES REGISTERED UNDER SECTION 12(g) OF THE EXCHANGE ACT:

Common Stock, $0.0001 Par Value
Redeemable Common Stock Purchase Warrants
1997-A Warrants

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 [ ]

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes [ ] No [X]

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

On June 28, 2002, the aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold, or the average bid and asked prices of such common equity was $9,113,190.

As of March 24, 2003 there were 4,424,314 shares of Common Stock, par value $0.0001 per share, outstanding.

Documents incorporated by reference: The information called for by Part III is incorporated by reference to the definitive proxy statement for the registrant's 2003 annual meeting of stockholders, which will be filed with the Securities and Exchange Commission not later than 120 days after December 31, 2002.

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FORM 10-K
For the Fiscal Year Ended December 31, 2002
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** Information required by Items 10, 11, 12 and 13 of Part III is incorporated by reference from the Company's definitive proxy statements for its 2003 annual meeting of shareholders.

CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING INFORMATION

Certain statements under the captions "Item 1. Business," "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operation," and elsewhere in this report constitute "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Certain, but not necessarily all, of such forward-looking statements can be identified by the use of forward-looking terminology such as "anticipates," "believes," "expects," "may," "will," or "should" or other variations thereon, or by discussions of strategies that involve risks and uncertainties. Our actual results or industry results may be materially different from any future results expressed or implied by such forward-looking statements. Factors that could cause actual results to differ materially include general economic and business conditions; our ability to implement our business and acquisition strategies; changes in the network marketing industry and changes in consumer preferences; competition; availability of key personnel; increasing operating costs; unsuccessful advertising and promotional efforts; changes in brand awareness; acceptance of new product offerings; changes in, or the failure to comply with, government regulations (especially food and drug laws and regulations); our ability to obtain financing for future acquisitions and other factors.



PART I

ITEM 1. BUSINESS

Advantage Marketing Systems, Inc., or AMS, began operations in 1987, and through a corporate reorganization in 1995, became an Oklahoma corporation. We market a product line consisting of approximately one hundred products in three categories; weight management, dietary supplement and personal care products. These products are marketed through a network marketing organization in which independent associates purchase products for resale to retail customers as well as for their own personal use.

The associates in our network are encouraged to recruit interested people to become new associates for our products. New associates are placed beneath the recruiting associate in the "network" and are referred to as being in that associate's "downline" organization. Our marketing plan is designed to provide incentives to build, maintain and motivate an organization of recruited associates in their downline organization to maximize their earning potential. Associates generate income by purchasing our products at wholesale prices and reselling them at retail prices. They also earn bonuses on product purchases generated by the associates in their downline organization. See "--Network Marketing."

On an ongoing basis, we review our product line for duplication and sales movement and make adjustments accordingly. As of December 31, 2002, our primary product line consisted of:

- 11 weight management products;
- 33 dietary supplement products; and
- 42 personal care products consisting primarily of skin care products.

Our products are manufactured by various manufacturers pursuant to formulations developed for us and are sold to our independent associates located in all 50 states, the District of Columbia and Canada.

We believe that our network marketing system is ideally suited to market weight management, dietary supplement and personal care products because sales of such products are strengthened by ongoing personal contact between associates and their customers. Our network marketing system appeals to a broad cross-section of people, particularly those looking to supplement family income or seeking part-time work. Associates are given the opportunity through sponsored events and training sessions to network with other associates, develop selling skills and establish personal goals. We supplement monetary incentives with other forms of recognition in order to further motivate and foster an atmosphere of excitement throughout our associate network.

ACQUISITION OF LIFESCIENCE TECHNOLOGIES, INC. ("LST")

Effective January 4, 2001, we purchased the LST group of companies for $1.2 million and a five-year payment of $41,667 per month or 5% of the gross sales of LST products, whichever is greater. The seller has the option to take up to 860,000 shares of common stock in lieu of cash at an option price of $3.00 per share. As a result of the acquisition, we added 14 products and over 5,000 associates.

KEY OPERATING STRENGTHS

We believe the source of our success is our support of and compensation program for our associates. We provide high-quality products and a highly attractive bonus program, along with extensive training and motivational events and services. We believe that we have established a strong operating platform to support associates and facilitate future growth. The key components of this platform include the following:

- Quality products, many of which emphasize herbs and other natural ingredients to appeal to consumer demand for products that contribute to a healthy lifestyle;

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- A compensation program that permits associates to earn income from profits on the resale of products and residual income from reorder bonuses on product purchases within an associate's downline organization, as well as to participate in various non-cash awards, such as vacations, offered through promotional programs;

- A superior communications and training program that effectively and efficiently communicates with associates by utilizing new technologies and marketing techniques, as well as motivational events and training seminars; and

- The employment of information technology to provide timely and accurate product order processing, weekly bonus payment processing, detailed associate earnings statements, and inventory management.

GROWTH STRATEGY

Our growth strategy is redirecting our product and business focus to capitalize on our performance-based nutrition, anti-aging and weight loss products, where AMS owns or controls proprietary formulations and exclusive worldwide distribution rights. This redirection, along with the addition of state of the art internet marketing technology, should increase our network of independent associates. An increase in the number of associates generally results in increased sales volume, and new products create enthusiasm among associates, serve as a promotional tool in selling other products, and attract new associates. Since 1995, we have introduced many new products to our product line in the weight management, dietary supplement and personal care categories, primarily through the acquisition of:

- Miracle Mountain International, Inc. in May 1996;

- Chambre International, Inc. in January 1997;

- The assets of Stay 'N Shape International, Inc., Solution Products International, Inc., Nation of Winners, Inc., and Now International, Inc. in April 1997;

- All rights, including formulations and trademarks for the ToppFast, ToppStamina and ToppFitt products from ToppMed, Inc. in July 1998; and

- Proprietary formulations and trademarks for LifeScience Technologies including the adaptogen products, Prime One and Breckman's Gold in January 2001.

We also seek to increase sales through initiatives designed to enhance sales in our existing markets. These initiatives include increasing the number of training and motivational events and teleconferences, hiring additional associate support personnel and establishing more convenient regional support centers in targeted geographic markets.

As noted above, we seek to grow through acquisitions. The network marketing industry is fragmented, has relatively low barriers to entry, and includes a number of small marketing companies, many of which are being acquired by larger companies. Our strategy is to capitalize on these market characteristics to achieve additional growth, both in terms of associates and product line enhancement, through the acquisition of additional network marketing companies or the assets of such companies.

The principal objective of our acquisition strategy is to acquire other network marketing organizations that can be combined with our network marketing organization, resulting in increased sales volume with minimal additional administrative cost. We will not consummate an acquisition unless, at the time, we anticipate that such acquisition will contribute to profitability and provide positive cash flows from operations. There is no assurance, however, that we will in the future be able to acquire other network marketing organizations, or that such acquisitions will result in increased profitability and cash flows.

Our growth strategy requires expanded associate services and support, increased personnel, expanded operational and financial systems and implementation of additional control procedures. There is no assurance



that we will be able to manage expanded operations effectively. Furthermore, failure to implement financial, information management, and other systems and to add control procedures could have a material adverse effect on our results of operations and financial condition. Our acquisitions could involve a number of risks including:

- The diversion of management's attention to the assimilation of the acquired companies or assets; and

- The possibility that the acquired company or assets will not contribute to our cash flows and profitability as expected.

Although we intend to focus principally on the expansion of sales within the United States, we are preparing for expansion into markets in other countries. We have products approved for sale in Japan and are reviewing other countries, such as the United Kingdom, Australia, the Philippines and Taiwan. We believe there are numerous additional international markets in which our network marketing organization and products could prove successful.

INDUSTRY OVERVIEW

Network Marketing. We believe that network marketing is one of the fastest growing channels of distribution for certain types of goods and services.

Weight Management and Dietary Supplement Products. We believe that the weight management and dietary supplement category is expanding because of heightened public awareness of reports about the positive effects of weight management and dietary supplements on health. Many individuals also use dietary supplements as a means of preventative health care. We believe several factors account for the steady growth of the dietary supplement category, including increased public awareness of the reported health benefits of dietary supplements and favorable demographic trends toward older Americans who are more likely to consume dietary supplements.

Over the past several years, widely publicized reports and medical research findings have suggested a correlation between the consumption of dietary supplements and the reduced incidence of certain diseases. The United States government and universities generally have increased sponsorship of research relating to dietary supplements. In addition, Congress has established the Office of Alternative Medicine within the National Institute of Health to foster research into alternative medical treatments, which may include natural remedies. Congress also recently established the Office of Dietary Supplements in the National Institute of Health to conduct and coordinate research into the role of dietary supplements in maintaining health and preventing disease.

In addition, we believe that the aging of the United States population, together with an increased focus on preventative health care measures, will continue to result in increased demand for dietary supplement products. We believe these trends have helped fuel the growth of the dietary supplement category. To meet the increased demand for dietary supplements, we and others have introduced a number of successful dietary supplement products the past several years, including function specific products for weight loss, sports nutrition, menopause, energy and mental alertness. In addition, the use of a number of ingredients, such as chromium picolinate, shark cartilage, proanthocyanidins, citrin and colloidal minerals, have created opportunities for us and others to offer new products.

Personal Care Products. We believe that the personal care products market is a mature category that has been historically immune to swings in the economy. Manufacturers and associates of personal care products must continually improve existing products, introduce new products and communicate product advantages to consumers. With the aging population, there appears to be a growing demand for a wide spectrum of new products in the area of skin care.



PRODUCTS

Our product line consists of products in the categories of weight management, dietary supplements and personal care. We currently market approximately one hundred products, exclusive of variations in product size, colors or similar variations of our basic product line.

Weight Management Category. During the years ended December 31, 2002, 2001 and 2000, 51.8%, 54.7% and 67.6% of our net sales were derived from the 11 products in the weight management category that we market under the Advantage Marketing Systems label. The following products represent the majority of our product sales in the weight management category:

- AM-300--A specialized blend of herbs, including an ephedra herb concentrate and chromium picolinate; and

- AS-200--A specialized blend of herbs and nutrients in addition to citrin and chromium picolinate.

Dietary Supplement Category. During the years ended December 31, 2002, 2001 and 2000, 40.2%, 38.9% and 25.3% of our net sales were derived from the 33 products in the dietary supplement category, which contain herbs, vitamins, minerals and other natural ingredients. They are sold under the Advantage Marketing Systems label. The following products represent the majority of our product sales in the dietary supplement category:

- Prime One and Breckman's Gold--A liquid nutritional containing natural adaptogens, considered to be the number one performance enhancing, health restorative and stress reliever in the world;

- Shark Cartilage Complex--Manufactured from shark fin cartilage and a blend of curcumin, boswellia and vanadium;

- Colloidal Silver--Contains essential elements required by plants, animals and man that we once naturally obtained from organic soils via fruits, vegetables, nuts, grains and legumes;

- Spark of Life--A liquid nutritional drink containing a blend of herbs, vitamins, minerals, amino acids and essential fatty acids; and

- Chlorella--Fresh water green algae containing amino acids of protein, nucleic acids, fibers, vitamins and minerals.

Personal Care Category. In January 1997, we expanded and improved our product line by acquiring Chambre International and its line of skin care, hair care, family care and cosmetic products. Chambre International had been marketing its products for over 24 years. During the years ended December 31, 2002,2001and 2000, 2.9%, 1.5% and 1.3% of our net sales were derived from the 42 personal care products marketed primarily under the Chambre label in the personal care category. The following products represent the majority of our product sales in the personal care category:

- NH2 Lift System--A three-part skin-care system combining enzymatic exfoliation and isometric action to firm the skin, build muscle tone and lift the face;

- Skin Care Collections--Include cleansing lotion, skin freshener, oatmeal scrub, night treatment, moisturizer and protein or moisture masque; and

- Hair Care Systems--Include keratin shampoo, conditioning rinse, reconstructor, hair hold and style and set.

Promotional Materials. We also derive revenues from the sale of various educational and promotional materials designed to aid our associates in maintaining and building their businesses. Such materials include various sales aids, informational videotapes and cassette recordings, and product and marketing brochures.



Other Products and Services. Prior to focusing on weight management, dietary supplement and personal care products in October 1993, we marketed various packages of consumer benefit services provided by third-party providers. The only remaining benefit service we offer is a pre-paid legal service. The pre-paid legal services are provided by Pre-Paid Legal Services, Inc. This program membership represented less than 1% of our net sales during 2002, 2001 and 2000.

New Product Identification. We expand our product line through the development and acquisition of new products. New product ideas are derived from a number of sources, including trade publications, scientific and health journals, our management, consultants, associates and other outside parties. Potential product acquisitions are identified in a similar manner. Prior to introducing new products, we investigate product formulation as it relates to regulatory compliance and other issues.

We do not maintain a product development staff, but rely upon Chemins Company, Inc. and other manufacturers, independent researchers, vendor research departments and others for such services. When a new product concept is identified or when an existing product must be reformulated, the new product concept or reformulation project is generally submitted to Chemins for technical development and implementation. We continually review our existing products for potential enhancements to improve their effectiveness and marketability. While we consider our product formulations to be proprietary trade secrets, such formulations are not patented. Accordingly, there is no assurance that another company will not replicate one or more of our products.

Product Procurement and Distribution; Insurance. Essentially all of our product line in the weight management and dietary supplement categories is manufactured by Chemins Company, Inc. utilizing our product formulations. Essentially all of our product line in the personal care category is manufactured by GDMI, Inc. and Columbia Cosmetics, Inc. Naturtech manufactures our adaptogen product line from our LifeScience Technologies acquisition.

We have not generally entered into long-term supply agreements with the manufacturers of our product line or the third-party providers of our consumer benefit services. However, we customarily enter into contracts with our manufacturers and suppliers to establish the terms and conditions of purchases. Our arrangements with Chemins Company, Inc. may be terminated by either party upon the completion of any outstanding purchase orders. Therefore, there can be no assurance that Chemins will continue to manufacture our products or provide research, development and formulation services. In the event the relationship with any of our manufacturers becomes impaired, we will be required to obtain alternative manufacturing sources for our products. In such event, there is no assurance that the manufacturing processes of our current manufacturers can be replicated by another manufacturer. Although we have not previously experienced product unavailability or supply interruptions, we believe that we would be able to obtain alternative sources for our weight management, dietary supplement and personal care products. A significant delay or reduction in availability of products, however, could have a material adverse effect on our business, operating results and financial condition.

We, like other marketers of products that are intended to be ingested, face an inherent risk of exposure to product liability claims in the event that the use of our products results in injury. We maintain a claims made policy, with limited product liability insurance with coverage limits of $1,000,000 per occurrence and $2,000,000 in the aggregate. Products containing ephedra, which represented 49% of our 2002 net revenue, are not covered by our product liability insurance. Although we do not obtain contractual indemnification, our product manufacturers carry product liability insurance that covers our products. Product liability claims in excess of insurance coverage may result in significant losses, which would adversely affect product sales, results of our operations, financial condition and the value of our common stock.

All of the items in our product line include a customer satisfaction guarantee. Within 30 days of purchase, any retail customer or associate who is not satisfied with our product for any reason may return it or any unused portion to the associate from whom it was purchased or to us for a full refund or credit toward the purchase of another product. Associates may obtain replacements from us for products returned to them by retail customers if they return such products on a timely basis. Furthermore, in most jurisdictions, we maintain a buy-back program. Under this program, we will repurchase products sold to an associate, subject to a 10% restocking charge, provided the associate resigns and returns the product in marketable condition within 12



months of original purchase, or longer where required by applicable state law or regulations. We believe this buy-back program addresses a number of the regulatory compliance issues pertaining to network marketing systems. For the years ended December 31, 2002, 2001 and 2000, the cost of products returned to us was 0.6%, 1% and 2% of gross sales.

Our product line is distributed principally from our facilities in Oklahoma City or from our regional support centers. Products are warehoused in Oklahoma City and at selected regional support centers.

NETWORK MARKETING

We market our product line through independent associates in a network marketing organization. At December 31, 2002, we had approximately 39,223 "active" associates. To be considered "active" an associate must have purchased $50 in products or $22 on autoship of our products within the preceding 12 months. Our associates are independent contractors who purchase products directly from us for resale to retail consumers. Associates may elect to work on a full-time or part-time basis. We believe our network marketing system appeals to a broad cross-section of people, particularly those seeking to:

- Supplement family income;
- Start a home business; or
- Pursue employment opportunities other than conventional, full-time employment.

A majority of our associates therefore sell our products on a part-time basis.

We believe that our network marketing system is ideally suited to market our product line because sales of such products are strengthened by ongoing personal contact between retail consumers and associates, many of whom use our products themselves. Sales are made through direct personal sales presentations as well as presentations made to groups in a format known as "opportunity meetings." These sales methods are designed to encourage individuals to purchase our products by informing potential customers and associates of our product line and results of personal use, and the potential financial benefits of becoming an associate. The objective of the marketing program is to develop a broad based network marketing organization within a relatively short period. Our marketing efforts are typically focused on middle-income families and individuals.

Our network marketing program encourages individuals to develop their own downline network marketing organizations. Each new associate is either linked to:

- The existing associate that personally enrolled the new associate into our network marketing organization; or

- The existing associate in the enrolling associate's downline as specified at the time of enrollment.

Growth of an associate's downline organization is dependent on the recruiting and enrollment of additional associates within such associate's downline organization.

Associates are encouraged to assume responsibility for training and motivation of others within their downline organization and to conduct opportunity meetings as soon as they are appropriately trained. We strive to maintain a high level of motivation, morale, enthusiasm and integrity among the members of our network marketing organization. We believe this result is achieved through a combination of products, sales incentives, personal recognition of outstanding achievement and quality promotional materials. Under our network marketing program, associates purchase sales aids and brochures from us and assume the costs of advertising and marketing our product line to their customers as well as the direct cost of recruiting new associates. We believe that this form of sales organization is cost efficient because our direct sales expenses are primarily limited to the payment of bonuses, which are only incurred when products are sold.



We continually strive to improve our marketing strategies, including the compensation structure within our network marketing organization and the variety and mix of products in our line, to attract and motivate associates. These efforts are designed to increase monthly product sales and the recruiting of new associates.

To aid associates in easily meeting the monthly personal product purchase requirement to qualify for bonuses, we developed the "autoship" in 1994. Under the autoship purchasing arrangement, associates establish a standing product order for an amount in excess of $22 that is automatically charged to their credit cards or deducted from their bank accounts for goods shipped that month. At December 31, 2002, 2001, and 2000, we had approximately 23,051, 27,912, and 29,761 associates participating in the autoship.

Growth of our network marketing organization is in part attributable to our bonus structure which provides for payment of bonuses on product purchases made by other associates in an associate's downline organization. Associates derive income from several sources:

- First, associates earn profits by purchasing from our product line at wholesale prices (which are discounted up to 40% from suggested retail prices) and selling to customers at retail.

- Second, associates who establish their own downline organization may earn bonuses of up to 40% on product purchases by associates within the first four levels of their downline organization.

- Third, associates who have personally enrolled three active associates and have (i) $300 per month of autoship product purchases by personally enrolled associates on their first level and (ii) $300 per month of autoship product purchases on their second level, become directors and have the opportunity to build an additional director downline organization and receive additional bonuses of 4% on product purchases by such downline organization.

- Fourth, associates who have personally enrolled six active associates and have (i) $600 per month of autoship product purchases by personally enrolled associates on their first level and (ii) $600 per month of autoship product purchases on their second level and have a total of $2,500 wholesale volume monthly in their downline, become silver directors and have the opportunity to build an additional silver director downline organization and receive additional bonuses of 5% on product purchases by such downline organization.

