

BITSTREAM INC
Form 10-K
March 31, 2003

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**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

FORM 10-K

(Mark One)

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

For the fiscal year ended December 31, 2002

or

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

For the transition period from _____ to _____

COMMISSION FILE NUMBER: 0-21541

BITSTREAM INC.

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

04-2744890
(I.R.S. Employer Identification No.)

215 First Street, Cambridge, Massachusetts 02142-1270

(Address of principal executive offices)

Registrant's telephone number, including area code: (617) 497-6222

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

Securities registered pursuant to Section 12(g) of the Act: Class A Common Stock

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§ 229.405 of this chapter) is not contained herein, and will not be contained, to the best of the 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.

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The aggregate market value of voting stock held by non-affiliates of the Registrant as of March 14, 2003 was approximately \$14.5 million.

On March 14, 2003, there were 8,475,125 shares of Class A Common Stock, par value \$0.01 per share, of which 125,809 were designated as treasury shares and no shares of Class B Common Stock, par value \$0.01 per share, outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant's definitive proxy statement for the 2003 Annual Meeting of Stockholders, to be filed with the Securities and Exchange Commission, are incorporated by reference into Part III of this Annual Report on Form 10-K. Except with respect to information specifically incorporated by reference in this Form 10-K, the Proxy Statement is not deemed to be filed as part hereof.

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PART I

ITEM 1. BUSINESS

GENERAL

Bitstream Inc. ("Bitstream" or the "Company"), headquartered in Cambridge, Massachusetts, is composed of three separate and distinct businesses: (1) Type, in which Bitstream develops and licenses its ThunderHawk browser, which has been designed specifically for browsing on handheld devices using the Company's font technology to corporations, wireless carriers, and end users, and its font technology, fonts, and custom font designs to manufacturers of information appliances, wireless devices, set-top boxes, embedded systems, printers, and personal digital assistants; (2) MyFonts.com, a showcase of the world's fonts in one easy-to-use e-commerce Web site operated by Bitstream's wholly-owned subsidiary, MyFonts.com, Inc. ("MyFonts"); and (3) Pageflex, in which the Company's wholly-owned subsidiary Pageflex, Inc. ("Pageflex") develops, markets and supports personal and enterprise server-based composition software for customizing template-based designs from Web forms or Pageflex's .EDIT interactive WYSIWYG browser-based Webtop publishing software or databases.

Bitstream was founded in 1981 as the first independent digital typeface supplier to computer hardware and software developers. The Company's library of typeface products are used by original equipment manufacturers ("OEMs"), independent software vendors ("ISVs"), and end users around the world in the creation of electronic documents. The Company was also an early developer of font rendering software for hardware and software developers. Its font display technologies are used to provide font-scaling functionality to operating systems, applications, network servers, computer printers, set-top boxes, personal digital assistants (PDAs), and other embedded systems and information appliances. More recently, Bitstream has focused its product development and marketing efforts on developing a leading-edge browser for handheld devices named ThunderHawk . ThunderHawk gives users of small handheld devices complete wireless access to any Web page in a format that can be viewed easily without excessive scrolling or the use of repurposed content. The Company has also focused its efforts in the Type segment on technology solutions that address the font-related browsing issues of small embedded systems and information appliances, and Linux operating systems and applications. These include the development of extremely compact fonts for large Asian language character sets, including Traditional Chinese, Simplified Chinese, Japanese, and Korean.

In January 1999, the Company established Pageflex as a wholly-owned subsidiary for the purpose of developing, marketing and supporting on-demand marketing and composition solutions based on its NuDoc XML-based composition engine and related technology. Pageflex has developed Mpower , an enterprise solution that allows companies to dynamically create customized business documents, Persona , a variable data desktop publishing application designed to produce personalized documents, and .EDIT which is a java-browser-based interactive WYSIWYG composition software that presents the user with templates they can then customize. These templates are controlled by design rules and access permissions that leave the original designer with far greater control over the design and branding of the final result than with conventional Desktop publishing tools. These products are based on the NuDoc XML-based composition engine, which uses flexible design templates incorporating "spring-loaded" text and image containers that dynamically adjust page layouts based on the sizes and shapes of the variable text and images that flow into them. Text and image containers resize and reposition to automatically maintain the design integrity of each document. Built on open standards, Pageflex products import data from any ODBC-compliant database and use XML as the data format between databases and page composition.

In December 1999, MyFonts was founded as a wholly-owned subsidiary of Bitstream to provide the world's most complete source of digital fonts in a single comprehensive Web site. The MyFonts.com Web site provides one of the largest collections of fonts ever assembled for on-line delivery, and offers easy ways to find and purchase fonts on-line, unique typographic resources, and a forum for interacting with type graphics experts and peers. By hosting fonts from a wide variety of font foundries and designers, MyFonts aims to be the single choice for finding and purchasing fonts on the Web.

The markets in which the Company participates are intensely competitive, evolving and subject to rapid technological change. The Company expects competition to persist and to increase in the future. The Company believes that while it competes with no single organization across its entire product line, a variety of companies offer products that compete with some of its products. Certain of the Company's competitors

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have greater name recognition, a larger customer base and significantly greater financial, technical, and marketing resources than the Company. Future sales of the Company's products will depend upon the Company's ability to develop or acquire, on a timely basis, new products or enhanced versions of its existing products that compete successfully with products offered by developers of competing technologies. There can be no assurance that the Company will be able to compete successfully against current or future competitors, or that competitive pressures faced by the Company will not materially adversely affect its business, financial condition and results of operations.

TYPE

INDUSTRY BACKGROUND

The rapid growth in the use of personal computers, advanced software applications and laser printers has dramatically transformed the document creation, production, and distribution process, giving rise to the widespread use of word processing and desktop publishing applications. Underlying the growth in word processing and desktop publishing were enabling technologies such as page description languages, printer control languages, and outline font technologies. Adobe's PostScript Type 1 format ("Type 1"), the original outline font technology, gained acceptance among graphic artists and the high-end electronic publishing market due to the technology's close links to high-resolution output devices used in service bureaus and publishing houses. TrueType was developed by Apple Computer, Inc. ("Apple"), as an alternative outline font technology to Type 1 and is integrated into the Windows and Macintosh operating systems.

The increased use of distributed client/server network architectures in the 1990s resulted in complex computing environments composed of mixed operating systems and multiple networking protocols. To create, transport, view, and print text-based digital information in such an environment, while preserving the appearance intended by the document's author, each individual computer must have specific font software and hardware drivers to display or print the document as the author intended. If a user's system did not have a particular font used by the author or attempted to output a document to a device that differs from the device on which the document was originally created, the user's end-product often lacked the font fidelity and appearance intended by the creator. For example, if an output device prints a document with a font substituted in place of the author's original font, a complete loss of original pagination or formatting within the document can often result. Such a result would make it difficult, if not impossible, for multiple users to review and comment collaboratively on the same document. Difficulties in retaining text integrity can be further complicated when users try to incorporate non-Latin fonts, such as Japanese, Chinese, Korean, Greek, or Hebrew, because font substitution for non-Latin fonts is typically not available in most operating systems and output devices.