- Fifth, silver directors who have personally enrolled 12 active associates and have (i) $1,200 per month of autoship product purchases by personally enrolled associates on their first level and (ii) $1,200 per month of autoship product purchases on their second level and have a total of $5,000 wholesale volume monthly in their downline, become gold directors and have the opportunity to receive an additional bonus of 3% on product purchases by their silver director downline organization. In addition, gold directors have the opportunity to receive generation bonuses of up to 3% on the product purchases by associates of silver director downline organizations that originate from their silver director downline organization through four generations.

- Sixth, gold directors who maintain the gold director requirements and develop four gold directors, each one from a separate leg of their downline organization plus $40,000 wholesale volume in downline organization, become platinum directors and have the opportunity to build an additional platinum director downline organization and receive additional bonuses of 5% on product purchases by such downline organization.

Combining these levels of bonuses, our total "pay-out" on products subject to bonuses is approximately 67% of the bonus value of product sales.

Each associate in our network marketing organization has a director, a silver director, a gold director and a platinum director. Each director has a silver director, a gold director and a platinum director. Each silver director has a gold director and a platinum director. Each gold director has a platinum director. As of December 31, 2002, we had 186 silver directors, 116 gold directors and 45 platinum directors.



Under our regional support center program, we designate associates to serve as regional support center directors and provide them special training and support. Each regional support center director functions as a product distribution center for our products. As of December 31, 2002, we had 58 regional support center directors.

We maintain a computerized system for processing associate orders and calculating bonus payments which enable us to remit such payments promptly. We believe that prompt and accurate remittance of bonuses is vital to recruiting and maintaining associates, as well as increasing their motivation and loyalty to us. We make weekly bonus payments based upon the previous week's product purchases, while most network marketing companies only make monthly bonus payments. During 2002, 2001 and 2000, we paid bonuses to 8,909, 11,814 and

11,902 associates, in the aggregate amounts of $9,414,421, $11,403,519 and $11,271,109.

We are committed to providing the best possible support to our associates. Associates in our network marketing organization are provided training guides and are given the opportunity to participate in our training programs. We sponsor regularly scheduled conference calls for our platinum directors which include testimonials from successful associates and satisfied customers as well as current product and promotional information. We produce a monthly newsletter which provides information on our products and network marketing system. The newsletter is designed to help recruit new associates by answering commonly asked questions and includes product information and business building information. The newsletter also provides a forum for additional recognition of associates for outstanding performance. In addition, we regularly sponsor training sessions for our associates across the United States. At these training sessions associates are provided the opportunity to learn more about our product line and selling techniques so they can build their businesses more rapidly. We produce comprehensive and attractive four color catalogues and brochures that display and describe our product line. We maintain a web page at www.amsonline.com, which provides general company information along with product line and network marketing system information.

Furthermore, in order to facilitate our continued growth and support associate activities, we continually upgrade our management information and telecommunications systems. These systems are designed to provide, among other things, financial and operating data for management, timely and accurate product ordering, bonus payment processing, inventory management and detailed associate records. Since 1994, we have invested more than $2,590,293 to enhance our computer and telecommunications systems.

REGULATION

In the United States, as well as in any foreign markets in which we may sell our products, we are subject to laws, regulations, administrative determinations, court decisions and similar constraints at the federal, state and local levels, collectively known as regulations. These regulations include and pertain to, among other things:

- The formulation, manufacturing, packaging, labeling, advertising, distribution, importation, sale and storage of our products;

- Our product claims and advertising, including direct claims and advertising as well as claims and advertising by associates, for which we may be held responsible; and

- Our network marketing organization.

Products. The formulation, manufacturing, packaging, labeling, advertising, distribution and sale and storage of our products are subject to regulation by a number of governmental agencies. The federal agencies include the Food and Drug Administration, or FDA, the Federal Trade Commission, the Consumer Product Safety Commission, the United States Department of Agriculture and the Environmental Protection Agency. Our activities are also regulated by various agencies of the states, localities and foreign countries in which our products are or may be manufactured, distributed or sold. The FDA, in particular, regulates the formulation, manufacturing and labeling of dietary supplements, cosmetics and skin care products, including some of our products.



The Dietary Supplement Health and Education Act of 1994, or DSHEA, revised the provisions of the Federal Food, Drug and Cosmetic Act, or FFDCA, concerning the composition and labeling of dietary supplements, which we believe is generally favorable to the dietary supplement industry. DSHEA created a new statutory class of "dietary supplements." This new class includes vitamins, minerals, herbs, amino acids and other dietary substances for human use to supplement the diet. However, DSHEA grandfathered, with certain limitations, dietary ingredients that were on the market before October 15, 1994. A dietary supplement containing a new dietary ingredient and placed on the market on or after October 15, 1994 must have a history of use or other evidence establishing a basis for expected safety. Manufacturers of dietary supplements having a "structure-function" statement must have substantiation that the statement is truthful and not misleading.

The majority of our sales come from products that are classified as dietary supplements under the FFDCA. The labeling requirements for dietary supplements have been set forth in final regulations with respect to labels affixed to containers beginning after March 23, 1999. These regulations include how to declare nutrient content information, and the proper detail and format required for the "supplement facts" box. During 1999, we revised our product labels in compliance with these regulations. Many states have also recently become active in the regulations of dietary supplement products. These states may require modification of labeling or formulation of certain of our products sold in these states.

In addition, on January 6, 2000, the FDA published a Final Rule on permissible structure/function statements to be placed on labels and in brochures. Structure/function statements are claims of the benefit or effect of a product or an ingredient on the body's structure or function. This regulation does not significantly change the way that the FDA interprets structure/function statements. Thus, we did not make any substantial label revisions based on this regulation regarding any of our structure/function product statements.

As a marketer of products that are ingested by consumers, we are subject to the risk that one or more of the ingredients in our products may become the subject of adverse regulatory action. For example, one of the ingredients in our AM-300 product is ephedra, an herb that contains naturally-occurring ephedrine alkaloids. Our manufacturer uses a powdered extract of that herb when manufacturing AM-300. We market AM-300 principally as an aid in weight management. The extract is an 8% extract, which means that every 100 milligrams of the powdered extract contains approximately eight milligrams of naturally occurring ephedrine alkaloids. In addition, our Sine-Eze product, used as a food supplement to relieve symptoms associated with allergies, contains ephedrine alkaloids. Ephedrine-containing dietary supplements have been the subject of adverse publicity in the United States and other countries relating to alleged harmful effects.

On April 10, 1996, the FDA issued a statement warning consumers not to purchase or ingest dietary supplements containing ephedrine that are claimed to produce certain effects. These effects include euphoria, heightened awareness, increased sexual sensations or increased energy. The FDA cautions that these products pose significant adverse health risks, including dizziness, headache, gastrointestinal distress, irregular heartbeat, heart palpitations, heart attack, strokes, seizures, psychosis and death.

The FDA published a proposed rule in the Federal Register on June 4, 1997 that proposed significant limitations on the sale of ephedrine-containing dietary supplements. The proposed rule would have significantly limited our ability to sell products containing ephedra if it had been made effective. On April 3, 2000, the FDA withdrew most of the provisions of its proposed rule. This action was prompted largely by a report issued by the United States General Accounting Office, or GAO, in which the GAO criticized the scientific basis for the proposed rule and the FDA's evaluation of approximately 900 reports of adverse events supposedly related to the consumption of dietary supplements containing ephedrine alkaloids. The FDA has made available for public inspection most of these adverse event reports.

On March 7, 2003, the FDA published a notice in the Federal Register, which indicates that it will be taking final action on the 1997 proposed rule in the near future. The FDA re-opened the public comment period, until April 7, 2003, to allow for additional public input on the two proposed limitations on the sale of ephedrine-containing dietary supplements that remained after the FDA's action of April 3, 2000. One



proposed limitation is a warning that would be required to appear on the label of all ephedrine-containing supplements. The other proposed limitation is that ephedrine-containing supplements may not contain other substances that are known to have stimulant effects (e.g., caffeine). The proposed warning addresses potential health risks allegedly associated with ephedrine-containing dietary supplements. It is similar, but not identical, to mandatory warnings that have been required by Texas law since 1999 and California law since January 1, 2003. AM-300 and our other ephedrine-containing supplements comply with these state law requirements. However, some of our ephedrine-containing products, like AM-300, contain caffeine or other stimulants. Therefore, if the proposed rule is made final in its current form, it will prohibit the sale of some of our products.

On March 13, 2003, the FDA published a proposed rule in the Federal Register which proposes comprehensive requirements for the manufacturing, packing and holding dietary supplements, also known as good manufacturing practices, or GMPs. The FDA is accepting public comments on the proposed GMPs until June 11, 2003; final GMPs will be promulgated after the FDA has reviewed the public comments. Once final GMP regulations become effective, our manufacturer will be required to adhere to them. The FDA will most likely institute an effective date for the GMPs which will allow our manufacturer a reasonable amount of time to conduct this review and, if necessary, revise its manufacturing operations to comply with the final GMP regulations.

The Texas Department of Health promulgated a new regulation, which became effective on January 1, 2001. The regulation requires a warning to appear on the product label indicating that the sale of ephedra-containing products to minors is illegal. Our AM-300 labels comply with this regulation.

In foreign markets, prior to commencing operations and prior to making or permitting sales of our products, we may be required to obtain an approval, license or certification from the country's ministry of health or comparable agency. Prior to entering a new market in which a formal approval, license or certificate is required, we are required to work extensively with local authorities to obtain the requisite approvals. The approval process generally requires us to present each product and product ingredient to appropriate regulators and, in some instances, arrange for testing of products by local technicians for ingredient analysis. Such approvals may be conditioned on reformulation of our products or may be unavailable with respect to certain products or ingredients.

Product Claims and Advertising. The Federal Trade Commission and certain states regulate advertising, product claims and other consumer matters, including advertising of our products. All advertising, promotional and solicitation materials used by associates require our approval prior to use. The Federal Trade Commission has instituted enforcement actions against several dietary supplement companies for false or deceptive advertising, including the use of testimonials.

We provide no assurance that:

- The Federal Trade Commission will not question our past or future advertising or other operations; or

- A state will not interpret product claims presumptively valid under federal law as illegal under that state's regulations.

Also, our associates and their customers may file actions on their own behalf, as a class or otherwise, and may file complaints with the Federal Trade Commission or state or local consumer affairs offices. These agencies may take action on their own initiative or on a referral from associates, consumers or others. If taken, these actions may result in:

- Entries of consent decrees;

- Refunds of amounts paid by the complaining associate or consumer;

- Refunds to an entire class of associates or customers;



- Other damages; and

- Changes in our method of doing business.

A complaint based on the practice of one associate, whether or not such activities were authorized by us, could result in an order affecting some or all associates in a particular state, and an order in one state could influence courts or government agencies in other states. Enforcement proceedings resulting from these complaints may result in significant defense costs, settlement payments or judgments and could have a material adverse effect on our results of operations or financial condition.

Compliance Efforts. We attempt to remain in full compliance with all applicable laws and regulations governing the manufacture, labeling, sale, distribution, and advertising of our dietary supplements. We retain special legal counsel for advice on both Food and Drug Administration and Federal Trade Commission legal issues. In particular, we work closely with special legal counsel who specializes in Dietary Supplement Health and Education Act regulations for label revisions, content of structure/function statements, advertising copy, and also the position of the Food and Drug Administration on ephedra-containing products.

Network Marketing System. Our network marketing system is subject to federal and state laws and regulations administered by the Federal Trade Commission and various state agencies. These laws and regulations include securities, franchise investment, business opportunity and criminal laws prohibiting the use of "pyramid" or "endless chain" types of selling organizations. These regulations are generally directed at ensuring that product sales are ultimately made to consumers (as opposed to other associates) and that advancement within the network marketing system is based on sales of products, rather than investment in the company or other non-retail sales related criteria.

The compensation structure of a network marketing system is very complex. Compliance with all of the applicable regulations and laws is uncertain because of the evolving interpretations of existing laws and regulations and the enactment of new laws and regulations pertaining in general to network marketing systems and product distribution. We have an ongoing compliance program with assistance from legal counsel experienced in the laws and regulations pertaining to network sales organizations. We are not aware of any legal actions pending or threatened by any governmental authority against us regarding the legality of our network marketing operations.

We currently have independent associates in all 50 states, the District of Columbia and Canada. We review the requirements of various states as well as seek legal advice regarding the structure and operation of our selling organization to ensure that it complies with all of the applicable laws and regulations pertaining to network sales organizations. On the basis of these efforts and the experience of our management, we believe that we are in compliance with all applicable federal and state regulatory requirements. We have not obtained any no-action letters or advance rulings from any federal or state security regulator or other governmental agency concerning the legality of our operations, nor are we relying on a formal opinion of counsel to this effect. Accordingly, there is the risk that our network marketing system could be found to be in noncompliance with applicable laws and regulations, which could then:

- Result in enforcement action and imposition of penalties;

- Require modification of our network marketing system;

- Result in negative publicity; or

- Have a negative effect on associate morale and loyalty.

Any of these consequences could have a material adverse effect on our sales as well as our financial condition.

We are subject to the risk of challenges to the legality of our network marketing system by our associates, both individually and as a class. Generally such challenges would be based on claims that our network marketing system was operated as an illegal "pyramid scheme" in violation of federal securities laws, state unfair practice and fraud laws and the Racketeer Influenced and Corrupt Organizations Act.



Two important Federal Trade Commission cases have established legal precedent for determining whether a network marketing system constitutes an illegal pyramid scheme. The first, IN RE KOSCOT INTERPLANETARY, INC., 86 F.T.C. 1106 (1975), set forth a standard for determining whether a marketing system constituted a pyramid scheme. Under the KOSCOT standard, a pyramid scheme is characterized by the participants' payment of money to a company in return for:

- The right to sell a product; and

- The right to receive, in return for recruiting other participants into the program, rewards that are unrelated to sales of the product to ultimate users.

Applying the KOSCOT standard in IN RE AMWAY CORP., 93 F.T.C. 618 (1979), the Federal Trade Commission determined that a company will not be classified as operating a pyramid scheme if the company adopts and enforces policies that in fact encourage retail sales to consumers and prevent "inventory loading". Inventory loading occurs when associates purchase large quantities of non-returnable inventory to obtain the full amount of compensation available under the system. In AMWAY, the Federal Trade Commission found that the marketing system of Amway Corporation did not constitute a pyramid scheme, noting the following Amway policies:

- Participants were required to buy back, from any person they recruited, any saleable, unsold inventory upon the recruit leaving Amway;

- Every participant was required to sell at wholesale or retail at least 70% of the products bought in a given month in order to receive a bonus for that month; and

- In order to receive a bonus in a month, each participant was required to submit proof of retail sales made to 10 different consumers.

We believe that our network marketing system is not classified as a pyramid scheme under the standards set forth in KOSCOT, AMWAY, and other applicable law. In particular, in most jurisdictions, we maintain an inventory buy-back program to address the problem of inventory loading. Pursuant to this program, we repurchase products sold to an associate (subject to a 10% restocking charge) provided that the associate:

- Resigns; and

- Returns the product in marketable condition within 12 months of original purchase, or longer where required by applicable state law or regulations.

Our literature provided to associates describes our buy-back program. In addition, pursuant to agreements with our associates, each associate represents that at least 70% of the products he or she buys will be sold to non-associates. However, as is the case with other network marketing companies, the bonuses paid by us to our associates are based on product purchases including purchases of products that are personally consumed by the downline associates. Basing bonuses on sales of personally consumed products may be considered an inventory loading purchase. Furthermore, associates' bonuses are based on the wholesale prices received by us on product purchases or, in some cases based upon the particular product purchased, on prices less than the wholesale prices.

In the event of challenges to the legality of our network marketing system by associates, we would be required to:

- Demonstrate that our network marketing policies are enforced; and

- That the network marketing system and associates' compensation thereunder serve as safeguards to deter inventory loading and encourage retail sales to the ultimate consumers.



In WEBSTER V. OMNITRITION INTERNATIONAL, INC., 79 F.3d 776 (9th Cir. 1996), the United States Court of Appeals held that a class action brought against Omnitrition International, Inc., a multilevel marketing seller of nutritional supplements and skin care products, should be allowed to proceed to trial. The plaintiffs, former associates of Omnitrition's products, alleged that Omnitrition's selling program was an illegal pyramid scheme and claimed violations of Racketeer Influenced and Corrupt Organizations Act and several federal and state fraud and securities laws. Despite evidence that Omnitrition complied with the AMWAY standards, the court ruled that a jury would have to decide whether Omnitrition's policies, many of which apparently were similar to compliance policies adopted by us, were adequate to ensure that Omnitrition's marketing efforts resulted in a legitimate product marketing and distribution structure and not an illegal pyramid scheme. We believe that our marketing and sales programs differ in significant respects from those of Omnitrition, and that our marketing program complies with applicable law. The two most significant differences are:

- The Omnitrition marketing plan required associates to purchase $2,000 in merchandise in order to qualify for bonuses as compared to $22 on autoship under our marketing program; and

- The Omnitrition inventory repurchase policy was limited to products that were less than three months old as compared to one year under our inventory repurchase policy.

Lessons from the OMNITRITION case are that:

- A selling program which operates to generate only the minimum purchases necessary to qualify for bonuses is suspect; and

- A selling program must operate to generate purchases independently of the payment of bonuses in order to have a legitimate product marketing and distribution structure.

We believe that our selling program operates to generate significant purchases "for intrinsic value" as demonstrated by our sales figures. During the month of December 2002, 19,639 of our associates placed a total of 24,201 orders averaging $58 in size while only a single $22 on autoship per month is necessary to qualify for bonuses. In view of the holding of the court of appeals in the OMNITRITION case, however, there is no assurance that, if challenged, we would prevail against private plaintiffs alleging violations of anti-pyramid and securities laws. A final ruling against us in such a suit could result in the imposition of a material liability against us. Moreover, even if we were successful in defending against such suit, the costs of such defense, both in dollars spent and in management time, could be material and adversely affect our operating results. In addition, the negative publicity of such a suit could adversely affect our sales and ability to attract and retain associates.

Nutrition for Life International, Inc., one of our competitors and a multilevel seller of personal care and nutritional supplements, announced in January 1997, that it had settled class action litigation brought by associates alleging fraud in connection with the operation of a pyramid scheme. Nutrition for Life paid in excess of $3 million to settle claims brought on behalf of its associates, and related securities fraud claims brought on behalf of certain purchasers of its stock.

We believe that our marketing program is significantly different from the program allegedly promoted by Nutrition for Life and that our marketing program is not in violation of anti-pyramid laws or regulations. Two issues in the Nutrition for Life matter were a $1,000 buy-in urged on new recruits, and the paying of commissions on product vouchers prior to the actual delivery of product. By design, our marketing program offers no incentive to anyone to make a large personal purchase nor do we use product vouchers. Actual average order size in December 2002 was $58. However, there is no assurance that claims similar to the claims brought against Nutrition for Life and other multilevel marketing organizations will not be brought against us, or that we will prevail in the event any such claims were made. Furthermore, even if we were successful in defending against any such claims, the cost of conducting such a defense, both in dollars spent and in management time, could be material and adversely affect our operating results and financial condition. In addition, the negative publicity of such a suit could adversely affect our sales and ability to attract and retain associates.



INTELLECTUAL PROPERTY

We use several trademarks and trade names in connection with our products and operations. As of December 31, 2002, we had 52 federal trademark registrations with the United States Patent and Trademark Office. We rely on common law trademark rights to protect our unregistered trademarks. Common law trademark rights do not provide us with the same level of protection as afforded by a United States federal registration of a trademark. Also, common law trademark rights are limited to the geographic area in which the trademark is actually used. In addition, our product formulations are not protected by patents and are not patentable. Therefore, there can be no assurance that another company will not replicate one or more of our products.

COMPETITION

We are subject to significant competition in recruiting associates from other network marketing organizations, including those that market products in the weight management, dietary supplement and personal care categories, as well as other types of products. There are over 300 companies worldwide that utilize network marketing techniques, many of which are substantially larger, offer a greater variety of products, and have available considerably greater financial resources than us. Our ability to remain competitive depends, in significant part, on our success in recruiting and retaining associates through an attractive bonus plan and other incentives. We believe that our bonus plan and incentive programs provide our associates with significant income potential. However, there can be no assurance that our programs for recruitment and retention of associates will continue to be successful.

In addition, the business of marketing products in the weight management, dietary supplement and personal care categories is highly competitive. This market segment includes numerous manufacturers, other network marketing companies, catalog companies, associates, marketers, retailers and physicians that actively compete in the sale of such products. We also compete with other providers of such products, especially retail outlets, based upon convenience of purchase and immediate availability of the purchased product. The market is highly sensitive to the introduction of new products or weight management plans, including various prescription drugs, which may rapidly capture a significant share of the market. As a result, our ability to remain competitive depends in part upon the successful introduction and addition of new products to our line.

Our network marketing competitors include small, privately held companies, as well as larger, publicly held companies with greater financial resources and greater product and market diversification and distribution. Our competitors include Shaklee Corporation, Market America, Inc., The A.L. Williams Corporation, Mary Kay Cosmetics, Inc., Amway Corporation, and Nutrition for Life International, Inc.

EMPLOYEES

As of December 31, 2002, we had 67 full-time and 11 part-time employees, consisting of 5 executive officers, 23 involved in administrative activities, 9 involved in marketing activities, 15 involved in customer service activities, 11 involved in business development activities and 15 involved in shipping activities. Our employees are not represented by a labor organization. We consider our employee relations to be good.

AVAILABILITY OF INFORMATION

We file periodic reports and proxy statements with the Securities and Exchange Commission, or SEC. The public may read and copy any materials we file with the SEC at the SEC's Public Reference Room at 450 Fifth Street, N.W., Washington, D.C. 20549. The public may obtain information about the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. We file our reports with the SEC electronically. The SEC maintains an Internet site that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC. The address of this site is http://www.sec.gov.

Our internet address is www.amsonline.com. We make available on our website, free of charge, copies of our annual report of Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and



amendments to those reports filed or furnished pursuant to Section 13(a) of the Exchange Act as soon as reasonably possible after we electronically file such material with, or furnish to, the SEC.

ITEM 2. PROPERTIES

We maintain our executive office in 10,003 square feet at 2601 Northwest Expressway, Suites 1210W and 1120W, Oklahoma City, Oklahoma 73112-7293. These premises are occupied pursuant to long-term leases which expire on May 31, 2003 and January 31, 2005, and which require monthly rental payments of $7,986 and $2,530. Both leases have been extended for terms to expire on May 31, 2008. In addition we have our prior warehouse facility, at 4000 N. Lindsay in Oklahoma City, under a lease expiring May 31, 2003, with monthly lease payments of $5,601. In June 2001, we completed our new warehouse and distribution facility. The 23,346 square foot, $1.3 million facility is subject to a mortgage. All our properties are in good condition.

ITEM 3. LEGAL PROCEEDINGS

The case of Ronald Potter et al v. Advantage Marketing Systems, Inc. et al, a products liability claim, was filed in the Oklahoma County District Court in March 2003. The Plaintiffs claim that the ingestion of ephedra included in AM-300 resulted in the death of Pamela Sue Potter. An answer to the petition is due by April 30, 2003. As such, we have not had sufficient time to either investigate the facts of this case or analyze appropriate defenses to the allegations. We will deny any wrongdoing and intend to vigorously defend the claim. The amount of damages sought is unknown, but include compensatory and punitive damages.

The case of In re Jose Garcia v. Advantage Marketing Systems, Inc., a products liability claim, was filed in the Superior Court of California, San Bernardino County, in February 2003. The Plaintiff claims personal injury and lost wages resulting from the ingestion of ephedra included in AM-300. An answer to the petition is due by April 23, 2003. As such, we have not had sufficient time to either investigate the facts of this case or analyze appropriate defenses to the allegations. We will deny any wrongdoing and intend to vigorously defend the claim. The amount of damages sought is unknown.

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

No matters were submitted to a vote of security holders during the fourth quarter of our fiscal year ended December 31, 2002.



PART II

ITEM 5. MARKET FOR COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

From November 6, 1997 to June 14, 1999, our common stock was traded on the Nasdaq SmallCap Market under the symbol "AMSO." On June 15, 1999, our common stock began trading on the American Stock Exchange under the symbol "AMM."

On March 24, 2003, the closing sale price of our common stock on the American Stock Exchange was $1.51. We believe there are approximately 1,606 holders of our common stock. The following table sets forth the high and low closing sale price of our common stock on the American Stock Exchange.

| | COMMON STOC CLOSING BID PR |
|---|---|
| | HIGH |
| 2002--CALENDAR QUARTER ENDED: | |
| March 31 | $2.60 |
| June 30 | $3.05 |
| September 30 | $2.35 |
| December 31 | $2.00 |
| 2001--CALENDAR QUARTER ENDED: | |
| March 31 | $3.30 |
| June 30 | $3.24 |
| September 30 | $3.06 |
| December 31 | $2.99 |

No cash dividends were declared as of December 31, 2002 or are anticipated.

Equity Compensation Plan Information

| Plan Category | (a) Number of securities to be issued upon exercise of outstanding options, warrants and rights | (b) Weighted-average exercise price of outstanding options, warrants and rights | Number remain for fu under compen (exclu reflec column |
|---|---|---|---|
| Equity plans approved by security holders | 1,083,403 | $2.66 | 4 |
| Equity compensation plan not approved by security holders | 673,250 | $1.95 | |
| Total | 1,756,653 | $2.36 | 4 |

Prior to approval of the 1995 Stock Option Plan, the Company issued 673,250 incentive stock options to employees and associates. These options have a term of 10 years, are exercisable, in whole or in part, at any time prior to the termination date, and have an exercise price of $1.75 to $2.00 per share. The options may be assigned or transferred, in whole or in part, so long as such assignment or transfer is in accordance with and subject to the provisions of the Securities Act of 1933, as amended, and the rules promulgated thereunder.



ITEM 6. SELECTED FINANCIAL DATA

The following table sets forth selected financial and statistical data, computed as a percentage of net sales, for the years ended December 31, 2002, 2001, 2000, 1999 and 1998. The selected financial data are derived from our audited consolidated financial statements and should be read in conjunction with them and the Notes thereto. The results of operations for the periods presented are not necessarily indicative of our future operations.

| | YEAR ENDED DECEMBER 31, | | | |
|---|---|---|---|---|
| | 2002 | 2001 | 2000 | 1 |
| INCOME STATEMENT DATA: | | | | |
| Net sales ............................ | $ 22,303,581 | $ 28,440,920 | $ 26,707,936 | $ 22, |
| Cost of sales ........................ | 15,126,983 | 19,231,150 | 17,929,701 | 15, |
| Gross profit ...................... | 7,176,598 | 9,209,770 | 8,778,235 | 6, |
| Marketing, distribution and administrative expenses: | | | | |
| Marketing ......................... | 2,487,006 | 2,304,922 | 2,981,372 | 1, |
| Distribution and administrative ... | 5,768,245 | 6,875,871 | 5,076,436 | 3, |
| Total marketing, distribution and administrative expenses .......... | 8,255,251 | 9,180,793 | 8,057,808 | 5, |
| Goodwill impairment .................. | 3,788,374 | -- | -- | |
| Income (loss) from operations ..... | (4,867,027) | 28,977 | 720,427 | 1, |
| Other income (expense): | | | | |
| Interest and dividends, net ....... | (53,984) | (31,800) | 310,599 | |
| Other income (expense) ............ | (39,170) | 16,841 | (81,560) | |
| Settlement of additional tax liability....................... | -- | -- | -- | |
| Total other income (expense) ......... | (93,065) | (14,959) | 229,039 | |
| Income (loss) before income taxes .... | (4,960,092) | 14,018 | 949,466 | 1, |
| Income tax (benefit) ................. | (1,755,057) | 5,467 | 456,532 | |
| Net income (loss) .................... | $ (3,205,035) | $ 8,551 | $ 492,934 | $ 1, |
| Net income (loss) per common share - basic ................... | $ (0.73) | $ -- | $ 0.12 | $ |
| Net income (loss) per common share - assuming dilution ........ | $ (0.73) | $ -- | $ 0.09 | $ |
| Weighted average common shares outstanding - basic .............. | 4,419,196 | 4,379,486 | 4,283,461 | 4, |
| Weighted average common shares outstanding - assuming dilution ... | 4,419,196 | 4,692,298 | 5,476,277 | 4, |

| | | | | |
|---|---|---|---|---|
| STATISTICAL DATA: | | | | |
| Total cost of sales .............. | 67.8 % | 67.6% | 67.1% | |
| Gross profit ...................... | 32.2 % | 32.4% | 32.9% | |
| Total marketing, distribution and administrative expense .......... | 37.0 % | 32.3% | 30.2% | |
| Net income (loss) ................ | (14.4)% | 0.0% | 1.8% | |
| CASH FLOW DATA: | | | | |
| Net cash provided by (used in) operating activities ............. | $ 694,712 | $ 1,508,177 | $ (62,480) | $ 2, |

19

| | | | | |
|---|---|---|---|---|
| Net cash provided by (used in) investing activities ............. | 68,193 | (1,383,960) | (885,350) | (5, |
| Net cash provided by (used in) financing activities ............. | (537,795) | 781,284 | (638,377) | ( |
| BALANCE SHEET DATA: | | | | |
| Total assets ...................... | $ 10,686,269 | $ 14,672,404 | $ 11,690,250 | $ 12, |
| Total liabilities ................. | 3,355,840 | 4,127,226 | 1,266,345 | 1, |
| Stockholders' equity ............. | 7,330,429 | 10,545,178 | 10,423,905 | 10, |

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATION

The following discussion should be read in conjunction with our consolidated financial statements and notes thereto under Item 8 below.

GENERAL

Our business and operations during the last five years have been significantly affected by the acquisitions of Miracle Mountain International, Inc. in May 1996, Chambre International, Inc. in January 1997, the assets of Stay 'N Shape International, Inc., Solution Products International, Inc., Nation of Winners, Inc., and Now International, Inc. in April 1997, ToppMed Inc. in July 1998 and LifeScience Technologies Inc. in January 2001. As a result of these acquisitions and asset purchases, we acquired 11,790 associates and added 129 products to our product line.

Miracle Mountain Acquisition. Effective May 31, 1996, Miracle Mountain International, Inc. became one of our wholly owned subsidiaries. Miracle Mountain was a network marketer of various third-party manufactured nutritional supplement products. In connection with the Miracle Mountain acquisition, we issued 20,000 shares of our common stock. As a result of the Miracle Mountain acquisition, we added one product to our line and 1,690 additional associates.

Chambre Acquisition. Effective January 31, 1997, Chambre International, Inc. became one of our wholly owned subsidiaries. Chambre International was a network marketer of various third-party manufactured cosmetic, skin care and hair care products. In connection with the Chambre acquisition, we issued 14,000 shares of our common stock. As a result of the Chambre acquisition, we added 74 products to our line, 68 in the personal care category and six in the dietary supplement category, and 2,100 additional associates.

Stay 'N Shape International Asset Purchase. We purchased all of the assets, including the network marketing organizations, of Stay 'N Shape International, Inc., Solution Products International, Inc., Nation of Winners, Inc., and Now International, Inc. on April 16, 1997. In connection with this asset purchase, we paid cash of $1,174,441 and issued 125,984 shares of our common stock. As a result of this asset purchase, we added 39 products to our line, 38 in the weight management and dietary supplement categories and one in the personal care category, and 3,000 additional associates.

ToppMed Asset Purchase. On July 31, 1998, we acquired all rights, including formulations and trademarks, for the ToppFast, ToppStamina and ToppFitt products from ToppMed, Inc. for $192,000.

LifeScience Technologies Acquisition. On January 4, 2001, we purchased the LifeScience Technologies, or LST, group of companies for $1.2 million and a five year payment of $41,667 per month or 5% of the gross sales of LifeScience Technologies products, whichever is greater. The seller has the option to take up to 860,000 shares of our common stock in lieu of cash at an option price of $3.00 per share. As a result of this acquisition, we added 14 products and over 5,000 associates.

Critical Accounting Policies. We prepare our consolidated financial statements in conformity with accounting principles generally accepted in the United States, which require us to make estimates and



assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the year. Actual results could differ from those estimates. We consider the following policies to be most critical in understanding the judgments that are involved in preparing our financial statements and the uncertainties that could impact our results of operations, financial condition and cash flows.

Throughout this report, "net sales" represents the gross sales amounts reflected on our invoices to our associates less associate discounts, sales returns, and freight income. Beginning June 1, 2001, we adopted a new billing policy, which requires billing customers a portion of freight costs, which is included in net sales. All of our products include a customer satisfaction guarantee. Our products may be returned within 30 days of purchase for a full refund or credit toward the purchase of another product. We also have a buy-back program whereby we repurchase products sold to an independent associate (subject to a restocking fee), provided the associate terminates his/her associateship agreement with us and returns the product within 12 months of original purchase in marketable condition. We receive our net sales price in cash or through credit card payments upon receipt of orders from associates.

Our "gross profit" consists of net sales less:

- Commissions and bonuses, consisting of commission payments to associates based on their current associate level within their organization, and other one-time incentive cash bonuses to qualifying associates;

- Cost of products, consisting of the prices we pay to our manufacturers for products and royalty overrides earned by qualifying associates on sales within their associate organizations;

and

- Cost of shipping, consisting of costs related to shipments, duties and tariffs, freight expenses relating to shipment of products to associates, and similar expenses.

We recognize revenue upon shipment of products, training aids and promotional material to the independent associates. All of our customers pay for sales in advance of shipment. As such, we have no trade receivables. Loans to associates are repayable in five years or less; are secured by commissions controlled by us; and are no longer allowed. Interest rates on loans are typically two percent or more above the Prime rate and are fixed. All loans and receivables are secured by guaranteed payment sources that are within our control. As such, management believes there is no need for an allowance for doubtful accounts.

In July 2001, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets". This standard requires companies to stop amortizing existing goodwill and intangible assets with indefinite lives effective January 1, 2002. Under the new rules, companies would only adjust the carrying amount of goodwill or indefinite life intangible assets upon an impairment of the goodwill or indefinite life intangible assets. We implemented these standards effective January 1, 2002. Based on an evaluation of goodwill at October 31, 2002, we determined that goodwill of approximately $3,800,000 was 100% impaired and should be written off in its entirety.

We write down our inventory to provide for estimated obsolete or unsalable inventory based on assumptions about future demand for our products and market conditions. If future demand and market conditions are less favorable than management's assumptions, additional inventory write-downs could be required. Likewise, favorable future demand and market conditions could positively impact future operating results if written-off inventory is sold.

We account for contingencies in accordance with SFAS No. 5, "Accounting for Contingencies". SFAS 5 requires that we record an estimated loss from a loss contingency when information available prior to issuance of our financial statements indicates that it is probable than an asset has been impaired or a liability has been incurred at the date of the financial statements and the amount of the loss can be reasonable estimated. Accounting for contingencies such as legal and income tax matters requires us to use our judgment. Many legal and tax contingencies can take years to resolve. Generally, as the time period



increases over which the uncertainties are resolved, the likelihood of changes to the estimate of the ultimate outcome increases. However, an adverse outcome in these matters could have a material impact on our results of operations, financial condition and cash flows.

Units Offering. On November 12, 1997, we completed the offering of 1,495,000 units, each consisting of one share of common stock and one redeemable common stock purchase warrant. As a result of this offering, we received proceeds of $6,050,000. Each redeemable common stock purchase warrant is exercisable for the purchase of one share of our common stock for $3.40 on or before November 6, 2002. In connection with this offering, we sold to the underwriters, Paulson Investment Company, Inc. and Joseph Charles & Assoc., Inc., warrants exercisable for the purchase of 130,000 units for $5.40 per unit on or before November 6, 2002. On September 16, 2002, we extended the exercise period for the redeemable stock purchase warrants and the underwriter warrants from November 6, 2002 to November 6, 2003.

Warrant Modification Offering and Rights Offering. In January 1997, we distributed non-transferable rights to our common stock shareholders. These rights entitled the holders to subscribe for and purchase up to 2,148,191 units, each unit consisting of one share of our common stock and one 1997-A warrant, for the price of $6.80 per unit.

Concurrently, we called and redeemed our outstanding class A and class B common stock purchase warrants for $.0008 per warrant on March 17, 1997. However, in connection with the warrant redemption, we offered to the holders of the class A and class B warrants the right to purchase units, each comprised of one share of common stock and one 1997-A warrant, at an exercise price of $6.00 per unit.

Each 1997-A warrant is exercisable on or before November 6, 2002, to purchase one share of common stock for $3.40, subject to adjustment in certain events. We may redeem the 1997-A warrants at any time upon 30 days notice, at a price of $.0001 per 1997-A warrant. On September 16, 2002, we extended the exercise period for the 1997-A warrants from November 6, 2002 to November 6, 2003.

We received proceeds from these two offerings of $2,154,357. Accumulated offering costs of $323,076 were charged against the net proceeds from these offerings. Pursuant to these offerings we issued 337,211 shares of common stock and the same number of 1997-A warrants.

Associate Stock Purchase Plan. We registered 5,000,000 stock purchase plan participation interests in the Advantage Marketing Systems, Inc. 1998 Associate Stock Purchase Plan. The participation interests are offered to the associates of our products and services in lots of five participation interests. A participant in this plan is entitled through purchase of the participation interests to purchase in the open market through the plan, shares of our common stock. The participation interests are non-transferable. Other than an annual service fee of $5.00 per participant and a transaction fee of $1.25 per month, we do not receive any proceeds from the purchase of the common stock by the plan. The offering price of each participation interest is $1.00, and each participant is initially required to purchase a minimum of 25 participation interests.

RESULTS OF OPERATIONS

Comparison of 2002 and 2001

Our net sales during the year ended December 31, 2002, decreased by $6,137,339, or 21.6%, to $22,303,581 from $28,440,920 during the year ended December 31, 2001. During 2002, we made sales to approximately 40,000 associates, compared to sales during 2001 to approximately 71,597 associates. Associates at December 31, 2002 were down from 2001 due to decreased recruiting activity. At December 31, 2002, we had approximately 39,000 "active" associates compared to approximately 69,700 at December 31, 2001. An associate is considered to be "active" if he or she has made a product purchase of $50 or more from us or is enrolled in our autoship program within the previous 12 months. Sales per associate per month increased to $58 for 2002, compared to $28 for 2001.

Our cost of sales during 2002 decreased by $4,104,167, or 21.3%, to $15,126,983 from $19,231,150 during 2001. This decrease was attributable to:



- A decrease of $2,432,420 in associate commissions and bonuses;

- A decrease of $1,279,169 in the cost of products sold; and

- A decrease of $391,582 in shipping costs.

Total cost of sales as a percentage of net sales increased to 67.8% during the year ended December 31, 2002, from 67.6% during the same period in 2001. This was primarily due to an increase in cost of shipping to 7.5% of net sales from 7.3%, which was due to increased rates and an increase in commissions and bonuses to 41.5% of net sales from 41.1%. This increase was partially offset by a decrease in cost of products sold to 18.8% of net sales from 19.2% due to efficiency in inventory purchasing and carrying cost.