Currently, techniques used to present text and graphics are based on existing desktop publishing technologies and, when used in new distribution media, often result in a loss of visual integrity, degraded system performance, or both. To efficiently deliver digital information that retains the author's intended visual impression, computer systems must use enabling technologies that reduce file size, minimize bandwidth consumption, and operate reliably across heterogeneous computing environments. The evolution of real time operating systems, cellular telephone operating systems, wireless Internet devices, PDAs, set-top boxes, information appliances, and embedded systems in general, will require the transition from text being displayed on these devices as bitmaps, as is currently done today, to text that can be scaled to fit the content being viewed on the device. Clear text that is easy to read on any device, at any size, and at any resolution is immeasurably important.

THE BITSTREAM SOLUTION

Since its founding over 20 years ago, Bitstream has played a leading role in the development of industry-standard font products and enabling technologies (e.g., font rendering and display software). Bitstream has also been actively developing font portability and compaction technology. The Company has built substantial expertise in digital type design and production, technical font formats, and font portability and compaction software. Bitstream intends to continue to develop or acquire technology to support its leadership position in these areas.

The Company believes that certain features of its products such as their performance, system scalability, cross-platform portability, small file application size, and high typographic quality, will facilitate their adaptation to new and emerging markets. These markets include the Internet, information appliances,

corporate intranets, embedded systems, set-top boxes, high definition televisions, multi-function devices (e.g. combined printer/fax/copiers), and handheld and wireless devices. Bitstream is currently developing, adapting and marketing its enabling technologies and font products to third parties whose products address these new and developing markets.

Bitstream's products and technologies have been designed to support existing technological and typographic standards, such as Unicode, TrueType, and Type 1, and to be embedded within full-featured products produced by OEMs and ISVs. The Company's products have also been designed to function in multi-platform computing environments, including Windows, UNIX, Linux, Macintosh, OS/9, and Java. The Company

plans to continue to promote the use of its products in multi-vendor configurations.

The Company has also expanded its product lines based on its type technology to include ThunderHawk, a browser for handheld devices. Management believes that the addition of ThunderHawk to its growing product line will significantly expand Bitstream's traditional type business into a new business focused on providing leading-edge browsing capabilities to small handheld devices, such as PocketPCs and cell phones. Today, Bitstream offers the complete ThunderHawk client-server solution to corporation, wireless carriers and to end-users as a Bitstream-hosted service. For corporations, the ThunderHawk Enterprise Edition gives a company's mobile workforce complete access to Internet and corporate intranet Web pages when the ThunderHawk server is deployed behind the corporate firewall. ThunderHawk also lets users work with Web-based business software, Web pages, and Web-based e-mail. The large virtual 800x600 screen size emulates the view that people are used to on desktop machines, enabling the users to access and modify web-based information from mobile devices efficiently using 802.11 networks or carrier WAN networks. For wireless carriers, ThunderHawk offers an enhanced browsing experience that can be offered by carriers as a way to increase data traffic and device usefulness.

PRODUCTS AND TECHNOLOGIES

The Company's products can be separated into three major groups: (1) Web browsing solutions; (2) type technology products, and (3) typeface products. Each of the product groups is described in greater detail below.

(1) Web Browsing Solutions

Bitstream's current Web browsing solutions are based on ThunderHawk, a wireless Web browsing technology for handheld devices, wireless devices, personal digital assistants, and other embedded systems. ThunderHawk relies on a server infrastructure combined with a small piece of thin-client code on the handheld device. The server infrastructure transmits Web content in a more compact format to the device, making fast and full-featured wireless Web browsing possible. In addition, ThunderHawk gives customers the same browsing experience on a handheld device as they are used to on the desktop. This includes viewing the full text and images of any Web page without excessive scrolling. By not relying on WAP or cHTML, ThunderHawk does not require Web content providers to repurpose their content or build separate Web sites one for the desktop and one for the wireless world. Instead, ThunderHawk enables users to see a Web page just as it appears on the desktop.

There are two versions of ThunderHawk, personal and enterprise editions. The personal edition was first released in May 2002 and was updated throughout the year to include support for more devices and in response to feature requests. The personal edition currently runs on a wide variety of Pocket PC devices. The enterprise edition was first released in August 2002, and was also updated with the personal edition. The enterprise edition currently runs on Pocket PC devices but also relies on servers in corporate offices. The enterprise edition allows corporate IT departments to deploy ThunderHawk on their networks, enabling their mobile workforce to browse both Internet and intranet Web pages giving their employees access to crucial corporate data, whether on the road or in the office. A mobile workforce can make database inquiries, update inventories, order products and publications, communicate with clients in the field, and schedule services and repairs. It is often more convenient for mobile employees to work with small wireless devices than bulky laptops.

(2) Type Technology Products

Type technology products consist of the following: (a) Font Fusion , font engine software that allows developers of operating systems, software applications, Web applications, low-resolution screen devices,

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multimedia servers, high-definition television screens (HDTVs), set-top boxes, continuous tone printers, PDAs, and other embedded systems and information appliances to render high-quality characters in any format, at any resolution, on any device; (b) btX2 , font engine software that allows Linux developers to render high-quality characters in industry-standard and highly compact formats; (c) TrueDoc®, portable font technology that provides for the efficient distribution of text, with fidelity, in a highly compact format; and (d) TrueDoc Imaging System (TDIS), formerly Bitstream's 4-in-1 TrueDoc Imaging System, font engine software for developers of operating systems, servers, applications, and printer controllers where a complete font solution is needed to provide scaleable resident fonts and support for downloaded, industry-standard fonts. Each of these products is described in greater detail below:

(a)

Font Fusion

Font Fusion is Bitstream's most advanced font engine. The Font Fusion software developers' kits (SDKs) provide developers with full font fidelity and high-quality typographic output at any resolution, on any device, while maintaining the integrity of the original character shapes. It is designed to support operating systems, software applications, Web applications, low-resolution screen devices,

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multimedia servers, high-definition television screens (HDTVs), set-top boxes, continuous tone printers, PDAs, and other embedded systems and information appliances. Font Fusion is independent of processor and operating system and compatible with all industry-standard font formats. It is a full-featured, next generation, small footprint, multilingual, outline font technology. Font Fusion is designed for color, grayscale and black-and-white ROM-based and non-ROM-based devices in a system where the fonts may reside locally or remotely.

Font Fusion development in 2002 included the release of version 2.2, which (1) improved the algorithms used for LCD displays; and (2) included a release of the Wireless Font Set, nine delta-hinted fonts designed specifically for LCD displays on wireless devices. In 2002, development also included the release of Font Fusion version 2.3, which (1) provided support for character-edge effects, including support for embossed, engraved, outline, and drop shadow text; and (2) included a release of the CCTV Font Set, seven high-quality, readable fonts for closed captioning display on digital and analog TVs. The 2.3 release of Font Fusion was done to support font requirements mandated by the Federal Communications Commission (FCC), as specified by the Electronics Industries Alliance (EIA). Bitstream can now provide developers with a complete solution for closed captioning display on both analog and digital television systems, including fonts, font styles, and font attributes. (Closed captioning involves displaying the "audio" portion of a TV broadcast as text, which is superimposed over the video portion. Most importantly, it allows viewers who are hearing impaired to access TV broadcasts. To display closed-captioned text, the viewers must have a set-top box decoder or a TV receiver that includes this decoding capability.) The FCC updated its closed captioning requirements for digital TVs: manufacturers must now include FCC-mandated decoder circuitry for closed captioning in their digital TV devices.

(b)

btX

btX was first released in 2001. The beta release of its successor, btX2, was released in December, 2002. While btX was server based, btX2 is client based. btX2 relies on a FreeType driver that provides access to Font Fusion, Bitstream's premier font rendering engine. btX2 enables developers to use the same application program interfaces (APIs) as FreeType. In addition to these APIs, developers can use the native TV mode offered by Font Fusion to render fonts on TV screens. btX2 supports Unicode encoding and can render international fonts.

btX2 is able to render eight font formats, including compact PFRs and compact Asian stroke-based fonts that can fit in embedded Linux systems and interactive TV devices, where space and memory are at a premium. That is, besides rendering industry-standard TrueType, Type 1, and PFR font formats, btX2 lets developers render very compact Asian fonts in stroke-based format. This is important because stroke-based fonts replace an unmanageable, large font with a small, manageable font. With stroke-based fonts, developers can scale characters to any size; use one font for all weights, from light to bold; and include all the characters in the font without having to subset it. Stroke-based fonts and btX2 provide a high-end font engine that can fine tune output for computer monitors, TV screens, and LCD displays.

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btX2 comes with a core set of 13 delta-hinted, TrueType screen fonts. Delta hinting involves fine-tuning fonts so that they look good on the screen, even at small point sizes on low-resolution devices, such as computer monitors. Such a solution gives Linux applications and systems the same look and feel that customers are used to on the Microsoft and Macintosh desktops.

(c)

TrueDoc

TrueDoc is a portable font compaction technology designed for the distribution of electronic text-based information. OEMs and ISVs license and incorporate TrueDoc into their document creating and viewing products to achieve reliable, compact, and efficient recording, transporting, viewing, and printing of typographic information, whether or not the fonts used for the original creation of the document are resident on the recipient's system. TrueDoc has been engineered to be small in file and application size, to comply with all industry font standards, and to be cross-platform compatible.

TrueDoc is composed of two main software components. The TrueDoc Character Shape Recorder, approximately 75 kilobytes in size, captures character shapes from a font processor, such as TrueType or Type 1, and creates a portable font resource ("PFR") that is transportable across networks or the Internet. TrueDoc's Character Shape Player, approximately 65 kilobytes in size, recreates the character shapes stored in the PFR and displays the text in a manner that maintains the integrity of the original shapes. The Company believes that TrueDoc's small file size and efficient playback capabilities present advantages in applications where limitations on bandwidth and memory are significant factors.

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The PFR is a compact, platform-independent format for representing high-quality characters from scalable fonts. The Bitstream PFR font format is open, public, and an industry standard. The PFR is the standard font format for digital TV. Many independent organizations responsible for setting digital TV standards have adopted the PFR as their standard font format, including the ATSC (Advanced Television Systems Committee); DAVIC (Digital Audio Visual Council), which set multimedia standards for international broadcasting; DTG (Digital TV Group), which coordinates standards for Digital TV broadcasting in the United Kingdom; DVB (Digital Video Broadcasting), a Swiss-based industry organization representing one standard for digital TV that has been adopted extensively in Europe; MHP (Multimedia Home Platform), which many European set-top box and digital TV manufacturers are using as their standard development platform; ISO/IEC 16500-6:1999 (International Organization for Standardization / International Electrotechnical Commission), which together form the specialized system for worldwide standardization; and OCAP (OpenCable Application Platform), which supports the DVB-MHP standard, including support for PFRs.

In December 2002, Bitstream released a beta version of PFRMaker. Bitstream PFRMaker is a utility program that allows developers to create custom PFRs from standard TrueType fonts. Using PFRMaker, developers can build any number of TrueType fonts into a custom PFR. It allows developers to create compact fonts, store as many characters as they want in a single PFR, and store font data (character IDs, character encodings, font metrics) that is also found in industry-standard font formats. PFRMaker is primarily for developers building to digital TV specifications that require the PFR as the standard font format, but anyone can license it.

(d)

TDIS

The modular architecture of the Company's "5-in-1" enabling technology, TDIS, provides software hooks to allow OEMs and ISVs to incorporate font scaling technologies into their products. The font scaling technologies included in TDIS are two industry standard font formats (TrueType and Type 1), the resident fonts used in Hewlett-Packard Company LaserJet laser printers, and a Bitstream TrueDoc-based font rasterizer that processes Bitstream-supplied resident font sets. In addition, this 5-in-1 architecture includes software that routes incoming font data to the appropriate processor and prepares the final rasterized characters for imaging by an output device or computer screen.

(3) Typeface Products

Bitstream has developed a library of over 900 digital typefaces deliverable in industry-standard TrueType and Type 1 font formats. Most of these typefaces are for use with English or other Western European language-based computer systems. A large number of typefaces are necessary to support OEMs and ISVs focused on the graphic arts market, who are accustomed to having a wide variety of typeface designs from which to choose. The remainder of the Company's typeface designs are non-Western language typefaces such

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as Japanese, Greek, Cyrillic, Chinese, Korean, Russian, Hebrew and Arabic. Bitstream is committed to increasing the number and variety of typeface designs it offers to its customers.

In August 2000, Bitstream announced the New Font Collection (NFC) program to add fonts to the library and seek out designs from new and established designers alike. The NFC program releases new fonts regularly. In 2002, Bitstream released 29 fonts from 11 designers, including 13 Bitstream exclusives, from international award-winning designers. For the first time, Bitstream also released NFC font packs, including NFC: Volume 1; Iowan Old Style: The Complete Family; and four theme-based NFC packs.

In 2002, Bitstream furthered its commitment to worldwide font development by releasing 1 Thai, 5 Hebrew, and 35 WGL4 (Windows Glyph List 4) fonts. Each WGL4 font includes 652 characters, including characters that Western, Central, and Eastern European writing systems rely on; each WGL4 font also includes Baltic, Cyrillic, Greek, and Turkish characters.

In addition to typefaces, the Company also offers custom design services. Depending on the needs of the client, the Company can digitize corporate logos, modify existing typeface designs, add special characters to typefaces, and create new typefaces. The Company's custom design services are marketed to its OEM, ISV and large corporate customers.

Bitstream has developed its own, proprietary, font design software tools. These tools enable the Company's typeface product engineers to develop and expand the Company's library of typeface products and to generate custom typeface products in an efficient and cost-effective manner. By using its own tools, Bitstream largely can avoid licensing or paying royalties for the use of third party development tools. In addition, the Company believes that its design tools improve its competitive position in the marketplace by helping the Company rapidly adapt its products to the specific requirements of its customers.

SALES & MARKETING

The type and technology sales organization, as of March 14, 2003, consisted of three people focused on OEM and ISV sales for ThunderHawk and type technology products, one person focused exclusively on ThunderHawk sales, and two individuals focused on corporate direct sales. The Company's sales efforts are managed from its corporate headquarters in Cambridge, Massachusetts. The Company also has a sales agent based in Tokyo to facilitate OEM sales to Japanese hardware manufacturers. Sales personnel receive a base salary plus commissions based on meeting sales targets, with additional commissions for sales in excess of annual targets.