Our gross profit decreased $2,033,172, or 22.1%, to $7,176,598 during 2002 from $9,209,770 during 2001. The gross profit decreased as a percentage of net sales to 32.2% in 2002 from 32.4% in 2001, as reflected in our cost of goods sold decrease.

Marketing, distribution and administrative expenses decreased $925,542, or 10.1%, to $8,255,251 during the year ended December 31, 2002, from $9,180,793 during the same period in 2001. This decrease was primarily attributable to:

- Non-recurring expenses in 2001 of approximately $255,000 related to the operation of the LifeScience Technologies California warehouse in January and February of 2001, plus the transition costs related to the LifeScience Technologies acquisition in January 2001;

- A decrease in depreciation and amortization expense of approximately $167,000, due to the cessation of goodwill amortization in 2002 per FASB 142 (See Note 1 to our financial statements);

- A decrease in professional services expense of approximately $300,000 due to the buyout of options in 2001, and a change in auditing firm in 2002, saving us approximately $76,000; and

- A decrease in contract services from 2001 of $193,600 incurred to supplement our technical staff during the LifeScience Technologies acquisition transition.

The marketing, distribution and administrative expenses as a percentage of net sales increased to 37.0% in 2002, from 32.3% in 2001.

In July 2001, the Financial Accounting Standards Board issued Statement of Financial Accounting Standard No. 142, "Goodwill and Other Intangible Assets". This standard required companies to stop amortizing existing goodwill and other intangible assets with indefinite lives effective January 1, 2002. Under the new rules, companies would only adjust the carrying amount of goodwill or indefinite life intangible assets upon an impairment of the goodwill or indefinite life intangible assets. We implemented this standard effective January 1, 2002. Upon an evaluation at October 31, 2002, we determined that goodwill was impaired and should be written off in its entirety. This resulted in a one-time impairment charge of $3,788,374, or 17.0% of net sales for 2002.

Our net other expense increased by $78,106 to net other expense of $93,065 during 2002, from a net other expense of $14,959 during the same period in 2001. This increase was primarily due to:

- A decrease in investment income of $28,000 related to marketable securities offset by an increase in interest income of $22,000;

- A decrease in collection of written off accounts receivable of $11,000 related to collection of old, outstanding debt;

- A loss on sale of marketable securities of $30,000; and

- A loss on sale of assets of $17,500.



Our income (loss) before taxes decreased $4,974,110, to a loss of $4,960,092 during 2002, from income of $14,018 during 2001. Income (loss) before taxes as a percentage of net sales was (22.2%) and 0.0% during 2002 and 2001. Income tax expense (benefit) during 2002 and 2001 was $(1,755,057) and $5,467. Our net income (loss) decreased $3,213,586, to a net loss of $3,205,035 during 2002, from a net income of $8,551 during 2001. This decrease in net income (loss) was attributable to:

- The increase in interest expense net of interest income of $78,106 to net other expense of $93,065 during 2002 from net other expense of $14,959 during 2001;

- The decrease in gross profit of $2,033,172 to $7,176,598 during 2002 from $9,209,770 during 2001;

- The impairment of goodwill of $3,788,374; and

- The decrease in marketing, distribution and administrative expense of $925,542 to $8,255,251 during 2002 from $9,180,793 during 2001.

Net income as a percentage of net sales decreased to (14.4%) during 2002, from 0.0% during 2001.

Comparison of 2001 and 2000

Our net sales during the year ended December 31, 2001, increased by $1,732,984, or 6.5%, to $28,440,920 from $26,707,936 during the year ended December 31, 2000. During 2001, we made sales to 71,597 associates, compared to sales during 2000 to 79,500 associates. At December 31, 2001, we had approximately 69,700 "active" associates compared to approximately 76,600 at December 31, 2000. Sales per associate per month increased from $28 to $33 for 2001, compared to 2000.

Our cost of sales during 2001 increased by $1,301,449, or 7.3%, to $19,231,150 from $17,929,701 during 2000. This increase was attributable to:

- An increase of $725,608 in associate commissions and bonuses due to increased sales;

- A decrease of $220,503 in the cost of products sold due to the consolidation of product lines; and

- An increase of $796,344 in shipping costs primarily due to increased shipping rates by U.P.S. and U.S.P.S.

Total cost of sales, as a percentage of net sales increased to 67.6% during the year ended December 31, 2001, from 67.1% during the same period in 2000. This was due to an increase in cost of shipping to 7.3% of net sales from 4.8%, due to increased rates. The increase was partially offset by a decrease in cost of products sold to 19.2% of net sales from 21.3% due to efficiency in inventory purchasing and carrying cost.

Our gross profit increased $431,535, or 4.9%, to $9,209,770 during 2001 from $8,778,235 during 2000. The gross profit decreased as a percentage of net sales to 32.4% of net sales from 32.9%, reflected in our cost of goods sold decrease.

Marketing, distribution and administrative expenses increased $1,122,985, or 13.9%, to $9,180,793 during the year ended December 31, 2001, from $8,057,810 during the same period in 2000. This increase was primarily attributable to:

- A decrease in promotion costs of approximately $460,000;

- An increase in staffing and related payroll cost of approximately $375,000 necessary to support our expected increase in sales activity and improve internal programs;



- Non-recurring expenses of approximately $255,000 related to the operation of the LifeScience Technologies California warehouse in January and February of 2001, which facilities have now been closed, plus the transition costs related to the LifeScience Technologies acquisition in January 2001;

- An increase in depreciation and amortization expense of approximately $335,000, including amortization of goodwill resulting from the LifeScience Technologies acquisition in the amount of $125,440;

- An increase in professional services cost of $120,000 due to the buyout of options;

- An increase in contract services of $245,000 incurred to supplement our technical staff during the LifeScience Technologies acquisition transition; and

- An increase in insurance expense of $245,000 due to policy premium increases on general liability and director and officer insurance, as well as higher levels of activity and corresponding increases in other variable costs, such as postage, telephone, newsletter, bank card service charges and supplies.

The marketing, distribution and administrative expenses as a percentage of net sales increased to 32.3% in 2001, from 30.2% in 2000.

Our net other income decreased by $243,998 to net other expense of $14,959 during 2001, from a net other income of $229,039 during the same period in 2000. This decrease was primarily attributable to a decrease in investment income of approximately $131,000 related to marketable securities, along with an increase in interest expense of $144,000 related to the LST note payable.

Our income before taxes decreased $935,447, or 98.5%, to $38,019 during 2001, from $949,466 during 2000. Income before taxes as a percentage of net sales was 0.0% and 3.6% during 2001 and 2000. Income taxes during 2001 and 2000 were $5,467 and $456,532. Our net income decreased $484,383, or 98.3%, to $8,551 during 2001, from $492,934 during 2000. This decrease in net income was attributable to:

- The decrease in interest income net of interest expense of $243,998, or 14.7%, to net other expense of $14,959 during 2001 from net other income of $229,039 during 2000;

- The increase in the marketing, distribution and administrative expenses; and

- The increase in gross profit of $431,535 to $9,209,770 during 2001 from $8,778,235 during 2000.

Net income as a percentage of net sales decreased to 0.0% during 2001, from 1.8% during 2000.

Seasonality

No pattern of seasonal fluctuations exists due to the growth patterns that we are currently experiencing. However, there is no assurance that we will not become subject to seasonal fluctuations in operations.

ACCOUNTING STANDARDS TO BE ADOPTED

In April 2002, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standard (SFAS) No. 145, "Rescission of FASB Statements No. 4, 44 and 64, Amendment of FASB Statement No. 13 and Technical Corrections", that, among other things, rescinded SFAS No. 4, "Reporting Gains and Losses from Extinguishment of Debt". With the rescission of SFAS No. 4, the early extinguishments of debt generally will no longer be classified as an extraordinary item for financial statement presentation purposes. The provision is effective for fiscal years beginning after May 15, 2002. We do not anticipate that the adoption of SFAS No. 145 will have a material effect on our financial position or results of operations.



In June 2002, the FASB issued SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities", which replaces Emerging Issues Task Force Issue No. 94-3, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity" (including Certain Costs Incurred in a Restructuring). The new standard required companies to recognize costs associated with exit or disposal activities when they are incurred rather than at the date of a commitment to an exit or disposal plan. The statement is to be applied prospectively to exit or disposal activities initiated after December 31, 2002. We do not anticipate that the adoption of SFAS No. 146 will have a material effect on our financial position or results of operations.

In December 2002, the FASB issued SFAS No. 148, "Accounting for Stock-Based Compensation-Transition and Disclosure", which amended SFAS No. 123, "Accounting for Stock-Based Compensation". The new standard provides alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. Additionally, the statement amends the disclosure requirements of SFAS No. 123 to require prominent disclosures in the annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used in reported results. This statement is effective for financial statements for fiscal years ending after December 15, 2002. In compliance with SFAS No. 148, we have elected to continue to follow the intrinsic value method in accounting for our stock-based employee compensation arrangement as defined by APB No. 25.

In November 2002, the FASB issued Interpretation No. 45, "Guarantor's Accounting and Disclosure Requirement for Guarantees, Including Indirect Guarantees of Indebtedness of Others", or FIN 45. For a guarantee subject to FASB Interpretation No. 45, a guarantor is required to measure and recognize the fair value of the guarantee liability at inception. For many guarantees, fair value will likely be determined using the expected present value method described FASB Concepts Statement 7, "Using Cash Flow Information and Present Value in Accounting Measurements". In addition, FIN 45 provides new disclosure requirements. We adopted the disclosure requirements of FIN 45 as of December 31, 2002. The measurement and liability recognition provisions are applied prospectively to guarantees or modifications after December 31, 2002. We anticipate that FIN 45 will not have a material impact on our financial statements.

In January 2003, the FASB issued Interpretation No. 46, "Consolidation of Variable Interest Entities", or FIN 46. Subject to certain criteria defined in the Interpretation, FIN 46 will require consolidation by business enterprises of variable interest entities if the enterprise has a variable interest that will absorb the majority of the entity's expected losses, receive the majority of it's expected returns, or both. The provisions of FIN 46 are effective immediately for interests acquired in variable interest entities after January 31, 2003, and at the beginning of the first interim or annual period beginning after June 15, 2003, for interests acquired in variable interest entities before February 1, 2003. We will adopt FIN 46 in the third quarter of 2003. Certain disclosures concerning variable interest entities are required in financial statements initially issued after January 31, 2003. We are evaluating the effect of FIN 46 but do not believe FIN 46 will have a material impact on our financial statements.

COMMITMENTS AND CONTINGENCIES

Recent Regulatory Developments - A significant portion of our net sales continues to be dependent upon our AM-300 product. Our net sales of AM-300 represented 48.8% and 52.0% of net sales for the years ended December 31, 2002 and 2001. One of the ingredients in our AM-300 products is ephedra, an herb that contains naturally occurring ephedrine. Our manufacturer uses a powdered extract of that herb when manufacturing AM-300. We market AM-300 principally as an aid in weight management. The extract is an 8% extract, which means that every 100 milligrams of the powdered extract contains approximately eight milligrams of naturally occurring ephedrine alkaloids. In addition, our Sine-Eze product, used as a food supplement to relieve symptoms associated with allergies, contains ephedrine alkaloids. Ephedrine containing products have been the subject of adverse publicity in the United States and other countries relating to alleged harmful effects.

The FDA published a proposed rule in the Federal Register on June 4, 1997, which proposed significant limitations on the sale of ephedrine-containing dietary supplements. The proposed rule would have significantly limited our ability to sell products containing ephedra if it had been made effective. On



April 3, 2000, the FDA withdrew most of the provisions of its proposed rule. This action was prompted largely by a report issued by the United States General Accounting Office, or GAO, in which the GAO criticized the scientific basis for the proposed rule and the FDA's evaluation of approximately 900 reports of adverse events supposedly related to the consumption of dietary supplements containing ephedrine alkaloids. The FDA has made available for public inspection most of these adverse event reports.

On March 7, 2003, the FDA published a notice in the Federal Register, which indicates that it will be taking final action on the 1997 proposed rule in the near future. The FDA re-opened the public comment period, until April 7, 2003, to allow for additional public input on the two proposed limitations on the sale of ephedrine-containing dietary supplements that remained after the FDA's action of April 3, 2000. One proposed limitation is a warning that would be required to appear on the label of all ephedrine-containing supplements. The other proposed limitation is that ephedrine-containing supplements may not contain other substances that are known to have stimulant effects (e.g., caffeine). The proposed warning addresses potential health risks allegedly associated with ephedrine-containing dietary supplements. It is similar, but not identical, to mandatory warnings that have been required by Texas law since 1999 and California law since January 1, 2003. AM-300 and our other ephedrine-containing supplements comply with these state law requirements. However, some of our ephedrine-containing products, like AM-300, contain caffeine or other stimulants. Therefore, if the proposed rule is made final in its current form, it will prohibit the sale of some of our products in their present formulations.

On March 13, 2003, the FDA published a proposed rule in the Federal Register which proposes comprehensive requirements for the manufacturing, packing and holding dietary supplements, also known as good manufacturing practices. The FDA is accepting public comments on the proposed GMPs until June 11, 2003; final GMPs will be promulgated after the FDA has reviewed the public comments. Once final GMP regulations become effective, our manufacturer will be required to adhere to them. The FDA will most likely institute an effective date for the GMPs which will allow our manufacturer a reasonable amount of time to conduct this review and, if necessary, revise its manufacturing operations to comply with the final GMP regulations.

Product Liability - We, like other marketers of products that are intended to be ingested, face the inherent risk of exposure to product liability claims in the event that the use of our products results in injury. We maintain limited product liability insurance coverage with limits of $1,000,000 per occurrence and $2,000,000 in the aggregate. Products containing ephedra, which represented approximately 49% of our 2002 net revenue, are not covered by our product liability insurance. We generally do not obtain contractual indemnification from our product manufacturers. However, all of our product manufacturers carry product liability insurance, which covers our products. A product liability claim could result in material losses.

Legal Proceedings - We are currently involved in two products liability suits related to the ingestion of our ephedra-based products. Answers to these petitions are due April 23 and 30, 2003. As such, we have not had sufficient time to either investigate the facts of these cases or analyze appropriate defenses to the allegations. We will deny any wrongdoing and intend to vigorously defend the claims. The amounts of damages sought are unknown, but include compensatory and punitive damages.

LIQUIDITY AND CAPITAL RESOURCES

Our primary source of liquidity has been cash provided by sales of our common stock, marketable securities and operating activities. At December 31, 2002, we had working capital of $3,186,584 compared to $3,110,607 at December 31, 2001. We believe our cash and cash equivalents and cash flows from operations will be sufficient to fund our working capital needs over the next 12 months. During the year ended December 31, 2002, net cash provided by operating activities was $694,712, net cash provided by investing activities was $68,193, and net cash used in financing activities was $537,795. We had a net increase in cash during this period of $225,111, primarily as a result of operations. Our working capital needs over the next 12 months consist primarily of marketing, distribution and administrative expenses.

In 2001, we completed construction of a 23,346 square foot distribution and call center facility in Oklahoma City. This project was funded, in part, with bank loans of $980,000 for the land and building and

$166,216 for the warehouse equipment. Both loans are with Bank One Oklahoma, N.A. and accrue interest at an annual rate of .25% under the prime rate.

The loans contain covenants restricting us from various activities without written consent of Bank One, the most significant of which restrict us from:

- Transferring, selling or otherwise disposing of any assets;

- Making any loans to any persons or entity in excess of $500,000 in the aggregate;

- Engaging in any merger or acquisition in which we are not the surviving corporation;

- Changing executive management personnel; and

- Purchasing or acquiring any interest in any other entity.

The loans also contain financial covenants requiring us to maintain:

- Tangible Net Worth, consisting of total assets excluding intangible assets less total liabilities excluding subordinated debt, of at least $5,500,000;

- Debt coverage ratio, consisting of net income plus amortization, depreciation and interest expense, divided by current maturities of long term debt and capital leases plus interest expense, of at least 125%; and

- Debt to EBITDA ratio, consisting of current and long term maturities of debt and capital leases, divided by net income plus amortization, depreciation, income tax and interest expense, of less than 250% through December 31, 2002, less than 225% for 2003 and less than 200% thereafter.

At December 31, 2002, we were not in compliance with our debt coverage ratio or the debt to EBITDA ratio. Per letter dated February 18, 2003, Bank One Oklahoma, N.A. granted a waiver for the covenant violations for the period ended December 31, 2002. We have negotiated a new agreement with Bank One, whereby the debt is secured by marketable securities. As such, the debt will no longer be subject to financial covenants.

The following summarizes our contractual obligations at December 31, 2002 and the effect such obligations are expected to have on our liquidity and cash flow in future periods.

| | TOTAL | LESS THAN 1 YEAR | 1-3 YEARS | 3-5 YEARS |
|---|---|---|---|---|
| Bank loans and notes (1) ... | $2,444,628 | $ 455,296 | $1,140,439 | $ 848,893 |
| Capital lease obligations .. | 257,500 | 109,898 | 147,602 | -- |
| Operating leases .......... | 137,332 | 102,000 | 35,332 | -- |
| Total .................... | $2,839,460 | $ 667,194 | $1,323,373 | $ 848,893 |

(1) See Note 4 to our financial statements.

At December 31, 2002, we had marketable debt and equity securities of $1,621,143 compared to $1,663,650 at December 31, 2001. All of our securities are unrestricted investments.

During the first quarter of 1998, we agreed to loan John W. Hail, our Chief Executive Officer and a major shareholder, up to $250,000. Subsequently we also agreed to loan up to an additional $75,000. In 2000, an additional $200,000 was approved. On January 1, 2001 the outstanding balance on all the notes plus interest were combined into one note payable in monthly installments. Our board of directors unanimously approved the loans and extension. These loans are collateralized by stock and property, and bear interest at 8% per annum. As of December 31, 2002, the balance due on these loans plus interest was $63,561. These loans will be paid in full in 2003. No new loans will be made to our officers or directors.

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ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Our balance sheet includes marketable securities, which we believe are a conservative blend of income and growth investments resulting in moderate market risk. We invest in equity marketable securities to generate capital growth, and fixed-income marketable securities to provide current income. Because of the nature of these investments, both current interest rates and equity market movements will affect total return and risk. Our fixed income investments of approximately $820,000 are subject to interest risk and market value risk. We have approximately $800,000 of equity investments that are exposed to market risk.

Interest Rate Risk. We currently maintain an investment portfolio of high-quality fixed-income marketable securities. All securities are available for sale and recorded in the balance sheet at fair value with fluctuations in fair value reported as a component of accumulated other comprehensive income in stockholders equity. We do not hedge our investment portfolio or our outstanding credit facility or other long-term indebtedness. Fixed-income investments with a maturity date of three months or less at the date of purchase are deemed to be cash equivalents. Any remaining fixed-income securities are considered short-term and mainly consist of investments in U.S. Treasury notes and bonds.

The following table lists our cash equivalents and our short-term fixed-income marketable securities at December 31, 2002 and December 31, 2001:

| | DECEMBER 31, 2002 | | | DECEMBER 31, 20 | |
|---|---|---|---|---|---|
| | AVERAGE INTEREST RATE(1) | COST | FAIR VALUE | AVERAGE INTEREST RATE (1) | COST |
| Cash equivalents ... | --% | $ 18,208 | $ 18,208 | --% | $ 975,835 |
| Short-term Investments ...... | 6.00% | 787,180 | 801,339 | 6.45% | 418,269 |
| | | $805,388 | $819,547 | | $1,394,104 |

======== ======== ==========

(1) Average interest rate is calculated by taking the individual security interest rates multiplied by each investments' weighted average share of the total fixed-income marketable securities.

Average interest rates for the year ended December 31, 2002 decreased .45% from December 31, 2001 due to the redemption of 100,000 units of 7.52% U.S. Government Agency securities in the first quarter, 100,000 units of 6.14% U.S. Government Agency securities in the third quarter and 95,000 units of 6.29% U.S. Government Agency securities in the fourth quarter 2002. These securities represented 70% of our total fixed-income marketable securities at December 31, 2001.

Fair value of the cash equivalents and fixed-income marketable securities decreased $586,253 during the year ended December 31, 2002 to $819,547 from $1,405,800 at December 31, 2001. This decrease was primarily due to the reinvestment of approximately $957,000 of cash equivalents to equity securities, partially offset by an increase in short-term investments of approximately $371,000.

Equity Market Risks. We currently maintain an investment portfolio of equity securities. All securities are available for sale and recorded in the balance sheet at fair value with fluctuations in fair value reported as a component of accumulated other comprehensive income in stockholders equity. We do not engage in hedging our equity portfolio or otherwise purchase derivative securities. Because of the quality of our portfolio and liquid nature of our equity investments, we do not consider the market risk related to these investments to be material. At December 31, 2002, our equity investments had a value of $801,595 compared to $257,850 at December 31, 2001, primarily due to the purchase of mutual fund equity investments in the second, third and fourth quarters of 2002.

We attempt to manage our interest and market risk by evaluating and purchasing what we believe to be the best investment securities and rates of return available.



ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

Our consolidated financial statements are set forth beginning on page F-1 hereof.

ITEM 9. CHANGES IN AND DISAGREEMENT WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

PART III

In accordance with the provisions of General Instruction G (3), information required by Items 10, 11, 12 and 13 of Form 10-K are incorporated herein by reference to our Proxy Statement for the Annual Meeting of Shareholders to be filed prior to April 30, 2003.

ITEM 14. CONTROLS AND PROCEDURES

Within the 90-day period prior to the filing of this report, an evaluation was carried out under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-14(c) under the Securities Exchange Act of 1934). Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the design and operation of these disclosure controls and procedures were effective. No significant changes were made in our internal controls or in other factors that could significantly affect these controls subsequent to the date of their evaluation.

PART IV

ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES AND REPORTS ON FORM 8-K

(a)(1) The following financial statements of Advantage Marketing Systems, Inc. are included in Item 8:


Report of Independent Certified Public Accountants.................................................
Independent Auditors' Report.......................................................................
Consolidated Balance Sheets as of December 31, 2002 and 2001..................................
Consolidated Statements of Operations for Years Ended December 31, 2002, 2001 and 2000...........
Consolidated Statements of Stockholders' Equity for Years Ended December 31, 2002, 2001 and 2000...................................................................................
Consolidated Statements of Cash Flows for Years Ended December 31, 2002, 2001 and 2000...........
Notes to Consolidated Financial Statements for Years Ended December 31, 2002 2001 and 2000.......


(a)(2) Financial Statement Schedules

All other schedules have been omitted since the required information is not present, or not present in amounts sufficient to require submission of the schedule, or because the information required is included in the consolidated financial statements or notes thereto.

(a)(3) Exhibits

| EXHIBIT NO. | DESCRIPTION |
|---|---|
| 3.1 | The Registrant's Certificate of Incorporation, incorporated by reference to the Registration Statement on Form SB-2 (Registration No. 333-47801) filed with the commission on March 11, 1998. |



| | |
|---|---|
| 3.2 | The Registrant's Bylaws, incorporated by reference to the Registration Statement on Form SB-2 (Registration No. 333-47801) filed with the commission on March 11, 1998. |
| 10.1 | Warrant Agreement between Registrant and U.S. Stock Transfer Inc., dated as of January 16, 1997, as amended and restated January 8, 1998, incorporated by reference to Amendment No. 2 |

| | |
|---|---|
| | to Form 8-A Registration Statement, filed with the Commission on January 13, 1998. |
| 10.2 | Unit and Warrant Agreement between Registrant and U.S. Stock Transfer Inc., dated as of November 6, 1997, as amended and restated January 8, 1998, incorporated by reference to Amendment No. 1 to Form 8-A Registration Statement, filed with the Commission on January 15, 1998. |
| 10.3 * | The Advantage Marketing Systems, Inc. 1998 Distributor Stock Purchase Plan, incorporated by reference to Amendment No. 1 to Registration Statement on Form SB-2 (Registration No. 333-47801) filed with the commission on October 7, 1998. |
| 10.4 * | The form of Advantage Marketing Systems, Inc. 1998 Distributor Stock Purchase Plan Stock Purchase Agreement, incorporated by reference to Amendment No. 1 to Registration Statement on Form SB-2 (Registration No. 333-47801) filed with the commission on October 7, 1998. |
| 10.5 | Purchase and Assignment Agreement by and among Advantage Marketing Systems, Inc., LifeScience Technologies Holdings, Inc., GHI Holdings, Inc., LifeScience Technologies, Inc. and RMS Limited Partnership, dated as of January 3, 2001, incorporated by reference to Form 8-K filed with the Commission on January 8, 2001. |
| 10.6 | Promissory Note dated January 3, 2001, to RMS Limited Partnership by Advantage Marketing Systems, Inc., LifeScience Technologies Holdings, Inc., LifeScience Technologies Holdings Limited Partnership, LifeScience Technologies Holdings, Inc., LifeScience Technologies of Japan and LST Fulfillment Limited Partnership, incorporated by reference to Form 8-K filed with the Commission on January 8, 2001. |
| 10.7 | Stock Option Agreement of Advantage Marketing Systems dated January 3, 2001, incorporated by reference to Form 8-K filed with the Commission on January 8, 2001. |
| 10.8 | Joint Marketing Agreement with PrimeBuy Network.com, Inc., dated August 30, 2002, incorporated by reference to Form 10-Q filed with the Commission on November 1, 2002. |
| 10.9 | Promissory Note executed by PrimeBuy Network.com, Inc., dated August 2, 2002, incorporated by reference to Form 10-Q filed with the Commission on November 1, 2002. |
| 10.10 * | The Advantage Marketing Systems, Inc. 1995 Stock Option Plan, incorporated by reference to Form SB-2 Registration Statement (No. 33-80629), filed with the Commission on November 20, 1996. |
| 10.11 * | Employment Agreement by and between David D'Arcangelo and Registrant dated effective as of November 25, 2002, filed herewith. |
| 10.12 * | Non-Qualified Stock Option Agreement by and between David D'Arcangelo and Registrant dated effective as of December 2, 2002, filed herewith. |
| 21 | Subsidiaries, incorporated by reference to Form 10-K filed with the Commission on April 17, 2001. |

| | |
|---|---|
| 23.1 | Consent of Grant Thornton LLP, filed herewith. |
| 23.2 | Consent of Deloitte & Touche LLP, filed herewith. |



| | |
|---|---|
| 99.1 | Chief Executive Officer Certification, filed herewith. |
| 99.2 | Chief Financial Officer Certification, filed herewith. |
| * | Designates a compensatory plan. |
| (b) | Reports on Form 8-K. |

- On November 4, 2002, the registrant filed an 8-K reporting the filing of CEO and CFO certifications relating to its 3rd Quarter Form 10-Q as required by Section 906 of the Sarbanes Oxley Act of 2002.

- On October 24, 2002, the registrant filed an 8-K reporting the resignation of its president.



SIGNATURES

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

REGISTRANT:
ADVANTAGE MARKETING SYSTEMS, INC.

Date: March 31, 2003 — By: /S/ JOHN W. HAIL
John W. Hail, Chief Executive Officer, Chairman of the Board and Director

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

| | |
|---|---|
| Date: March 31, 2003 | By: /S/ JOHN W. HAIL<br>John W. Hail, Chief Executive Officer, Chairman of the Board and Director |
| Date: March 31, 2003 | By: /S/ DAVID D. D'ARCANGELO<br>David D. D'Arcangelo, President and Director |
| Date: March 31, 2003 | By: /S/ DENNIS LONEY<br>Dennis Loney, Chief Operational Officer |

| | |
|---|---|
| Date: March 31, 2003 | By: /S/ REGGIE COOK<br>Reggie Cook, Chief Financial Officer and Secretary Treasurer |
| Date: March 31, 2003 | By: /S/ M. THOMAS BUXTON III<br>M. Thomas Buxton III, Director |
| Date: March 31, 2003 | By: /S/ STEVEN M. DICKEY<br>Steven M. Dickey, Director |
| Date: March 31, 2003 | By: /S/ HARLAND C. STONECIPHER<br>Harland C. Stonecipher, Director |
| Date: March 31, 2003 | By: /S/ STEVEN R. HAGUE<br>Steven R. Hague, Director |

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I, John W. Hail, Chief Executive Officer, certify that:

1. I have reviewed this annual report on Form 10-K of Advantage Marketing Systems, Inc. (the "registrant");

2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this annual report;

3. Based on my knowledge, the financial statements, and other financial information included in this annual report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this annual report;

4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and have:

   (a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this annual report is being prepared;

   (b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this annual report (the "Evaluation Date"); and

   (c) presented in this annual report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):

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

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

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

Advantage Marketing Systems, Inc.

Date: March 31, 2003

By: /S/ JOHN W. HAIL
----------------
John W. Hail
Chairman and Chief Executive Officer



I, Reggie B. Cook, Chief Financial Officer, certify that:

1. I have reviewed this annual report on Form 10-K of Advantage Marketing Systems, Inc. (the "registrant");

2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this annual report;

3. Based on my knowledge, the financial statements, and other financial information included in this annual report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this annual report;

4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and have:

   (d) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this annual report is being prepared;

(e) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this annual report (the "Evaluation Date"); and

(f) presented in this annual report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):

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

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

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

Advantage Marketing Systems, Inc.

Date: March 31, 2003

By: /S/ REGGIE B. COOK
--------------------------------
Reggie B. Cook
Chief Financial Officer

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AUDITED CONSOLIDATED FINANCIAL STATEMENTS:

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2000....................................................................................
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REPORT OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS

Board of Directors and Stockholders of
Advantage Marketing Systems, Inc. and Subsidiaries

We have audited the accompanying consolidated balance sheets of Advantage Marketing Systems, Inc. and Subsidiaries as of December 31, 2002 and 2001, and the related consolidated statements of operations, stockholders' equity and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Advantage Marketing Systems, Inc. and Subsidiaries as of December 31, 2002 and 2001, and the results of their operations and their cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 1 to the consolidated financial statements, the Company adopted Statement of Financial Accounting Standards No. 142, Goodwill and Other Intangibles, on January 1, 2002.

GRANT THORNTON LLP

Oklahoma City, Oklahoma
February 22, 2003



INDEPENDENT AUDITORS' REPORT

To the Board of Directors and Shareholders of
Advantage Marketing Systems, Inc. and Subsidiaries
Oklahoma City, Oklahoma

We have audited the accompanying consolidated balance sheet of Advantage Marketing Systems, Inc. and subsidiaries (the "Company") as of December 31, 2000, (not presented herein) and the related consolidated statements of income, stockholders' equity, and cash flows for the year then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2000, (not presented herein) and the results of its operations and its cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

DELOITTE & TOUCHE LLP

Oklahoma City, Oklahoma
April 12, 2001



ADVANTAGE MARKETING SYSTEMS, INC.
AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS
DECEMBER 31, 2002 AND 2001

| | 2002 |
|---|---|
| **ASSETS** | |
| CURRENT ASSETS: | |
| Cash and cash equivalents | $ 1,207,299 |
| Marketable securities, available for sale, at fair value | 1,621,143 |
| Receivable - net of allowance of $0 and $92,931 respectively | 123,838 |
| Receivable from affiliates | 63,561 |
| Prepaid taxes and income tax receivable | 464,975 |
| Inventory | 798,153 |
| Deferred income taxes | 120,343 |
| Other assets | 31,215 |
| Total current assets | 4,430,527 |
| RECEIVABLES, Net, $433,035 from related party in 2001 | 338,839 |
| PROPERTY AND EQUIPMENT, Net | 3,905,432 |
| GOODWILL, Net | -- |
| COVENANTS NOT TO COMPETE and other intangibles, Net | 635,821 |
| DEFERRED INCOME TAXES | 1,276,859 |
| OTHER ASSETS | 98,791 |
| TOTAL | $ 10,686,269 |
| **LIABILITIES AND STOCKHOLDERS' EQUITY** | |
| CURRENT LIABILITIES: | |
| Accounts payable | $ 219,533 |

| | |
|---|---|
| Accrued commissions and bonuses | 171,310 |
| Accrued other expenses | 151,289 |
| Accrued sales tax liability | 136,618 |
| Notes payable | 455,296 |
| Capital lease obligations | 109,898 |
| Total current liabilities | 1,243,944 |
| LONG-TERM LIABILITES: | |
| Notes payable | 1,989,332 |
| Capital lease obligations | 122,564 |
| Deferred taxes | -- |
| Total liabilities | 3,355,840 |
| COMMITMENTS AND CONTINGENCIES (Notes 5 and 12) | |
| STOCKHOLDERS' EQUITY: | |
| Common stock - $.0001 par value; authorized 495,000,000 shares; issued 4,896,674 and 4,882,174 shares; outstanding 4,424,314 and 4,409,814 shares, respectively | 490 |
| Paid-in capital | 11,793,240 |
| Notes receivable for exercise of options | (31,000) |
| Retained earnings (accumulated deficit) | (2,118,857) |
| Accumulated other comprehensive loss, net of tax | (68,968) |
| Total capital and retained earnings (accumulated deficit) | 9,574,905 |
| Less cost of treasury stock (472,795 shares) | (2,244,476) |
| Total stockholders' equity | 7,330,429 |
| TOTAL | $ 10,686,269 |

SEE NOTES TO CONSOLIDATED FINANCIAL STATEMENTS.



ADVANTAGE MARKETING SYSTEMS, INC.
AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS
YEARS ENDED DECEMBER 31, 2002, 2001 AND 2000

| | 2002 | 20 |
|---|---|---|
| Net sales | $22,303,581 | $28,44 |
| Cost of sales | 15,126,983 | 19,23 |
| Gross profit | 7,176,598 | 9,20 |
| Marketing, distribution and administrative expenses: | | |
| Marketing | 2,487,006 | 2,30 |
| Distribution and administration | 5,768,245 | 6,87 |

| | | |
|---|---|---|
| Total marketing, distribution and administrative expenses ............ | 8,255,251 | 9,18 |
| Goodwill impairment ............................................... | 3,788,374 | |
| Income (loss) from operations ..................................... | (4,867,027) | 2 |
| Other income (expense): | | |
| Interest and dividends, net ....................................... | (53,895) | (3 |
| Other income (expense), net ....................................... | (39,170) | 1 |
| Total other income (expense) ...................................... | (93,065) | (1 |
| INCOME (LOSS) BEFORE TAXES ........................................ | (4,960,092) | 1 |
| INCOME TAX EXPENSE (BENEFIT) ...................................... | (1,755,057) | |
| NET INCOME (LOSS) ................................................. | $(3,205,035) | $ |
| Net income (loss) per common share - basic ........................ | $ (.73) | $ |
| Net income (loss) per common share - assuming dilution ............ | $ (.73) | $ |
| Weighted average common shares outstanding - basic ................ | 4,419,196 | 4,37 |
| Weighted average common shares - assuming dilution ................ | 4,419,196 | 4,69 |

SEE NOTES TO CONSOLIDATED FINANCIAL STATEMENTS.



ADVANTAGE MARKETING SYSTEMS, INC.
AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY
YEARS ENDED DECEMBER 31, 2002, 2001 AND 2000

| | SHARES (SEE NOTE 6) | COMMON STOCK | PAID-IN CAPITAL | NOTES RECEIVABLE FOR EXERCISE OF OPTIONS | RETAINED EARNINGS (ACCUMU- LATED DEFICIT |
|---|---|---|---|---|---|
| BALANCE, | | | | | |

| | | | | | |
|---|---|---|---|---|---|
| JANUARY 1, 2000 | 4,083,238 | $ 428 | $ 10,232,700 | $ (50,999) | $ 759,6 |
| Payments on notes receivable .......... | -- | -- | -- | 19,911 | |
| Options exercised with cash ................ | 373,504 | 37 | 843,480 | -- | |
| Options exercised by tendering mature shares, net ......... | 76,239 | 8 | -- | -- | |
| 1997-A Warrants exercised ........... | 28,443 | 3 | 96,703 | -- | |
| Redeemable common stock purchase warrants exercised ... | 59,000 | 6 | 200,594 | -- | |
| Purchases of treasury stock, at cost ....... | (271,610) | -- | -- | -- | |
| Tax benefit from exercise of non-qualified options ............. | -- | -- | 268,711 | -- | |
| Purchase and cancellation of warrants............. | -- | -- | -- | -- | (174,9 |
| Comprehensive Income: | | | | | |
| Net Income ............ | -- | -- | -- | -- | 492,9 |
| Unrealized loss on available for sale securities, net of tax.................. | -- | -- | -- | -- | |
| Comprehensive income.... | -- | -- | -- | -- | |
| | --------- | ------ | ----------- | ----------- | --------- |
| BALANCE, DECEMBER 31, 2000..... | 4,348,814 | $ 482 | $11,642,188 | $ (31,088) | $ 1,077,6 |
| Options exercised with cash ................ | 61,000 | 6 | 121,994 | -- | |
| Comprehensive Income: | | | | | |
| Net Income ............ | -- | -- | -- | -- | 8,5 |
| Unrealized loss on available for sale securities, net of tax.................. | -- | -- | -- | -- | |
| Comprehensive Income ... | -- | -- | -- | -- | |
| | --------- | ------ | ----------- | ----------- | --------- |
| BALANCE, DECEMBER 31, 2001..... | 4,409,814 | $ 488 | $11,764,182 | $ (31,088) | $ 1,086,1 |
| Options exercised with cash ................ | 14,500 | 2 | 29,058 | -- | |
| Payments of notes receivable .......... | -- | -- | -- | 88 | |
| Comprehensive Income: | | | | | |
| Net Loss .............. | -- | -- | -- | -- | (3,205,0 |
| Unrealized loss on available for sale securities, net of tax.................. | -- | -- | -- | -- | |
| Comprehensive Income (Loss) ................ | -- | -- | -- | -- | |
| | --------- | ------ | ----------- | ----------- | --------- |
| BALANCE, DECEMBER 31, 2002..... | 4,424,314 | $ 490 | $11,793,240 | $ (31,000) | $(2,118,8 |
| | ========= | ====== | =========== | =========== | ========= |

| | COMPRE- HENSIVE INCOME (LOSS) | ACCUMU- LATED OTHER COM- PREHENSIVE INCOME (LOSS), NET OF TAX | TREASURY STOCK | TOTAL STOCK- HOLDERS EQUITY |
|---|---|---|---|---|
| BALANCE, JANUARY 1, 2000 | | $ (10,531) | $ (699,307) | $10,231, |
| Payments on notes receivable ........... | -- | -- | -- | 19, |
| Options exercised with cash ................ | -- | -- | -- | 843, |
| Options exercised by tendering mature shares, net .......... | -- | -- | -- | |
| 1997-A Warrants exercised ........... | -- | -- | -- | 96, |
| Redeemable common stock purchase warrants exercised ... | -- | -- | -- | 200, |
| Purchases of treasury stock, at cost ....... | -- | -- | (1,545,169) | (1,545, |
| Tax benefit from exercise of non-qualified options ............. | -- | -- | -- | 268, |
| Purchase and cancellation of warrants............. | -- | -- | -- | (174, |
| Comprehensive Income: | | | | |
| Net Income ............ | $ 492,934 | -- | -- | 492, |
| Unrealized loss on available for sale securities, net of tax.................. | (10,297) | (10,297) | -- | (10, |
| Comprehensive income.... | $ 482,637 | -- | -- | |
| BALANCE, DECEMBER 31, 2000..... | | $ (20,828) | $(2,244,476) | $10,423, |
| Options exercised with cash ................ | -- | -- | -- | 122, |
| Comprehensive Income: | | | | |
| Net Income ............ | 8,551 | -- | -- | 8, |
| Unrealized loss on available for sale securities, net of tax............... | (9,278) | (9,278) | -- | (9, |
| Comprehensive Income ... | $ (727) | -- | -- | |

| | | | | |
|---|---|---|---|---|
| BALANCE, DECEMBER 31, 2001..... | | $ (30,106) | $(2,244,476) | $10,545, |
| Options exercised with cash ................. | -- | -- | -- | 29, |
| Payments of notes receivable ........... | -- | -- | -- | |
| Comprehensive Income: | | | | |
| Net Loss ............... | (3,205,035) | -- | -- | (3,205, |
| Unrealized loss on available for sale securities, net of tax................... | (38,862) | (38,862) | -- | (38, |
| Comprehensive Income (Loss) ................. | $(3,243,897) | -- | -- | |
| BALANCE, DECEMBER 31, 2002..... | | $ (68,968) | $(2,244,476) | $7,330, |

SEE NOTES TO CONSOLIDATED FINANCIAL STATEMENTS.