Marketing activities, as of March 14, 2003, are carried out by three individuals who are located at the Company's headquarters in Cambridge, Massachusetts. In addition, the Company promotes its products through attendance and exhibition at major industry trade shows and through its Web site, <http://www.bitstream.com>. The principal objective of the Company's marketing strategy is to grow the sales of the Company's browsing technologies based on Thunderhawk and to continue to expand the sale of the Company's font technologies to OEMs and ISVs, who integrate the Company's software into their own products, and to end users. OEM and ISV agreements range from those licensing a small group of typefaces to agreements whereby an entire range of font products and/or technologies are incorporated into the customer's hardware or software products. As new opportunities arise, the Company intends to evaluate other marketing approaches.

CUSTOMERS

The Company licenses its Web browsing technologies to corporations, end users and wireless carriers. The Company licenses its type technology and typeface products to a wide variety of OEM and ISV customers. The Company also sells custom and other typeface products directly to corporate customers and individual end users. No single Type segment customer accounted for 10% or more of the Company's revenue for any of the years ended December 31, 2002, 2001 or 2000. For the year ended December 31, 2002 one Type customer accounted for 10% of the revenue for that segment. However, no single Type segment customer accounted for 10% or more of the segment's revenue for the years ended December 31, 2001 or 2000. From time to time, product sales to large customers during a single fiscal quarter may constitute more than 10% of Company revenue for such quarter. The Company has broadened and intends to continue to broaden, its customer base through expanded product offerings and increased marketing

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efforts. Revenue by geographic area is included in Footnote 10 in the Notes to the financial statements enclosed herewith.

RESEARCH AND DEVELOPMENT

Bitstream is committed to developing innovative software to enhance the browsing experience on handheld devices and to improve text imaging for wireless devices, operating systems, software applications, information appliances, Web applications, low-resolution screen devices, multimedia servers, high-definition television screens (HDTVs), set-top boxes, PDAs, and other embedded systems. To accomplish this goal, the Company has invested, and expects to continue to invest, significant resources in research and development. The Company's research and development activities are centered around advancing the Company's software products for its corporate, OEM and ISV customers and for wireless carriers. The Company maintains specific expertise in the areas of font formats, multilingual fonts, font portability, font compaction, and font processing technology. The Company emphasizes cross-platform portability, small file and application size, and extensibility to new technologies in its software development. To support these design objectives, the Company utilizes advanced software development techniques.

Bitstream is committed to advancing the Company's wireless browsing and font rendering products and technologies. During 2002, Bitstream's research and development activities produced:

ThunderHawk the enhanced wireless Web browsing technology for mobile devices. ThunderHawk brings the desktop browsing experience to wireless devices. The initial version was launched in April 2002. This was followed by four more point releases including feature enhancements and added device support. Additionally work was done on future ThunderHawk technologies including work on a future cell phone version.

FontFusion the company's smallest, most advanced font rasterizing engine, and the fastest font engine on the market. Two new versions were released which included improved support for Adobe OpenType fonts, and support for FCC edge effects standards for closed captioning, and improved small screen rendering. An optional new CCTV font set and an optional new Wireless font set was also released.

btX2 a beta version of this premier Font Rendering technology for Linux was released. btX2 is a FreeType driver that provides access to Bitstream's Font Fusion font rendering technology. btX2 allows developers to use the same function calls as FreeType. btX2

supports Unicode encoding and can render international fonts.

As of March 14, 2003, the Company employed 15 individuals who engage in Type research and development activities, including the Company's Chief Technology Officer who is currently focused on MyFonts.com. Of these, six focus on ThunderHawk, four focus on font product development, three on developing enabling technology, TrueDoc, Font Fusion, and btX, and two on all of these areas. The Company also uses outside consultants to support the ThunderHawk and stroke-based font development efforts.

COMPETITION

Bitstream's browsing solutions compete with the browsing solutions offered by a wide variety of companies, including large software companies and boutique companies focused on delivering solutions to a narrow part of the browser market. The markets for browsing solutions are the subject of intense industry activity, and it is likely that a number of software developers are devoting significant resources to developing and marketing technology and products that may compete with the Company's technology and products. Bitstream believes ThunderHawk compares favorably against the competition because of the desktop like web browsing experience and robust web-standards compliance. Browser competitors include PocketIE from Microsoft Corporation, Opera SmartPhone Edition from Opera software ASA, NetFront from Access Co. Ltd., and Blazer from Handspring, Inc. The competing solutions produce a lesser browser experience by offering a scrollable view of only a small section of the web-page and sometimes also by reformatting the page into a lengthy one-dimensional vertical structure.

The Company's typeface and type technology products compete with the solutions offered by a variety of companies, including other suppliers of enabling technologies, software application developers, and vendors of computer operating systems. Moreover, the market for the Company's enabling technologies and

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products may be adversely affected to the extent that computer hardware, operating system, and application software vendors incorporate similar functionality or bundle competitive offerings with their products and thereby reduce the market for the Company's technology or products. The competition for the Company's sales of typefaces generally comes from a number of comparably sized or smaller companies offering their own typeface libraries and custom typeface services. Competition with the Company's enabling technologies principally comes from Agfa with its iType and Universal Font Scaling Technology ("UFST"). UFST has a similar architecture to the Company's TDIS enabling technology product. The competition for Font Fusion and the TrueDoc Imaging System consists primarily of software from Agfa, which includes a font compression technology known as MicroType Express. Other competition for Font Fusion comes from software from Slangsoft, which includes intelligent text input and display known as iTID. Competition for btX comes from FreeType, an open source collaborative organization that provides its Linux font rendering code for free.

The Company believes that the principal competitive factors affecting its market include product features and functionalities, such as scalability, ease of integration, ease of implementation, ease of use, quality, performance, price, customer service and support, and effectiveness of sales and marketing efforts. Although the Company believes that it currently competes effectively with respect to such factors, there can be no assurance that the Company will be able to maintain its competitive position against current and potential competitors.

MYFONTS

INDUSTRY BACKGROUND

Traditionally, individual digital fonts and font packages consisting of a variety of fonts have been sold through many different channels including: (1) catalog sales; (2) sales through resellers who typically handle fonts from multiple foundries together with other graphic arts supplies; and (3) CD ROMs containing many fonts which can be unlocked by means of a purchased key code.

While these approaches to selling fonts are generally satisfactory for professionals, they represent a barrier for the non-professional, casual user who is simply looking for a particular font. For example, if someone sees a font used in a magazine, traditional sales channels offer no quick and easy way of finding out what it is. Even when the name of the font can be determined, it is not obvious where to buy it from among the hundreds, if not thousands, of font foundries offering their fonts through numerous channels. As a result of such obstacles, font sales to non-professionals have historically been almost non-existent. Bitstream believes that this represents a large untapped market for fonts and established MyFonts in 1999 to capitalize on this market.

THE MYFONTS SOLUTION

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In 1999, MyFonts developed a prototype Web site. This Web site included a few thousand fonts together with powerful search facilities to help users find a particular font. Some of these search facilities, such as the ability to browse fonts of a selected style, are commonly found on other Web sites featuring fonts. A keyword search engine, more powerful than commonly found on such sites, was developed to make it easier to pick fonts suitable for a given project. For example, if a consumer needs fonts for a wedding invitation, he or she may type the word "wedding" to find a variety of suitable fonts from a large number of competing vendors. In addition, novel capabilities allowing the user to ask to see fonts similar to a particular font are also included on the site.