ADVANTAGE MARKETING SYSTEMS, INC.
AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS
YEARS ENDED DECEMBER 31, 2002, 2001 AND 2000

| | 2002 |
|---|---|
| CASH FLOWS FROM OPERATING ACTIVITIES: | |
| Net income ............................................................... | $(3,205,035) |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities: | |
| Depreciation and amortization ........................................... | 1,016,260 |
| Goodwill impairment ..................................................... | 3,788,374 |
| Deferred taxes .......................................................... | (1,331,778) |
| Provision for bad debts.................................................. | -- |
| (Gain) loss on sale of assets ........................................... | 17,568 |
| Realized (gain) loss on sale of marketable securities.................... | 33,841 |
| Impairment of Inventory & other Assets .................................. | 116,143 |
| Changes in assets and liabilities which provided (used) cash: | |
| Receivables ........................................................... | 200,988 |
| Inventory ............................................................. | 421,156 |
| Prepaid taxes and income tax receivable ............................... | (365,855) |
| Other assets .......................................................... | 183,853 |
| Accounts payable and accrued expenses ................................. | (180,803) |
| Net cash provided by (used in) operating activities ................. | 694,712 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | |
| Purchases of property and equipment ........................................ | (717,515) |

| | |
|---|---|
| Sales of property and equipment | 284,438 |
| Advances to affiliates | 36,438 |
| Advances to notes receivable | -- |
| Receipts on notes receivable | 85,631 |
| Proceeds from sale of assets | -- |
| Repayment of related party receivables | 433,036 |
| Purchase of marketable securities, available for sale | (1,817,520) |
| Purchase of marketable securities, held to maturity | -- |
| Sale of marketable securities, available for sale | 1,763,685 |
| Maturity of marketable securities, held to maturity | -- |
| Purchase of other intangibles | -- |
| Acquisition of new business, net of cash acquired | -- |
| Net cash provided by (used in) in investing activities | 68,193 |
| CASH FLOWS FROM FINANCING ACTIVITIES: | |
| Proceeds from issuance of common stock | 29,061 |
| Proceeds from notes payable | -- |
| Purchase of treasury stock | -- |
| Purchase and cancellation of other warrants | -- |
| Repayments of notes receivable for exercise of stock options | 88 |
| Payment of notes payable | (455,295) |
| Principal payment on capital lease obligations | (111,649) |
| Net cash provided by (used in) financing activities | (537,795) |
| NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS | 225,111 |
| CASH AND CASH EQUIVALENTS, BEGINNING | 982,188 |
| CASH AND CASH EQUIVALENTS, ENDING | $ 1,207,299 |

SEE NOTES TO CONSOLIDATED FINANCIAL STATEMENTS.



ADVANTAGE MARKETING SYSTEMS, INC.
AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
YEARS ENDED DECEMBER 31, 2002, 2001 AND 2000

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

PRINCIPLES OF CONSOLIDATION - The consolidated financial statements include the accounts of Advantage Marketing Systems, Inc. and its wholly owned subsidiaries, Miracle Mountain International, Inc. and Chambre' International, Inc. (the "Company"). All significant intercompany accounts have been eliminated.

NATURE OF BUSINESS - The Company markets a product line of consumer oriented products in the weight management, dietary supplement and personal care categories that are produced by various manufacturers. The Company sells its product line through a network of full and part-time independent associates developed by the Company.

The Company also sells supplies and materials to its independent associates.

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

REVENUE RECOGNITION - The Company recognizes revenue upon shipment of products, training aids and promotional material to the independent associates.

LOANS AND TRADE RECEIVABLES - All of the Company's customers pay for sales in advance of shipment. As such, the Company has no trade receivables. Loans to associates are repayable in five years or less; are secured by commissions controlled by the Company; and are no longer allowed. Interest rates on loans are typically two percent or more above the Prime rate and are fixed.

CREDIT LOSSES AND DOUBTFUL ACCOUNTS - All loans and receivables are secured by guaranteed payment sources that are within the Company's control. As such, management believes there is no need for an allowance for doubtful accounts.

SALES RETURNS - All of the Company's products include a customer satisfaction guarantee. Company products may be returned within 30 days of purchase for a full refund or credit toward the purchase of another Company product. The Company also has a buy-back program whereby it will repurchase products sold to an independent associate (subject to a restocking fee) provided that the associate terminates his/her associateship agreement with the Company and returns the product within 12 months of original purchase in marketable condition. The cost of products returned to the Company is included in net sales. For the years ended December 31, 2002 and 2001, the cost of products returned to the Company was less than one percent of gross sales. For the year ended December 31, 2000, the cost of products returned to the Company was less than two percent of gross sales.

CASH AND CASH EQUIVALENTS - Cash and cash equivalents consist of cash in banks and all short term investments with initial maturities of three months or less. The Company maintains its cash and cash equivalents in accounts that may not be federally insured. The Company has not experienced any losses in such accounts and believes it is not exposed to any significant credit risk.

MARKETABLE SECURITIES - All of the Company's marketable securities are classified as available for sale and reported at fair value. The related unrealized gains and losses are excluded from earnings and reported net of income tax as a separate component of stockholders' equity until realized. Realized gains and losses on sales of securities are based on the specific identification method. Declines in the fair value of investment securities below their carrying value that are other than temporary are recognized in earnings.

INVENTORY - Inventory consists of consumer product inventory and training and promotional material such as video tapes, cassette tapes and paper supplies held for sale to customers and independent associates. Inventory is stated at the lower of cost or market. Cost is determined on a first-in, first-out method.

SHIPPING AND HANDLING COSTS - Shipping and handling costs are included as a component of cost of goods sold. Fees charged to customers are included in sales.

INTANGIBLES - Intangible assets consist of covenants not to compete and other intangibles, which have a significant residual value. Covenants not to compete are being amortized over the life of the contracts.

The table below details the gross carrying amount and accumulated amortization:

| | FOR THE YEAR ENDED DECEMBER 31, | | |
|---|---|---|---|
| | 2002 | 2001 | 2000 |
| Non-compete covenants, gross ...... | $ 644,000 | $ 644,000 | $ 644,000 |
| Other intangibles, gross .......... | 428,338 | 428,338 | -- |
| Total intangibles, gross ...... | $1,072,338 | $1,072,338 | $ 644,000 |
| Accumulated amortization, non-compete covenants ............... | $ 393,683 | $ 337,283 | $ 280,883 |
| Accumulated amortization, other intangibles .................... | 42,884 | 21,417 | -- |
| Total accumulated amortization | $ 436,517 | $ 358,700 | $ 280,883 |

Intangible amortization for the years ended December 31, 2002, 2001 and 2000, was $77,817, $77,817 and $73,729, respectively. Estimated amortization expense for the years 2003, 2004, 2005 and 2006 is $77,817 and estimated amortization expense for the year 2007 is $46,134.

PROPERTY AND EQUIPMENT - Property and equipment are stated at cost or, in the case of leased assets under capital leases, at the fair value of the leased property and equipment, less accumulated depreciation and amortization. Property and equipment are depreciated using the straight-line method over the estimated useful lives of the assets of three to 20 years. Assets under capital leases and leasehold improvements are amortized over the lesser of the term of the lease or the life of the asset.

LONG-LIVED ASSETS - Management of the Company assesses recoverability of its long-lived assets whenever events or changes in circumstances indicate that the carrying value of the asset may not be recoverable through future cash flows generated by that asset. Recoverability is assessed and measured on long-lived assets using an estimate of the undiscounted future cash flows attributable to the asset. Impairment is measured based on future cash flows discounted at an appropriate rate.

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FAIR VALUE DISCLOSURE - The Company's financial instruments include cash and cash equivalents, marketable securities, receivables, short-term payables, notes payable and capital lease obligations. The carrying amounts of cash and cash equivalents, receivables and short-term payables approximate fair value due to their short-term nature. Marketable securities held for sale are carried at fair value. The carrying amounts of capital lease obligations approximate fair value based on borrowing rates currently available to the Company. Notes payable with carrying amounts of $2,444,628 and $2,899,923 had fair values of approximately $2,520,000 and $2,900,000 at December 31, 2002 and 2001, respectively.

EARNINGS PER SHARE - Earnings per common share is computed based upon net income divided by the weighted average number of common shares outstanding during each period. Earnings per common share-assuming dilution is computed based upon net income divided by the weighted average number of common shares outstanding during each period adjusted for the effect of dilutive potential common shares calculated using the treasury stock method. The following is a reconciliation of the common shares used in the calculations of earnings per common share and earnings per common share - assuming dilution:

| | INCOME (NUMERATOR) | SHARES (DENOMINA |
|---|---|---|
| For the year ended December 31, 2002: | | |
| Earnings (loss) per common share: | | |
| Income (loss) available to common stockholders .................. | $(3,205,035) | |
| Weighted average common shares outstanding ...................... | | 4,419,1 |
| Earnings (loss) per common share - assuming dilution: | | |
| Options....................................................... | -- | |
| Income (loss) available to common stockholders plus assumed conversions ...................................... | $(3,205,035) | 4,419,1 |
| For the year ended December 31, 2001: | | |
| Earnings per common share: | | |
| Income available to common stockholders ......................... | $ 8,551 | |
| Weighted average common shares outstanding ...................... | | $4,379,4 |

| | | |
|---|---|---|
| Earnings per common share - assuming dilution: | | |
| Options | -- | 312,8 |
| Warrants | -- | |
| Income available to common stockholders plus assumed conversions | $ 8,551 | 4,692,2 |
| For the year ended December 31, 2000: | | |
| Earnings per common share: | | |
| Income available to common stockholders | $ 492,934 | |
| Weighted average common shares outstanding | | 4,283,4 |
| Earnings per common share - assuming dilution: | | |
| Options | -- | 706,7 |
| Warrants | -- | 486,0 |
| Income available to common stockholders plus assumed conversions | $ 492,934 | 5,476,2 |

Options to purchase 1,756,653 shares of common stock at exercise prices ranging from $1.31 to $6.13 per share were outstanding at December 31, 2002 but were not included in the computation of earnings per common share-assuming dilution because such inclusion would not be dilutive. At December 31, 2002, 526,664 common shares issuable pursuant to the terms of a convertible acquisition note payable





were excluded from the determination of diluted earnings per share under the if-converted method, because the effect of inclusion was antidilutive.

Options to purchase 1,193,691 shares of common stock at exercise prices ranging from $2.95 to $6.13 per share were outstanding at December 31, 2001 but were not included in the computation of earnings per common share-assuming dilution because the options' exercise price was greater than the average market price of the common shares. At December 31, 2001, 693,332 common shares issuable pursuant to the terms of a convertible acquisition note payable were excluded from the determination of diluted earnings per share under the if converted method because the effect of inclusion was antidilutive.

Options to purchase 138,005 shares of common stock at exercise prices ranging from $4.75 to $6.13 per share were outstanding at December 31, 2000 but were not included in the computation of earnings per common share - assuming dilution because the options' exercise price was greater than the average market price of the common shares.

Warrants to purchase 1,874,768 shares of common stock at exercise prices ranging from $3.40 to $5.40 per share at December 31, 2002 and 2001, and warrants to purchase 130,000 shares of common stock at $5.40 per share at December 31, 2000 were outstanding but were not included in the computation of earnings per common share-assuming dilution because the warrants' exercise price was greater than the average market price of the common shares.

ACCOUNTING STANDARDS YET TO BE ADOPTED - In April 2002, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standard (SFAS) No. 145, "Rescission of FASB Statements No. 4, 44 and 64, Amendment of FASB Statement No. 13 and Technical Corrections", that, among other things, rescinded SFAS No. 4, "Reporting Gains and Losses from Extinguishment of Debt". With the rescission of SFAS No. 4, the early extinguishments of debt generally will no longer be classified as an extraordinary item for financial statement presentation purposes. The provision is effective for fiscal years beginning after May 15, 2002. The Company does not anticipate that the adoption of SFAS No. 145 will have a material effect on its financial position or results of operations.

In June 2002, the FASB issued SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities", which replaces Emerging Issues Task Force Issue No. 94-3, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity" (including Certain Costs Incurred in a Restructuring). The new standard required companies to recognize costs associated with exit or disposal activities when they are incurred rather than at the date of a commitment to an exit or disposal plan. The statement is to be applied prospectively to exit or disposal activities initiated after December 31, 2002. The Company does not anticipate that the adoption of SFAS No. 146 will have a material effect on its financial position or results of operations.

In December 2002, the FASB issued SFAS No. 148, "Accounting for Stock-Based Compensation-Transition and Disclosure", which amended SFAS No. 123, "Accounting for Stock-Based Compensation". The new standard provides alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. Additionally, the statement amends the disclosure requirements of SFAS No. 123 to require prominent disclosures in the annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used in reported results. This statement is effective for financial statements for fiscal years ending after December 15, 2002. However, certain disclosures are effective for the Company's year ended December 31, 2002. In compliance with SFAS No. 148, the





Company has elected to continue to follow the intrinsic value method in accounting for its stock-based employee compensation arrangement as defined by APB No. 25.

In November 2002, the FASB issued Interpretation No. 45, "Guarantor's Accounting and Disclosure Requirement for Guarantees, Including Indirect Guarantees of Indebtedness of Others", or FIN 45. For a guarantee subject to FASB Interpretation No. 45, a guarantor is required to measure and recognize the fair value of the guarantee liability at inception. For many guarantees, fair value will likely be determined using the expected present value method described FASB Concepts Statement 7, "Using Cash Flow Information and Present Value in Accounting Measurements". In addition, FIN 45 provides new disclosure requirements. The disclosure requirements of FIN 45 were effective for the Company as of December 31, 2002. The measurement and liability recognition provisions are applied prospectively to guarantees or modifications after December 31, 2002. The Company anticipates that FIN 45 will not have a material impact on the financial statements.

In January 2003, the FASB issued Interpretation No. 46, "Consolidation of Variable Interest Entities", or FIN 46. Subject to certain criteria defined in the Interpretation, FIN 46 will require consolidation by business enterprises of variable interest entities if the enterprise has a variable interest that will absorb the majority of the entity's expected losses, receive the majority of it's expected returns, or both. The provisions of FIN 46 are effective immediately for interests acquired in variable interest entities after January 31, 2003, and at the beginning of the first interim or annual period beginning after June 15, 2003, for interests acquired in variable interest entities before February 1, 2003. The Company will adopt FIN 46 in the third quarter of 2003. Certain disclosures concerning variable interest entities are required in financial statements initially issued after January 31, 2003. The Company is evaluating the effect of FIN 46 but does not believe FIN 46 will have a material impact on its financial statements.

COMPREHENSIVE INCOME - The Company classifies other comprehensive income items by their nature in the financial statements and displays the accumulated balance of other comprehensive income separately in the stockholders' equity section of the balance sheet. The Company's only other comprehensive income item is related to unrealized gains on investment securities classified as available for sale.

| | 2002 | 2001 | 200 |
|---|---|---|---|
| Unrealized gain (loss) on investment arising during the period | $ (69,299) | $ (5,564) | $ 44 |
| Less reclassification adjustment for gains (losses) included in net earnings | (30,437) | 3,714 | 54 |
| Unrealized gain (loss) on investment, net of income taxes of $23,517, $5,615 and $6,301, respectively | $ (38,862) | $ (9,278) | $ (10 |

INCOME TAXES - The Company uses an asset and liability approach to account for income taxes. Deferred income taxes are recognized for the tax consequences of temporary differences and carryforwards by applying enacted tax rates applicable to future years to differences between the financial statement amounts and the tax bases of existing assets and liabilities. A valuation allowance is established if, in management's opinion, it is more likely than not that some portion of the deferred tax asset will not be realized.

RECLASSIFICATIONS - Certain reclassifications have been made to prior year balances to conform to the presentation for the current period.

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GOODWILL - During 2001 and 2000, goodwill was amortized using the straight-line method over 7 to 20 years and the Company assessed the recoverability of goodwill by determining whether the amortization of the asset balance over its remaining life could be recovered through the undiscounted future operating cash flows of the acquired operation. The amount of impairment, if any, was measured based on projected discounted future operating cash flows. Effective January 1, 2002, the Company adopted SFAS No. 142, "Goodwill and Other Intangible Assets" and ceased amortizing goodwill. Major provisions of this statement are as follows:

- Intangible assets acquired in a business combination must be recorded separately from goodwill if they arise from contractual or other legal rights or are separable from the acquired entity and can be sold, transferred, licensed, rented, or exchanged, either individually or as a part of a related contract, asset, or liability;

- Goodwill and intangible assets with indefinite lives are not amortized but are tested for impairment at least annually, except in certain circumstances, and whenever there is an impairment indicator; and

- All acquired goodwill must be assigned to reporting units for purposes of impairment testing and segment reporting.

The following table reconciles reported net income (loss) and related per share amounts to amounts that would have been presented exclusive of amortization expense recognized for goodwill that is no longer being amortized (tax-effected):

| | YEARS ENDED DECEMBER 31, | | |
|---|---|---|---|
| | 2002 | 2001 | 2000 |
| Reported net income (loss).................... | $ (3,205,035) | $ 8,551 | $ 492,934 |
| Add back: Goodwill amortization.............. | -- | 141,733 | 65,214 |
| Adjusted net income (loss).................... | $ (3,205,035) | $ 150,284 | $ 558,148 |
| BASIC EARNINGS (LOSS) PER SHARE: | | | |
| Reported net income (loss).................. | $ (.73) | $ .00 | $ .12 |
| Goodwill amortization....................... | -- | .03 | .02 |
| Adjusted net income (loss).................. | $ (.73) | $ .03 | $ .14 |
| DILUTED EARNINGS (LOSS) PER SHARE: | | | |

| | | | |
|---|---|---|---|
| Reported net income (loss).................. | $ (.73) | $ .00 | $ .09 |
| Goodwill amortization....................... | -- | .03 | .01 |
| Adjusted net income (loss).................. | $ (.73) | $ .03 | $ .10 |

The Company evaluated its goodwill as of the adoption of SFAS No. 142 on January 1, 2002 and determined that there were no indicators of impairment since the Company's market capitalization was in excess of the value of identifiable net assets as of January 1, 2002. The Company obtained a valuation from an independent third-party appraiser.