The most powerful search technology included on the MyFonts.com Web site allows any user to upload an image scanned from a magazine or newspaper, and to get a list of the closest fonts matching the scanned image. This technology, called WhatTheFont, is believed to be one of the keys to making MyFonts.com easy and accessible to casual users. During 2000, Bitstream filed for a U.S. Patent relating to the use of automatic font recognition in conjunction with e-commerce.

MyFonts is designed to handle virtually all fonts available irrespective of their source. The Company's strategy for the MyFonts.com Web site is to become the universal and complete source for fonts from all font vendors and designers. To implement its strategy, the Company approached a number of key font

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foundries and invited them to participate in the MyFonts.com Web site. Three levels of participation are currently available:

1. Level 1 A participating font foundry provides copies of its fonts for addition to the MyFonts database. This makes its fonts available to all searching and browsing facilities. In addition, it allows users to see images of the fonts for evaluation and comparison. If a user wishes to purchase a font from a participating foundry, he follows a link to the foundry's Web site where the purchase actually takes place. MyFonts collects no revenue from these sales. In many cases, however, MyFonts earns referral fees when such purchases are made.
2. Level 2 Similar to level 1 but the participating foundry allows its fonts to be sold directly by MyFonts. With each sale, MyFonts pays a royalty.
3. Level 3 Similar to level 2 but the participating foundry shares in the ownership and control of MyFonts. As of the date of this filing, no participants have elected to participate at this level.

Since launching the e-commerce portion of its Web site in April 2000, the Company has monitored sales and feedback from its users and used this information to make ongoing improvements to the Web site. As a result, the Company believes that the current Web site presents substantially fewer obstacles to finding and buying fonts than any other Web site offering fonts for sale.

PRODUCTS AND TECHNOLOGIES

In early 2000, Bitstream officially launched MyFonts.com, a showcase of the world's fonts from one easy-to-use Web site. Created by Bitstream and joined by some of the industry's most influential font foundries, MyFonts provides one of the largest collections of fonts ever assembled. It features new ways to find and purchase fonts on-line, and offers unique typographic resources and a forum for interacting with font experts.

As of the date of this filing, over 110 foundries, large and small, participate as partners with MyFonts to offer their fonts for sale. This represents an aggregate collection of over 27,000 fonts.

Some of the key features of MyFonts.com include: (1) MyFonts Valet which enables users to browse and locate fonts using keywords a novice or expert can understand; (2) WhatTheFont which allows users to scan images of typefaces and upload them to MyFonts.com for identification; (3) the ability to find fonts similar to a particular typeface design using the "Show me more fonts like this..." feature; (4) test driving a font in your own text; (5) exploring the world of fonts with links to typographic resources available on the Web; (6) the ability to collect fonts into one or more Font Albums for side-by-side comparison and collaborative decision making; and (7) the ability to interact with type experts and fellow users on-line, ask questions, or join the on-line MyFonts Forum.

The mission of MyFonts is to make fonts accessible to everyone, which benefits both users and the font foundries. Fonts have been an anomaly to the general computer user difficult to find, purchase, and install, and often an unknown aspect of their desktop environment. MyFonts

hopes to endear fonts to all users, not just graphic arts professionals.

SALES & MARKETING

Marketing activities are carried out by one individual drawn from Bitstream's Type business located at the Company's headquarters in Cambridge, Massachusetts. Since its inception, marketing of MyFonts has been focused on recruiting participation from font foundries, making Web users aware of MyFonts.com and bringing them to the Web site. Since 2002, the Company has focused marketing efforts for MyFonts.com on increasing awareness of, and sales on, the site. Marketing activities to increase awareness on the part of potential font buyers consists of a tradeshow presence in combination with efforts aimed at building Web links from search engines and other Internet sites. To complement this presence, the Company strives to further increase awareness by encouraging editorial coverage in relevant publications and through print and Internet advertising.

Analysis of sales results suggests that most of MyFonts.com's customers find the site by means of search engine queries. The Company has worked and continues to work vigorously to develop and improve its ranking on search engines. In addition, the Company enters into referrer agreements with selected Internet sites that share a portion of revenue in return for referring new customers.

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One of the most promising and innovative means of making access to MyFonts.com as easy as possible is by building in a connection to MyFonts.com from font managers. By automating the often-troublesome font installation process, one significant barrier to new users is removed. The first implementation of this approach was developed jointly between the Company and Corel Corporation in the form of an enhanced Bitstream Font Navigator released in November 2000. This technology has subsequently been incorporated into DiamondSoft's Font Reserve font manager. The Company plans to work with other developers of other font managers to implement this powerful technology more broadly.

Using the same technology that enables font managers to handle the purchasing and addition of fonts, MyFonts also provides back-end font searching and e-commerce facilities to other Web sites including *www.bitstream.com*.

CUSTOMERS

MyFonts licenses typefaces to end users worldwide through its e-commerce Web site. No single MyFonts segment customer accounted for 10% or more of the Company's revenue or that segment's revenue for the years ended December 31, 2002, 2001, or 2000.

RESEARCH AND DEVELOPMENT

The Company is committed to developing leading-edge technology for its MyFonts.com Web site to ensure that the site is the primary site to purchase fonts on the Web. As of March 14, 2003, the Company employed three individuals and two consultants who focus on research and development activities relating to the technology incorporated into the MyFonts.com Web site, including Bitstream's Chief Technology Officer. Additional Bitstream personnel also assist in the research and development effort for the site including Bitstream's internal font experts.

COMPETITION AND OTHER RISKS

Competitors to MyFonts include individual font foundry Web sites and other font-related Web sites that offer a variety of fonts for sale online. However, MyFonts believes that it has no direct competitors who offer such a wide variety of fonts on one easy-to-use Web site aimed at people who have never previously purchased a font. However, there can be no assurance that consumers will prefer to use MyFonts.com over Web sites hosted by individual font foundries. There also can be no assurances that MyFonts will succeed in hosting virtually all of the available digital fonts in the world. If there are critical omissions due to non-participation by key foundries, the value of the site as a one-stop shop will be reduced. Even with the powerful search tools and the ability to find any font in one place, there is no assurance that additional sales of fonts will occur in sufficient numbers to justify the cost of operating MyFonts.

PAGEFLEX

INDUSTRY BACKGROUND

Corporate marketing departments in the United States spend approximately \$20 billion on commercial printing each year. Market Research firm CAP Ventures estimated in early 2000 that for every dollar spent on printed product, ten dollars is spent in creating, revising, ordering,

warehousing, distributing, and obsoleting inventory.

Marketing documents are typically created through an expensive, labor-intensive process. After all the text and image content has been created, the process of laying the content out on a page and preparing it for the printing press involves hand-offs between two or three separate departments or firms, with manual intervention and rework by each. The desktop publishing revolution has made the process of developing the component text, images, tables, charts, and illustrations very efficient. However, once an original design is created, the process by which other people such as dealers, distributors, and franchisees implement and customize it for their local situation is cumbersome at best. This workflow requires sending multiple drafts back and forth between designer and content provider, which takes shipping time and adds to the labor time and cost.