The Company updated its analysis of goodwill impairment as of October 31, 2002 and determined that there was an indicator of impairment of its recorded goodwill; accordingly, the Company completed the second phase of impairment testing. Based on the impairment test, the Company





recognized an impairment of approximately $3.8 million as of December 31, 2002, which eliminated goodwill in its entirety.

The impairment was required because economic conditions at the time of testing reduced the market capitalization of the Company to a level below the value of identifiable net assets. Under SFAS No. 142, an impairment adjustment recognized after adoption is required to be recognized as an operating expense.

ADVERTISING COSTS - The Company expenses the cost of advertising the first time advertising takes place. Advertising expense for the years ended December 31, 2002, 2001 and 2000 was approximately $2,254, $38,704 and $3,675, respectively.

STOCK-BASED COMPENSATION - The Company applies Accounting Principles Board Opinion No. 25 and related interpretations in accounting for its stock-based compensation awards. Accordingly, no compensation cost has been recognized for stock options granted in the accompanying consolidated financial statements. The following pro forma data is calculated net of tax as if compensation cost for the Company's stock-based compensation awards (see also Note 6) was determined based upon the fair value at the grant date consistent with the methodology prescribed under SFAS No. 123.

| | YEARS ENDED DECEMBER 31, | | |
|---|---|---|---|
| | 2002 | 2001 | 2000 |
| Net income as reported............................ | $(3,205,035) | $ 8,551 | $ 492,93 |
| Adjustment, net of tax.......................... | (141,610) | (426,941) | (167,29 |

| | | | |
|---|---|---|---|
| Proforma net income (loss)........................ | $(3,346,645) | $ (418,390) | $ 325,64 |
| Net income (loss) per common share as reported..... | $ (.73) | $ -- | $ .1 |
| Adjustment, net of tax.......................... | (.03) | (.10) | (.0 |
| Proforma net income (loss) per common share........ | $ (.76) | $ (.10) | $ .0 |
| Proforma net income (loss) per common share - assuming dilution.............................. | $ (.76) | $ (.09) | $ .0 |
| Weighted average common shares outstanding......... | 4,419,196 | 4,379,486 | 4,283,46 |
| Weighted average common shares outstanding - assuming dilution.............................. | 4,419,196 | 4,379,486 | 5,476,27 |

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model with the following weighted average assumptions used for grants in 2002, 2001 and 2000, respectively: risk-free interest rates of 2.92, 4.86 and 6.14 percent; no dividend yield or assumed forfeitures; expected lives of 5.0 years; and volatility of 55, 63 and 66 percent. The pro forma amounts above are not likely to be representative of future years because there is no assurance that additional awards will be made each year.

2. MARKETABLE SECURITIES

Investments in securities are summarized as follows:

| | DECEMBER 31, 2002 | | |
|---|---|---|---|
| Type of investment | COST/ AMORTIZED COST | GROSS UNREALIZED GAINS | GROSS UNREALIZED LOSSES |
| Short term investments - available for sale ......... | $ 18,208 | $ -- | $ -- |



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| | | | |
|---|---|---|---|
| Debt securities - available for sale | | | |
| U.S. Treasury and other U.S. government corporations and agencies ........................ | $ 100,250 | $ 344 | $ -- |
| Foreign bonds, notes and debentures ................. | 24,930 | -- | (148 |
| Mutual Funds ........................................ | 662,000 | 14,057 | (94 |
| | $ 787,180 | $ 14,401 | $ (242 |
| Equities - available for sale | | | |
| Preferred Stock ..................................... | $ 38,089 | $ 4,457 | $ (312 |
| Mutual Funds ........................................ | 892,804 | -- | (133,442 |

| | | | |
|---|---|---|---|
| | $ 930,893 | $ 4,457 | $ (133,754 |
| | $ 1,736,281 | $ 18,858 | $ (133,996 |

| Type of investment | DECEMBER 31, 2001<br>COST/ AMORTIZED COST | GROSS UNREALIZED GAINS | GROSS UNREALIZ LOSSES |
|---|---|---|---|
| Short term investments - available for sale ............ | $ 975,835 | $ -- | $ |
| Debt securities - available for sale | | | |
| U.S. Treasury and other U.S. government corporations and agencies .......................... | $ 393,339 | $ 12,424 | $ - |
| Foreign bonds, notes and debentures .................. | 24,930 | -- | (7 |
| | $ 418,269 | $ 12,424 | $ (7 |
| Equities - available for sale | | | |
| Preferred Stock ....................................... | $ 43,669 | $ 2,774 | $ (2,5 |
| Mutual Funds ........................................... | 278,636 | 7,145 | (71,8 |
| | $ 322,305 | $ 9,919 | $ (74,3 |
| | $ 1,716,409 | $ 22,343 | $ (75,1 |

The amortized cost and estimated fair values of debt securities, by contractual maturity, at December 31, 2002 are shown below. Actual maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call prepayment penalties.

| | AVAILABLE FOR SALE<br>AMORTIZED COST | ESTIMATED FAIR VALUE |
|---|---|---|
| Due within one year .............. | $110,349 | $110,693 |
| Due one to five years ............ | 14,831 | 14,683 |
| | $125,180 | $125,376 |

Proceeds from sales of available for sale securities were $1,763,685, $1,840,000 and $8,075 for 2002, 2001 and 2000, respectively. Gross gains of $2,161, $10,031 and $11 and gross losses of $32,598, $6,317 and $254 for 2002, 2001 and 2000, respectively, were realized on those sales.





For the years ended December 31, 2002, 2001 and 2000, interest income for available for sale securities was $29,066, $77,618 and $100, respectively. Dividend income for available for sales securities for the years ended December 31, 2002, 2001 and 2000 was $29,437, $8,443 and $2,192, respectively.

3. PROPERTY AND EQUIPMENT

Property and equipment consists of the following at December 31:

| | 2002 | 2001 |
|---|---|---|
| Office furniture, fixtures and equipment | $ 4,362,068 | $ 4,069,450 |
| Vehicles ................................ | 842,081 | 801,109 |
| Leasehold improvements ................. | 62,793 | 62,793 |
| Building ............................... | 1,521,083 | 1,521,083 |
| Land ................................... | 148,308 | 148,308 |
| | 6,936,333 | 6,602,743 |
| Accumulated depreciation and amortization | (3,030,901) | (2,257,369) |
| Total property and equipment, net ....... | $ 3,905,432 | $ 4,345,374 |

Depreciation expense for the years ended December 31, 2002, 2001 and 2000 was $855,570, $790,115, and $548,661, respectively.

During 2001, the Company completed construction of a state-of-the-art distribution and call center facility in Oklahoma City. The 23,346 square foot facility has the capability of handling warehouse volumes of up to $100 million in annual sales, and up to 100 employees in the call center. The Company funded this project, in part, with bank loans of $980,000 for the land and building and $166,216 for warehouse equipment. The interest rate on both loans is the Prime Rate minus .25%, which was 4.0% as of December 31, 2002, and requires 60 monthly principal and interest payments of $9,570, with the remaining balance due on September 30, 2006.

4. DEBT

Notes payable and long-term debt consisted of the following at December 31:

| | 2002 |
|---|---|
| Note payable to bank, with interest at prime less .25% (4.0% and 4.5% at December 31, 2002 and 2001, respectively), payable in monthly installments of principal and interest, due on September 30, 2006, collateralized by warehouse and equipment | $ 911,686 |
| Note payable to bank, with interest at prime less .25% (4.0 % and 4.5% at December 31, 2002 and 2001, respectively), payable in monthly installments of principal and interest, due on September 30, 2006, collateralized by certain assets | 154,630 |
| Note payable to RMS Limited Partnership, 7.5% effective rate, payable in 60 monthly installments net of discount of $169,070 and $287,676 at December 31, 2002 and 2001, respectively (See Note 10) | 1,372,610 |



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| | |
|---|---|
| 9% note payable to Ford Credit, payable in monthly installments of $720.13 | 5,702 |
| | 2,444,628 |
| Less current maturities | 455,296 |
| | $ 1,989,332 |

Interest expense for the year ended December 31, 2002, 2001 and 2000 was approximately $167,000, $199,000 and $54. Under the bank notes, the Company is subject to various covenants, which include minimum tangible net worth, minimum debt service coverage ratio, and maximum debt to EBITDA ratio requirements.

At December 31, 2002, the Company was not in compliance with its debt coverage ratio or the debt to EBITDA ratio. Per letter dated February 18, 2003, Bank One Oklahoma, N.A. granted a waiver for the covenant violations for the period ended December 31, 2002. We have negotiated a new agreement with Bank One, whereby the debt is secured by marketable securities. As such, the debt will no longer be subject to financial covenants.

Future maturities of long-term debt consists of the following at December 31, 2002:

| | |
|---|---|
| 2003...................................... | $ 455,296 |
| 2004...................................... | 573,377 |
| 2005...................................... | 567,062 |
| 2006...................................... | 848,893 |
| | $2,444,628 |

5. LEASE AGREEMENTS

The Company has various capital leases for office equipment. The lease terms range from 24 to 60 months. Additionally, annual lease rental payments for each lease range from $700 to $40,000 per year. The schedule of future minimum lease payments below reflects all payments under the leases.

The property and equipment accounts include $718,554 and $690,547 for leases that have been capitalized at December 31, 2002 and 2001, respectively. Related accumulated amortization amounted to $473,109 and $337,461 at December 31, 2002 and 2001, respectively.

The Company leases office and warehouse space under noncancellable operating leases. Future annual minimum lease payments under capital leases and noncancellable operating leases with initial or remaining terms of one year or more at December 31, 2002 are as follows:

| | CAPITAL LEASES | OPERATING LEASES | TOTAL |
|---|---|---|---|
| Year ending: | | | |
| 2003 ........................................ | $109,898 | $102,000 | $248,796 |
| 2004 ........................................ | 102,339 | 32,607 | 98,048 |
| 2005 ........................................ | 45,263 | 2,725 | 47,988 |
| Total minimum lease payments ................. | $257,500 | $137,332 | $394,832 |
| Less amount representing interest............. | 25,038 | | |





| | |
|---|---|
| Present value of net minimum lease payments.... | 232,462 |
| Less current portion......................... | 109,898 |
| Long-term capital lease obligations........... | $ 122,564 |

Rental expense under operating leases for the years ended December 31, 2002, 2001 and 2000 was $202,122, $202,951, and $218,738, respectively.

6. STOCKHOLDERS' EQUITY

Common Stock - On March 4, 1998, the Company announced its intent to repurchase up to one million shares of the Company's common stock in the open market for cash. In connection with such repurchase, the Company filed with the Securities and Exchange Commission pursuant to Section 13(e)(1) of the Securities Exchange Act of 1934, as amended, an Issuer Tender Offer Statement on March 4, 1998. As of December 31, 2002, the Company had repurchased 472,795 shares of the common stock at a total cost of $2,244,476.

Common Stock Options and Other Warrants - During 2002, the Company granted 325,982 options to employees at exercise prices ranging from $1.31 per share to $2.28 per share. Options were granted primarily for services rendered and to ensure the future availability of those services to the Company. During 2002, 14,500 prior options were exercised for cash. In addition, during the period, 97,714 options were canceled and 13,870 options expired.

During 2001, the Company granted 388,694 options to employees at exercise prices ranging from $2.60 per share to $3.00 per share. Options were granted primarily for services rendered and to ensure the future availability of those services to the Company. None of the options granted during 2001 were exercisable at December 31, 2001 due to a one year minimum vesting period. During 2001, 61,000 prior options were exercised for cash. In addition, during the period 257,976 options were canceled and no options expired.

During 2000, the Company granted 428,450 options at exercise prices ranging from $2.75 per share to $6.13 per share. Options were granted primarily for services rendered and to ensure the future availability of those services to the Company. A total of 122,750 and 100,000 of the options granted during 2000 were unexercisable at December 31, 2000 due to a six month vesting period and a contingency requirement, respectively. During 2000, 107,375 options were exercised with 31,136 mature shares (shares owned by the optionee in excess of six months as of the date of exercise). In addition, during the period, 215,059 options were canceled and 14,750 options expired.

The following table summarizes the Company's employee stock option and other warrants activity for the years ended December 31, 2002, 2001 and 2000:

| | 2002 | WEIGHTED AVERAGE EXERCISE PRICE | 2001 | WEIGHTED AVERAGE EXERCISE PRICE | 2000 |
|---|---|---|---|---|---|
| Options and other warrants outstanding beginning of year........... | 1,556,755 | $ 2.54 | 1,487,037 | $ 2.62 | 1,769,275 |
| Options and other warrants issued | | | | | |

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| | | | | | |
|---|---|---|---|---|---|
| during the year.............. | 325,982 | 1.60 | 388,694 | 2.71 | 428,450 |
| Options and other warrants exercised during the year.............. | (14,500) | 2.00 | (61,000) | 2.00 | (480,879 |
| Option and other warrants cancelled during the year.............. | (97,714) | 2.74 | (257,976) | 3.40 | (215,059 |
| Options and other warrants expired during the year.............. | (13,870) | 2.24 | -- | -- | (14,750 |
| Options and other warrants outstanding, end of year.................. | 1,756,653 | $ 2.36 | 1,556,755 | $ 2.54 | 1,487,037 |

The weighted average grant-date fair value of options and other warrants granted during 2002, 2001 and 2000 was $0.73, $1.80 and $2.83 per share, respectively.

| | Options and Other Warrants Outstanding | | | Op |
|---|---|---|---|---|
| RANGE OF EXERCISE PRICES | NUMBER OUTSTANDING AT 12/31/02 | WEIGHTED-AVERAGE REMAINING CONTRACTUAL LIFE | WEIGHTED-AVERAGE EXERCISE PRICE | N EXE AT |
| $1.75 - $2.95 | 1,430,104 | 2.47 years | $2.01 | 8 |
| $3.00 - $4.75 | 272,088 | 2.81 years | $3.67 | 1 |
| $5.25 - $6.13 | 54,461 | 2.24 years | $5.82 | |
| | 1,756,653 | | | 9 |

Common Stock Warrants - The following table summarizes the Company's common stock warrants and their activity for the years ended December 31, 2002, 2001 and 2000:

| | WARRANTS ISSUED AND OUTSTANDING | EXERCISE PRICE | EXERCISE PERIOD |
|---|---|---|---|
| December 31, 2002: | | | |
| 1997-A Warrants, beginning of the year ....... | 308,768 | $ 3.40 | 1/31/97-11/06/03 |
| 1997-A Warrants, exercised during the year ...................................... | -- | | |
| 1997-A Warrants, end of the year ............ | 308,768 | $ 3.40 | 1/31/97-11/06/03 |
| Redeemable Common Stock Purchase Warrants .................................. | 1,436,000 | $ 3.40 | 11/06/97-11/06/03 |
| Underwriters' Warrants ...................... | 130,000 | $ 5.40 | 11/12/98-11/12/03 |
| December 31, 2001: | | | |
| 1997-A Warrants, beginning of the year ....... | 308,768 | $ 3.40 | 1/31/97-11/06/02 |
| 1997-A Warrants, exercised during the year ...................................... | -- | | |
| 1997-A Warrants, end of the year ............ | 308,768 | $ 3.40 | 1/31/97-11/06/02 |





| | | | |
|---|---|---|---|
| Redeemable Common Stock Purchase Warrants, beginning of the year ........... | 1,436,000 | $ 3.40 | 11/06/97-11/06/02 |
| Redeemable Common Stock Purchase Warrants, exercised during the year ........ | -- | | |
| Redeemable Common Stock Purchase Warrants, end of the year ................. | 1,436,000 | $ 3.40 | 11/06/97-11/06/02 |
| Underwriters' Warrants ...................... | 130,000 | $ 5.40 | 11/12/98-11/12/02 |
| December 31, 2000: | | | |
| 1997-A Warrants ............................ | 308,768 | $ 3.40 | 1/31/97-11/06/02 |
| Redeemable Common Stock Purchase Warrants .................................. | 1,436,000 | $ 3.40 | 11/06/97-11/06/02 |
| Underwriters' Warrants ...................... | 130,000 | $ 5.40 | 11/12/98-11/12/02 |

Each warrant entitles the holder to purchase one share of common stock.

As of January 8, 1998, the Company reduced the exercise price of the 1997-A Warrants from $12.00 to $3.40 and extended the exercise period from January 31, 1999 to November 6, 2002, to correspond more closely to the terms of the Redeemable Common Stock Purchase Warrants. In addition, on September 16, 2002 the Company extended the exercise period from November 6, 2002 to November 6, 2003.

As of January 6, 1998, the exercise price of the Redeemable Common Stock Purchase Warrants was adjusted from $5.40 to $3.40. In addition, on September 16, 2002 the Company extended the exercise period from November 6, 2002 to November 6, 2003.

There was no expense recognized in the Company's financial statements relating to either of the warrant exercise price reductions as the changes only affected allocations of additional paid-in capital because the Redeemable Common Stock Purchase Warrants and the 1997-A Warrants were issued in conjunction with an equity offering of the Company. The reduced exercise prices exceeded the market value of the Company's common stock on the date of the reduction. In addition, there was no expense recognized in the Company's financial statements relating to the extension of the exercise period for either the 1997-A Warrants or the Redeemable Common Stock Purchase Warrants.

The Redeemable Common Stock Purchase Warrants are subject to redemption by the Company at $0.25 per warrant. All of the outstanding Redeemable Common Stock Purchase Warrants must be redeemed if any are redeemed. The Company may redeem the 1997-A Warrants for $0.0001 per warrant. Any redemption of unexercised 1997-A Warrants would be for all such outstanding warrants. The Underwriters' Warrants were issued in connection with the sale of common stock and Redeemable Warrants in November 1997 and were in addition to other fees paid to the underwriters. The Underwriters' Warrants entitle the holder to purchase one unit consisting of one share of the Company's common stock and one Redeemable Common Stock Purchase Warrant.

7. STOCK OPTION PLAN

During 1995, the Company approved the 1995 Stock Option Plan (the "Plan"). Under this Plan, options available for grant can consist of (i) nonqualified stock options, (ii) nonqualified stock options with stock appreciation rights attached, (iii) incentive stock options, and (iv) incentive stock options with stock appreciation rights attached. The Company has reserved 1,125,000 shares of the Company's common stock $.0001 par value, for the Plan. The Plan limits participation to employees, independent contractors, and consultants. Non-employee directors are excluded from Plan participation. The option price for shares of stock subject to this Plan is set by the Stock Option Committee of the Board of Directors at a price not less than 85% of the market value of the stock on the date of grant. No stock





options may be exercised within six months from the date of grant, unless under a Plan exception, nor more than ten years after the date of grant. The Plan provides for the grant of stock appreciation rights, which allow the holder to receive in cash, stock or combination thereof, the difference between the exercise price and the fair value of the stock at date of exercise. The fair value of stock appreciation rights is charged to compensation expense. The stock appreciation right is not separable from the underlying stock option or incentive stock option originally granted and can only be exercised in tandem with the stock option. No stock appreciation rights are attached to any options outstanding. During the years ended December 31, 2002 and 2001 the Company issued 325,982 and 388,694 options, respectively under the Plan. At December 31, 2002 and 2001, the Company had 1,756,653 and 1,556,755, respectively, stock options outstanding of which only 1,083,403 and 883,505, respectively, were issued pursuant to the plan.