In the past few years, corporate marketing departments have learned to take advantage of the Web as a new marketing medium. These departments are becoming familiar with the qualities and opportunities of the new medium, such as the abilities to update information quickly and easily, to generate content pages

dynamically directly from corporate databases, and to personalize the customer experience. The Internet is fast becoming the first place a potential customer goes to search for general information or learn about a company and its offerings. Web sites are, or will soon be, the primary information source for customers and potential customers. Compared to the Web, traditionally produced print is slow, unwieldy, and expensive. Internet speed has made printed materials far more likely to be out-dated and thrown away.

With today's manual page layout and cumbersome prepress process, it is impossible to personalize printed pages the way one can with the Web. It is also not economically feasible with today's offset presses to print less than 1,000 copies of any document, let alone a run of one, as would be required for ultimate personalization. Today, companies have separate teams dedicated to print and Web publishing. Often the only time these teams share input is by manually cutting and pasting between Web and print authoring tools and databases. Each team typically publishes from its own database, and each database must be independently updated.

Companies are realizing the increased customer loyalty and profits that result from treating customers as individuals. They recognize the importance of identifying their most valuable customers and lavishing attention on them in a way tailored exactly to their needs. The heart of systems for this kind of personalization is the maintenance of a unique profile of each customer. Companies like credit card providers, airlines, auto manufacturers, and computer manufacturers all have databases of their customers, with unique purchase profiles to leverage in the creation of personalized communications. Customer relationship management (CRM) software, integrated with Pageflex software to create personalized marketing communications for customers, can enhance customer loyalty and boost future revenues. Marketing industry consultants Don Peppers and Martha Rogers have popularized the notion of marketing to an audience of one. To implement one-to-one communications, all marketing communications must be moved from a one-size-fits-all approach to a custom manufacturing model, in which thousands of variations can be produced at low cost. The market is demanding solutions to implement this one-to-one concept.

Pageflex software, together with high-speed color printers and digital presses, makes one-to-one marketing a practical reality. With or without the added complexity of one-to-one marketing, companies must create thousands of unique marketing documents to meet the needs of their distribution partners and to present all their products and services. The number of variations required can be computed by considering combinations of the following factors:

The number of revisions of the document in a year

The number of basic document templates

The number of product and service variations to go through the template

The number of distributors who want the document customized for local markets.

The number of languages needed for each country

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The combinations of variations from one-to-one marketing

CAP Ventures observed in 2002 that the variable-data segment of the black-and-white print-on-demand market was already 8% among commercial printers and 12% in corporate environments, and that print-on-demand as a whole will experience a 17% compound annual growth rate (CAGR) through 2006, when it will represent a \$17.1 billion market.

Pageflex has actively pursued the Web-to-print market since the release of Mpower 2.0 in early 2000. Mpower is currently in revision 3.5. Much of the current Pageflex customer base uses Mpower in a transactional mode as part of an e-commerce solution. These customers provide customized marketing materials in on-demand mode to corporations. Marketing managers, sales people, and franchise owners are among the types of users who choose marketing templates online, select images, type custom content into a Web form, review a PDF proof Mpower generates and then displays in their Web browser, and order the digital or offset printing of a customized marketing document. Web-to-print custom publishing systems streamline production processes and save money, since marketing collateral can be designed once and then repurposed numerous times. Such systems also enable those who need marketing collateral to receive printed documents in a matter of days instead of weeks. Fortune 1000 marketing departments are the target market for these Web-to-print services, and Pageflex users include Ford, IBM, Xerox, Whirlpool, Birkenstock, Wise Business Forms, and USA Direct.

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THE PAGEFLEX SOLUTION

The Company develops technologies that distinguish it as a pioneer and leader in the publishing world and empower major corporations to rethink their marketing strategies and workflows. The products are as follows:

Mpower is an enterprise solution that allows companies to dynamically create customized business documents. Driven by customer profile information entered into a Web form or database, Mpower selects tailored text and graphics elements and assembles them into sophisticated documents even for naïve users. Mpower uses highly flexible design templates that contain thorough copy-fitting rules and careful permissions to determine how and by whom each design can be altered. Mpower creates GIF, JPEG, and PDF document previews and generates PostScript, PDF, and Personalized Print Markup Language (PPML) output. Mpower also includes output drivers for selected vendor-specific formats like Xerox VDP.

Persona is a desktop application designed to produce personalized documents driven from a database. It is an easy-to-use product that offers powerful features not found in existing solutions to companies just getting started in variable-data printing. Persona projects easily migrate to Mpower, since the two share the same templates. Persona includes drivers for PPML and PostScript output, and select vendor-specific drivers are available separately.

.EDIT is an innovative new technology launched in May 2002 and released in version 2.0 in February 2003. .EDIT enables non-designers to create typography-rich, layout-rich print documents from within a Web browser. The user experience is full interactive WYSIWYG, as with desktop publishing but without extra software installation and with the added benefit of built-in design rules and permissions. Pageflex has developed this technology to target Web-to-print service providers who need to offer more creative freedom to their customers than possible with typical template-driven publishing workflows, while precluding extra labor costs and longer production cycles. Within an automated publishing workflow, .EDIT makes a print document available for remote hands-on editing, styling, and content positioning changes. This feature set with all the richness of desktop publishing is presented in an easy-to-use interface right in the customer's familiar Web browser. The user interface can be made as simple as necessary to match user skill levels, empowering even publishing novices.

Variable-data printing (VDP) changes the focus from marketing one product to thousands of customers to marketing many products to a selected group of customers or to an individual customer. By merging database records and digital imaging technology, VDP makes it possible for each printed copy of a document to be different from all others. Pageflex combines VDP capabilities with the ability to print flexible run lengths just in time for delivery, to create a complete print-on-demand marketing solution. Companies can instantly create customized materials for their customers and print just as many as they need immediately. Not only does this model improve the response rates of customers, it also allows a company to maintain last-minute, accurate information in its materials. Writers, editors, and graphic designers can customize their documents to contain material appropriate for each reader while ensuring that the latest product descriptions and updates are included with each new distribution. The return on investment (ROI) for this kind of technology includes eliminating the losses in throwing out old literature and increasing the marketing yield with more personal campaigns.

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As acceptance for one-to-one marketing and targeted audiences grows, the Company finds that its software products are becoming necessary tools in the publishing industry. In this time of revolution in the way we view publishing, Pageflex continues with an aggressive and innovative development program to create products with strong print-on-demand customization and personalization capabilities.

Pageflex products and technologies have been designed to support existing technological standards. Pageflex is a founding member of the Print On Demand Initiative (PODi), an alliance of key vendors and service providers working in the digital color printing market. PODi promotes a greater awareness about the applications and benefits of digital color printing through the journal articles, independent research, industry seminars, and special events. Membership in PODi is open to leading vendors and service providers in digital printing, database marketing, and mail product development. PODi members include Adobe, Creo, Electronics for Imaging (EFI), Hewlett-Packard, IBM, and Xerox.

Pageflex also participates in the PODi Personal Printing Initiative (PPI). The PPI seeks to understand and quantify the value of variable color digital printing as a means of improving customer acceptance and

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application. The goal of the PPI is to help eliminate obstacles facing users of variable-data systems, thus accelerating market acceptance. The PPI has completed and released a PPML standard harmonizing the ten vendor-specific proprietary protocols currently used to drive digital presses at high speed into one open standard supporting PostScript, PDF, and AFP. Pageflex software, since its inception, has sought to drive all brands of digital printers. Pageflex has a neutral position as a creator of output that has enabled it to play a central role within the PPI working group. With strong Pageflex input, PPML has been adopted as a standard across the industry, and Pageflex continues to play a leading role in the standardization program.

Pageflex also is actively involved in the Extensible Stylesheet Language (XSL) working group of the World Wide Web Consortium (W3C). Pageflex was invited onto the committee by the chairperson, based on the Company's years of experience developing style sheet languages. XSL is one of the components of the W3C XML standards effort. Dr. Jeffrey Caruso represents Pageflex and serves along with representatives from Adobe, Sun, IBM, Microsoft, and about twenty other prominent firms. Dr. Caruso worked with Adobe to co-edit the print-oriented formatting part of the standard. In October 2001 the World Wide Web Consortium released XSL 1.0 as a formal W3C Recommendation.

The XSL standard is of great strategic importance to Pageflex. The Pageflex underlying composition engine, NuDoc , currently uses its own proprietary TSL style language. The Company is making plans to develop its NuDoc composition engine for XSL. This version of NuDoc will make Pageflex solutions based entirely on open standards, using XML for content and XSL for form, and joining them together to create PDF, PostScript, and other output formats.

PRODUCTS AND TECHNOLOGIES

The Company's Pageflex products consist of: (1) Mpower, for Internet-driven customized documents targeted at a particular market segment or an individual reader; (2) .EDIT, to allow all users from novices to experts to modify templated designs in an interactive WYSIWYG environment but under the constraint of rules and permissions set by the designer and (3) Persona, a desktop application designed to produce sophisticated personalized documents in PDF or PostScriPART. All three products are based on the NuDoc document composition engine and the set of template authoring tools in Pageflex Designer.

Mpower

Mpower is an integrated suite of software applications that gives enterprises in many industries and digital printing service providers the ability to design and produce customized-database- or Internet-driven marketing communications on demand. Mpower can assemble complex projects dynamically and deliver them instantly in print or bitmap formats to a wide range of output devices, the Web, and e-mail.

Mpower can use customer profile information about a recipient to control the selection of digital content for a document, including its logos, imagery, illustrations, and text. The customer profile information is stored in a database or collected from a Web form. Typically a call center, the salespeople, or the recipients themselves complete these Web forms. Mpower then uses intelligent, flexible templates to automatically assemble this personalized content into final documents for output.

Mpower is based on the principle of separating document content from document design. Content is the raw information, and form is the presentation how the page is laid out, what fonts and colors are used, and how images are sized and positioned. Pageflex captures the design of a document in the form of a flexible, intelligent template that represents the original vision for the page. The copy-fitting and placement rules, together with permissions that govern user ability to change elements, are built into each design template by the designer. The designer is thus

able to protect the whole from degradation and damage by content providers who have little or no design skill but can modify and add their content. Document designs originally developed in Quark Xpress, Adobe InDesign, Microsoft Word, or other applications can be imported into Mpower through the use of Pageflex plug-ins that enable these third-party applications to export to the Pageflex XML data format. The flexible templates are populated with images, text, and other content, customizing the page based on variables created as part of a template. The variables are attached to customer information stored in a database or collected from a Web form, as well as to meta tags used by a content management system. Pageflex software interprets the variables to determine which copy and illustrations to select for the customized document it is assembling.

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By separating content and design and helping users easily and intelligently recombine them, Mpower lets users assemble pages on the fly, based on market profile or user preference. Mpower leverages the valuable customer information stored in corporate databases by using it to tailor a marketing message directly aimed at individual customers. It also allows the user to repurpose content the text, images, and other digital files used to market their business and make it work in far more productive ways. Mpower redefines a document from a static single-purpose entity into a flexible multi-purpose asset the user can use again and again, with far greater result each time.

Mpower is layered on top of the Company's NuDoc composition engine. Development in NuDoc started in the 1980s with a product called Archetype Designer used for advertising makeup. Further development in NuDoc targeted newspaper and classified advertising systems. Development of the Mpower application layer began in 1997. Total investment in Mpower and NuDoc is approximately 155 staff-years.

In May of 2002, Pageflex released Mpower in version 3.5. Mpower 3.5 also included a variety of additional new features, usability improvements, and performance enhancements, notably support for:

Pageflex .EDIT workflows

Native PDF output

Placed PDF

Advanced copy-fitting rules

Spot colors and tints

The Company believes that Mpower 3.5 defines the state of the art for Web-to-print custom publishing software. By incorporating advanced copy-fitting capabilities, the ability to place PDF objects, and enhanced color support, Mpower 3.5 also appeals to marketing and advertising users who are developing one-to-one marketing campaigns and who want to let their users customize designs through a simple Web interface. Good examples of this model include expresscopy.com, through which realtors in all 50 states access flyer, postcard, and business card designs to customize for short print runs; and Ford Germany, whose dealers create new car advertisements by customizing templates in an online interface.

.EDIT

Pageflex .EDIT is the first Web browser-based design and editing application that enables non-designers to create typography-rich, layout-rich documents with just a browser and an Internet connection.

.EDIT represents a revolutionary level of interactivity for Web-to-print solutions. It enables companies to offer interactive document editing capabilities to customers, employees, marketing partners, and dealers or franchise owners over a corporate Web site. Users need only a Web browser and an Internet connection, without any plug-ins or additional software applications.

Customers deploying .EDIT on their Web site can create templates that maintain their brand and corporate identity by using approved fonts, design elements, and images. They can also limit the editing capabilities made available to their end users and constrain portions of the document so that they cannot be modified. Authorized visitors to a .EDIT-enabled Web site can interactively modify the document directly

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online to create layout-rich, typography-rich versions of the documents. In essence, each user creates the ultimate customized document.

.EDIT enables companies to:

Offer applications in which Web site users directly select, edit, and style text, images, and shapes

Offer forms-based preview applications, in which users enter variable data into forms and quickly see a preview of the updated document

Streamline document review cycles by providing a Web interface with which internal and external customers can safely make any last-minute document changes

Control the look and feel of corporate documents, while permitting restricted modification of both content and style

Use the client application out-of-the-box for quick deployment

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Customize components to control exactly which functionality users can access and use

Customize the visual appearance of components so that the application best integrates within an existing Web site

Integrate components in workflows that involve a proxy server for security or caching

.EDIT allows end users to:

Edit documents without having to install or learn software, in a highly intuitive graphical interface

Create professional-looking documents by adding personal text and images to well-designed templates

Create documents that use corporate-approved fonts, colors, design elements, and images

Create documents leveraging sophisticated design features

Count on the final output matching the screen, since both use the same underlying composition engine and fonts

.EDIT was first released in May of 2002. In February 2003, Pageflex released version 2.0 of .EDIT with significant enhancements for enterprise Web-top publishing applications. These include several performance enhancements, support for proxy-servers, and wide support for browsers for Windows, Mac OS X, and Mac OS 9.x.