8. RELATED PARTIES

During 2002, 2001 and 2000, the Company received approximately $7,069, $15,231 and $5,931, respectively, from Pre-Paid Legal Services, Inc. ("Pre-Paid Legal"), a shareholder, for commissions on sales of memberships for the services provided by Pre-Paid Legal. As of July 1, 2000, the Company began offering the Company's employees access to the services provided by Pre-Paid Legal through an employee benefit option. The Company pays half of the cost for each employee electing to participate in the plan. During 2002, 2001 and 2000, the Company paid $6,934, $7,593 and $5,059, respectively, to Pre-Paid Legal for these services. The Company's Chairman of the Board and Chief Executive Officer, John W. Hail, is a director of Pre-Paid Legal.

On October 8, 1998, John W. Hail, an affiliate, surrendered an option to purchase 100,000 shares of the Company's common stock for $2.70 per share with an expiration date of May 20, 2007 in exchange for an option having the same terms other than an exercise price of $1.75 per share of common stock, which was equal to the fair value of the common stock on the date of exchange. These options became exercisable on April 8, 1999.

During the first quarter of 1998, the Company agreed to loan John W. Hail up to $250,000. Subsequently the Company also agreed to loan up to an additional $75,000. In 2000, an additional $200,000 was approved. On January 1, 2001 the outstanding balance on all the notes were combined into one note payable in monthly installments. The loans and extension were unanimously approved by the board of directors. These loans are collateralized by stock and property, and bear interest at 8% per annum. As of December 31, 2002, the balance due on these loans was $63,561 plus interest, which is included in receivables from affiliate.

Also during 2002, 2001 and 2000, the Company paid Mr. Loney and his wife sales bonuses of $30,887, $38,028 and $24,709, respectively. These bonuses were based upon purchases by them and their downline associates in accordance with the Company's network marketing program applicable to all independent associates in effect at the time of the sales. Mr. Loney's wife is the daughter of John W. Hail.

9. INCOME TAXES

Income taxes for 2002, 2001 and 2000 are comprised of current tax (benefit) expense of $(423,279), $(37,722) and $444,710 and deferred taxes of $(1,331,778), $43,189 and $11,822, respectively. A reconciliation of the statutory Federal income tax rate to the effective income tax rate for the years ended December 31, 2002, 2001, and 2000 is as follows:

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| | 2002 | 2001 | 2000 |
|---|---|---|---|
| Statutory federal income tax rate | (34.0)% | 34.0% | 34.0% |
| State tax effective rate | (4.0) | 4.0 | 4.0 |
| Permanent differences | 2.1 | 2.1 | 8.9 |
| Benefit of graduated tax rates | 0.2 | - | (0.6) |
| Prior year assessments finalized | - | (1.5) | 7.0 |
| Other | 0.3 | 0.4 | (5.2) |
| | (35.4)% | 39.0% | 48.1% |

The change in the total deferred tax net assets from December 31, 2001 to December 31, 2002 was $1,355,295. This difference is allocated as $1,331,778 included in tax expense reduced by $23,517 classified in stockholders' equity, respectively.

Deferred tax liabilities and assets at December 31, 2002 and 2001 are comprised of the following:

| | DECEMBER 31, 2002 | DECEMBER 31, 2001 |
|---|---|---|
| Deferred tax liabilities: | | |
| Depreciation | $ (178,789) | $(147,742) |
| Other | - | (27,605) |
| Total deferred tax liabilities | (178,789) | (175,347) |
| Deferred tax assets: | | |
| Goodwill impairment | 1,276,895 | - |
| Net operating loss carryforwards | 151,371 | 87,806 |
| Receivables | - | 35,072 |
| Inventory | 60,518 | 30,474 |
| Unrealized losses | 43,448 | 20,778 |
| Other | 43,759 | 43,124 |
| Total deferred tax assets | 1,575,991 | 217,254 |
| Net deferred taxes | 1,397,202 | 41,907 |
| Less current portion of net deferred tax assets | 120,343 | 65,546 |
| Noncurrent portion of deferred tax asset (liability) | $1,276,859 | $ (23,639) |

On a regular basis, management evaluates all available evidence, both positive and negative, regarding the ultimate realization of the tax benefits of its deferred tax assets. Management has concluded that it is more likely than not that a tax benefit will be realized from its deferred tax assets. The Company has net operating loss carryforwards of $401,136 available to reduce future taxable income, which will begin to expire in 2009. Net operating loss carryforwards of $196,000 are limited in usage.

10. ACQUISITIONS

On January 4, 2001, the Company and one of its wholly owned subsidiaries, LifeScience Technologies Holdings, acquired LifeScience Technologies Holding Limited Partnership, LifeScience Technologies Limited, LifeScience Technologies of Japan, LST Fulfillment limited Partnership and LifeScience Technologies of Canada, Inc. (the "LifeScience Technologies Acquisition"). The purchase price to the Company was approximately $1.2 million cash plus $41,667 per month or 5% of LifeScience Technology product sales, whichever is greater, payable for 60 months commencing in January 2001. The seller, at its option, has the right to take shares of the Company's common stock at an option price of $3.00 per share in lieu of cash for the monthly payment. However, such option is limited to a total of





860,000 shares and shares not taken in a month are not cumulative. No shares have been issued under the agreement at December 31, 2002.

The estimated fair value of assets acquired and liabilities assumed at acquisition are as follows:

| | |
|---|---|
| Estimated Fair value of assets | |
| Cash | $ 76,760 |
| Inventory | 793,629 |
| Property and equipment | 283,924 |
| Goodwill and other intangibles | 2,508,805 |
| Total fair value of assets | 3,663,118 |
| Liabilities assumed | |
| Accounts payable | 176,060 |
| Accrued expenses | 181,223 |
| Estimated fair value of acquisition | $3,305,835 |

The LifeScience Technologies Acquisition was accounted for as a purchase under Accounting Principles Board Opinion No. 16 ("APB No.

16"). In accordance with APB No. 16, the company allocated the purchase price of the LifeScience Technologies acquisition based on the fair value of the assets acquired and liabilities assumed.

The following summarized pro forma unaudited information assumes the acquisition occurred on January 1, 2000.

| | YEAR ENDED DECEMBER 31, 2000 |
|---|---|
| Revenues | $33,588,695 |
| Loss | (802,790) |
| Loss per share, basic and diluted | (.19) |

11. SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION

| | YEAR ENDED DECEMBER 3 | |
|---|---|---|
| | 2002 | 2001 |
| Cash paid during the year for: | | |
| Interest | $ 194,386 | $ 198,740 |
| Income taxes - net of refund | (56,912) | (288,598) |
| Noncash financing and investing activities: | | |
| Property and equipment acquired by capital lease | -- | 92,202 |
| LifeScience Technologies Acquisition: | | |
| Fair value of tangible net assets acquired | $ -- | $ 797,030 |
| Purchase price in excess of tangible net assets acquired | -- | 2,508,805 |
| Present value of future payments required | -- | (2,079,439) |
| Cash included in tangible net assets acquired | -- | (76,760) |
| Cash paid for acquisition, net of cash acquired | $ -- | $ 1,149,636 |



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12. COMMITMENTS, CONTINGENCIES AND GUARANTEES

RECENT REGULATORY DEVELOPMENTS - A significant portion of the Company's net sales continues to be dependent upon the Company's AM-300 product. The Company's net sales of AM-300 represented 48.8% and 52.0% of net sales for the years ended December 31, 2002 and 2001, respectively. One of the ingredients in the Company's AM-300 products is ephedra, an herb that contains naturally- occurring ephedrine. The Company's manufacturer used a powdered extract of that herb when manufacturing AM-300. The Company markets AM-300 principally as an aid in weight management. The extract is an 8% extract, which means that every 100 milligrams of the powdered extract contains approximately eight milligrams of naturally occurring ephedrine alkaloids. In addition, our Sine-Eze product, used as a food supplement to relieve symptoms associated with allergies, contains ephedrine alkaloids. Ephedrine containing products have been the subject of adverse publicity in the United States and other countries relating to alleged harmful effects.

The FDA published a proposed rule in the Federal Register on June 4, 1997, which proposed significant limitations on the sale of ephedrine-containing dietary supplements. The proposed rule would have significantly limited the Company's ability to sell products containing ephedra if it had been made effective. On April 3, 2000, the FDA withdrew most of the provisions of its proposed rule. This action was prompted largely by a report issued by the United States General Accounting Office ("GAO") in which the GAO criticized the scientific basis for the proposed rule and the FDA's evaluation of approximately 900 reports of adverse events supposedly related to the consumption of dietary supplements containing ephedrine alkaloids. The FDA has made available for public inspection most of these adverse event reports.

On March 7, 2003, the FDA published a notice in the Federal Register, which indicates that it will be taking final action on the 1997 proposed rule in the near future. The FDA re-opened the public comment period, until April 7, 2003, to allow for additional public input on the two proposed limitations on the sale of ephedrine-containing dietary supplements that remained after the FDA's action of April 3, 2000. One proposed limitation is a warning that would be required to appear on the label of all ephedrine-containing supplements. The other proposed limitation is that ephedrine-containing supplements may not contain other substances that are known to have stimulant effects (e.g., caffeine). The proposed warning addresses potential health risks allegedly associated with ephedrine-containing dietary supplements. It is similar, but not identical, to mandatory warnings that have been required by Texas law since 1999 and California law since January 1, 2003. AM-300 and the Company's other ephedrine-containing supplements comply with these state law requirements. However, some of the Company's ephedrine-containing products, like AM-300, contain caffeine or other stimulants. Therefore, if the proposed rule is made final in its current form, it will prohibit the sale of some of the Company's products.

On March 13, 2003, the FDA published a proposed rule in the Federal Register which proposes comprehensive requirements for the manufacturing, packing and holding dietary supplements, also known as good manufacturing practices ("GMP" or "GMPs"). The FDA is accepting public comments on the proposed GMPs until June 11, 2003; final GMPs will be promulgated after the FDA has reviewed the public comments. Once final GMP regulations become effective, the Company's manufacturer will be required to adhere to them. The FDA will most likely institute an effective date for the GMPs which will allow the Company's manufacturer a reasonable amount of time to conduct this review and, if necessary, revise its manufacturing operations to comply with the final GMP regulations.

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The Company is currently involved in two products liability suits related to the ingestion of its ephedra-based products. Answers to these petitions are due April 23 and 30, 2003. As such, the Company has not had sufficient time to either investigate the facts of these cases or analyze appropriate defenses to the allegations. The Company will deny any wrongdoing and intends to vigorously defend the claims. The amounts of damages sought are unknown, but include compensatory and punitive damages.

The Company's certificate of incorporation and bylaws provide that the Company will indemnify its directors and officers to the fullest extent permitted by the Oklahoma General Corporation Act. Under such provisions, any director or officer, who in his capacity as such, is made or threatened to be made, a party to any suit or proceeding, may be indemnified if the Company's board of directors determines such director or officer acted in good faith and in a manner he reasonably believed to be in or not opposed to its best interests.

The Company's certificate of incorporation and bylaws and the Oklahoma General Corporation Act further provide that such indemnification is not exclusive of any other rights to which such individuals may be entitled under its certificate, its bylaws, an agreement, vote of shareholders or disinterested directors or otherwise. Insofar as indemnification for liabilities arising under the Securities Act of 1933 may be permitted to the Company's directors and officers pursuant to the foregoing provisions, or otherwise, the Company has been advised that in the opinion of the Securities and Exchange Commission such indemnification is against public policy and is, therefore, unenforceable.

The Company, like other marketers of products that are intended to be ingested, faces an inherent risk of exposure to product liability claims in the event that the use of its products results in injury. The Company maintains a claims made policy, with limited liability insurance coverage. The limits of this coverage are $1,000,000 per occurrence and $2,000,000 in the aggregate. Products containing ephedra, which represented approximately 49% of the Company's 2002 net revenue, are not covered by the Company's product liability insurance. The Company generally does not obtain contractual indemnification from parties manufacturing its products. However, all of the manufacturers of the Company's products carry product liability insurance, which covers the Company's products. Although the Company has never had a product liability claim, such claims against the Company could result in material losses to the Company.

13. QUARTERLY RESULTS OF OPERATIONS (UNAUDITED)

The following is a summary of the quarterly results of operations for the years ended December 31, 2002 and 2001.

| | 2002 | | |
| --- | --- | --- | --- |
| | DECEMBER 31 | SEPTEMBER 30 | JUNE 30 |

| | | | |
|---|---|---|---|
| Revenues | $ 4,630,657 | $ 5,525,701 | $ 5,865,850 |
| Costs and expenses | 9,547,803 | 5,845,558 | 5,738,921 |
| Income (loss) before income taxes | (4,917,146) | (319,857) | 126,929 |
| Income tax expense (benefit) | (1,738,308) | (124,744) | 49,502 |
| Net income (loss) | $ (3,178,838) | $ (195,113) | $ 77,427 |
| Net income (loss) per common share - basic | $ (0.73) | $ (0.04) | $ 0.02 |
| Net income (loss) per common share - assuming dilution | $ (0.73) | $ (0.04) | $ 0.02 |



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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)
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Net Income (loss) per share is computed independently for each of the quarters presented; therefore, the sum of the quarterly income (loss) per share does not necessarily equal the total for the year.

| | 2001 | | |
|---|---|---|---|
| | DECEMBER 31 | SEPTEMBER 30 | JUNE 30 |
| Revenues | $ 7,062,205 | $ 7,142,367 | $ 7,140,458 |
| Costs and expenses | 7,376,134 | 7,114,239 | 6,867,377 |
| Income (loss) before income taxes | (313,929) | 28,128 | 273,081 |
| Income tax expense (benefit) | (127,769) | 16,423 | 107,722 |
| Net income (loss) | $ (186,160) | $ 11,705 | $ 165,359 |
| Net income (loss) per common share - basic | $ (0.04) | $ -- | $ 0.04 |
| Net income (loss) per common share - assuming dilution | $ (0.04) | $ -- | $ 0.04 |

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Net Income (loss) per share is computed independently for each of the quarters presented; therefore, the sum of the quarterly income (loss) per share does not necessarily equal the total for the year.

14. YEAR-END ADJUSTMENTS

The Company made certain year-end adjustments in 2002 resulting from the impairment of goodwill, the write off of obsolete fixed assets and the creation of an inventory reserve for obsolete items that were material to the results of the fourth quarter. These adjustments, after applicable income tax effects, reduced net income (loss) as follows:

| | |
|---|---|
| Goodwill impairment.................. | $ 2,310,908 |
| Write off of obsolete fixed assets.... | 136,583 |
| Inventory reserve.................... | 70,848 |
| | $ 2,518,339 |

These adjustments reduced fourth quarter basic income (loss) per share by $0.57.



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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)
YEARS ENDED DECEMBER 31, 2002, 2001 AND 2000

15. VALUATION AND QUALIFYING ACCOUNTS

The table below shows the beginning balance, activity and ending balance for the Company's reserves and allowances deducted from asset accounts:

| Description | Balance at Beginning of Period | Additions: Charged to Costs and Expenses | Additions: Charged to Other Accounts | Deduc |
|---|---|---|---|---|
| YEAR ENDED DECEMBER 31, 2002: | | | | |
| Reserves and allowances deducted from asset accounts: | | | | |
| Allowance for doubtful accounts.... | $ 92,931 | | | $ 92 |
| Allowance for obsolete inventory... | -- | 116,143 | | |
| YEAR ENDED DECEMBER 31, 2001: | | | | |
| Reserves and allowances deducted from asset accounts: | | | | |

| | | | |
|---|---|---|---|
| Allowance for doubtful accounts.... | $ 157,804 | | $ 64 |
| Allowance for obsolete inventory... | -- | -- | |
| YEAR ENDED DECEMBER 31, 2000: | | | |
| Reserves and allowances deducted from asset accounts: | | | |
| Allowance for doubtful accounts.... | $ 55,332 | $179,334 | $ 76 |
| Allowance for obsolete inventory... | -- | -- | |

* * * * * *

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Exhibit Index

3.1 The Registrant's Certificate of Incorporation, incorporated by reference to the Registration Statement on Form SB-2 (Registration No. 333-47801) filed with the commission on March 11, 1998.

3.2 The Registrant's Bylaws, incorporated by reference to the Registration Statement on Form SB-2 (Registration No. 333-47801) filed with the commission on March 11, 1998.

10.1 Warrant Agreement between Registrant and U.S. Stock Transfer Inc., dated as of January 16, 1997, as amended and restated January 8, 1998, incorporated by reference to Amendment No. 2 to Form 8-A Registration Statement, filed with the Commission on January 13, 1998.

10.2 Unit and Warrant Agreement between Registrant and U.S. Stock Transfer Inc., dated as of November 6, 1997, as amended and restated January 8, 1998, incorporated by reference to Amendment No. 1 to Form 8-A Registration Statement, filed with the Commission on January 15, 1998.

10.3 * The Advantage Marketing Systems, Inc. 1998 Associate Stock Purchase Plan, incorporated by reference to Amendment No. 1 to Registration Statement on Form SB-2 (Registration No. 333-47801) filed with the commission on October 7, 1998.

10.4 * The form of Advantage Marketing Systems, Inc. 1998 Associate Stock Purchase Plan Stock Purchase Agreement, incorporated by reference to Amendment No. 1 to Registration Statement on Form SB-2 (Registration No. 333-47801) filed with the commission on October 7, 1998.

10.5 Purchase and Assignment Agreement by and among Advantage Marketing Systems, Inc., LifeScience Technologies Holdings, Inc., GHI Holdings, Inc., LifeScience Technologies, Inc. and RMS Limited Partnership, dated as of January 3, 2001, incorporated by reference to Form 8-K filed with the Commission on January 8, 2001.

10.6 Promissory Note dated January 3, 2001, to RMS Limited Partnership by Advantage Marketing Systems, Inc., LifeScience Technologies Holdings, Inc., LifeScience Technologies Holdings Limited Partnership, LifeScience Technologies Holdings, Inc., LifeScience Technologies of Japan and LST Fulfillment Limited Partnership, incorporated by reference to Form 8-K filed with the Commission on

| | |
|---|---|
| | January 8, 2001. |
| 10.7 | Stock Option Agreement of Advantage Marketing Systems dated January 3, 2001, incorporated by reference to Form 8-K filed with the Commission on January 8, 2001. |
| 10.8 | Joint Marketing Agreement with PrimeBuy Network.com, Inc., dated August 30, 2002, incorporated by reference to Form 10-Q filed with the Commission on November 1, 2002. |
| 10.9 | Promissory Note executed by PrimeBuy Network.com, Inc., dated August 2, 2002, incorporated by reference to Form 10-Q filed with the Commission on November 1, 2002. |
| 10.10 * | The Advantage Marketing Systems, Inc. 1995 Stock Option Plan, incorporated by reference to Form SB-2 Registration Statement (No. 33-80629), filed with the Commission on November 20, 1996. |
| 10.11 * | Employment Agreement by and between David D'Arcangelo and Registrant dated effective as of November 25, 2002, filed herewith. |
| 10.12 * | Non-Qualified Stock Option Agreement by and between David D'Arcangelo and Registrant dated effective as of December 2, 2002, filed herewith. |
| 21 | Subsidiaries, incorporated by reference to Form 10-K filed with the Commission on April 17, 2001. |
| 23.1 | Consent of Grant Thornton LLP, filed herewith. |
| 23.2 | Consent of Deloitte & Touche LLP, filed herewith. |
| 99.1 | Chief Executive Officer Certification, filed herewith. |
| 99.2 | Chief Financial Officer Certification, filed herewith. |
| * | Designates a compensatory plan. |