Persona

Persona, a variable content publishing application, allows users to create sophisticated, personalized documents in PDF, PostScript, or PPML. Persona is an easy-to-use desktop application for Windows, consisting of a subset of features from Mpower, Pageflex's enterprise marketing-on-demand solution. Built upon open standards, Persona is the first variable content publishing solution to use XML as the intermediate data format between databases and the page composition process. Like Mpower, Persona uses Pageflex's advanced NuDoc page

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composition engine, offering precise control over the design of page templates while maintaining a strict separation of design and content. Using an ODBC-compliant database as a customer profile data source, Persona users can create conditional rules that determine which content is chosen for a particular profile. The content is then dynamically placed in the template to create the final document.

Persona users can build a document template from scratch by creating image containers, text containers, and other graphic elements using familiar GUI tools. And because Persona incorporates a full composition engine, it offers the standard composition tools such as leading, kerning, justification, and hyphenation. Persona shares Mpower's "flex" capabilities, the ability to automatically adjust a container size based on the size or orientation of the content that flows into it. In addition, surrounding containers move in concert to adjust with the change, maintaining the design integrity.

Other key features of Persona include:

Support for if/then/else selection rules for variable content

Support for keyword queries of variable content with Pageflex Librarian

Previewing for each individualized record

PPML and object-based PostScript output

Import of Quark and PageMaker documents through Adobe InDesign and a plug-in

Optional output for Creo VPS, Indigo JLYT, and PPML

Pageflex released Persona 1.5 in the first quarter of 2002. The release highlighted output drivers and included a new PPML driver with additional functionality for the EFI Fiery line, as well as enhancements to the existing Creo VPS driver.

NuDoc

NuDoc is an advanced document composition engine based on the principle of separating form from content. Leveraging object-oriented technology, NuDoc is a reusable building block for document processing

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applications. NuDoc object classes provide an application programming interface (API) that supports the importing, editing, displaying, or printing of electronic documents. One of the strengths of NuDoc is its ability to dynamically create layout-intensive pages through import of separate content and style files. In NuDoc, a document object is made up of style, content, and page layout sub-objects. A style object contains rules that govern the form or appearance of the document. Content elements such as words, images, and movies are organized into a tagged tree structure that represents the logical organization of the information into sections and sub-sections. W3C Extensible Markup Language (XML) is the default content data representation. Styles are represented by a set of model objects. NuDoc uses a new style file format called Template Style Language (TSL) to represent the model objects. TSL styles describe the colors, fonts, and geometric rules that govern how structured content is formatted into the desired visual appearance. The TSL uses the metaphor of a flexible container to describe how to adjust the sizes and positions of text blocks, images, and other elements to produce a well-designed page.

SALES AND MARKETING

As of March 14, 2003, the Pageflex sales and marketing organization consisted of five people focused on maintaining and expanding reseller and OEM relationships as well as completing a limited amount of direct sales. The Company's sales efforts are managed from its corporate headquarters in Cambridge, Massachusetts. The Company also seeks to enhance its relationships with existing and potential customers through its training and technical support teams who work with existing and potential customers, resellers, and strategic partners to support the sales process and to facilitate the implementation and use of the Company's software products and technologies.

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The Company promotes its products through attendance and exhibition at major industry trade shows such as Direct Marketing and Print on Demand; through participation in booths sponsored by its strategic partners, like Electronics For Imaging, Xerox, HP, Indigo, Adobe and Creo Scitex; and through its Web site, www.pageflexinc.com. The principal objective of Pageflex marketing strategy is to continue to expand awareness of its on-demand marketing software products to Web-to-print providers, digital service and print providers, corporate marketing departments, design firms, advertising agencies, direct mail houses, and other corporations and end users. As new opportunities arise, the Company will expand its portfolio of marketing approaches. To date the most successful segments have been printers and marketing and advertising agencies.

CUSTOMERS

The Company licenses its Pageflex products directly to Web-to-print providers, print service providers, major corporations and end users, and indirectly through resellers and strategic partners. No single customer of the Pageflex business segment accounted for 10% or more of the total Company revenue for the years ended December 31, 2002 and 2001, nor did any single Pageflex customer account for 10% or more of that segment's revenue during those years. For the year ended December 31, 2000 this segment generated license fees and royalty revenue under a long-term contract with Atex Media Solutions, Inc. ("Atex") of \$874,000, accounting for 10% of the Company's revenue for the year ended December 31, 2000 and 32% of the Pageflex segment's revenue for the same period. During the year ended December 31, 2000 the Pageflex segment had revenues from two additional customers, which accounted for less than 10% each in total Company revenues but 16%, and 12%, respectively, of that segment's revenue during the year. The customer that accounted for 16% of the Pageflex segment's revenues during the year ended December 31, 2000 was Xerox, which signed a development and distribution agreement with the Company during the fourth quarter of 2000. The Company intends to continue to broaden its customer base through increased marketing efforts, by developing relationships with systems integrators, OEMs, and partners in 2003, and by introducing new product offerings. Revenue by geographic area is included in Footnote 10 in the Notes to the financial statements enclosed with this document.

RESEARCH AND DEVELOPMENT

Pageflex is committed to advancing the Company's on-demand marketing products and technologies. As of March 14, 2003, the Company employed ten individuals who engage in research and development

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activities for its Pageflex business, and two individuals who provide customer technical support. During 2002, Pageflex research and development activities produced:

.EDIT 1.0 The Web browser-based design and editing technology allowing non-designers to create professional-looking documents within browser session. With .EDIT, companies can provide employees, dealers, and customers the ability to edit every aspect of highly-designed documents over the Internet. On the other side of the equation, marketing departments can control the look and feel of corporate documents while also permitting restricted modification of both content and style. A .EDIT solution uses Java applets and JavaScript within client browsers, as well as a .EDIT server running the Pageflex NuDoc composition engine. Users can edit documents using Internet Explorer or Netscape on Macintosh or Windows computers. The .EDIT offering will complement the existing Pageflex dynamic publishing technologies.

Mpower 3.5 A major upgrade to the flagship product with support for .EDIT, native PDF output and placement, and other major usability and performance enhancements.

A product with the codename Park Street An enterprise server technology addressing the document customization and scalability demands of the Web-to-print market. Park Street provides concurrent processing of custom document previews and output; queuing and load balancing across multiple job processing engines; and Web-based job status tracking. Park Street is advantageous when Mpower server load reach thousands of jobs an hour or experience consistent instances of concurrent processing requests. Park Street, currently in beta testing, supports Pageflex Mpower and .EDIT projects.

Persona 1.5 A release focused on output drivers and including a new PPML driver with additional functionality for the EFI Fiery line, plus enhancements to the existing Creo VPS driver.

DesignOut plug-in 2.0 A package adding support for Adobe InDesign 2.0 by enabling export of InDesign documents to the Pageflex format.

COMPETITION

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Pageflex believes its products compete favorably based on rich feature sets, ease of use, stability, and scalability. In addition, the Persona application is a desktop tool that offers an easy upgrade path to the server-based solution Mpower, which uses the same templates. The Company believes that Park Street and .EDIT will solidify the position of Pageflex as the industry-leading one-to-one marketing communications solution in the Web-to-print fulfillment space.

Pageflex Persona competes with entry-level variable-data tools created by various digital press vendors. This market is focused on the creation of personalized documents requiring optimized output capabilities, many of which are vendor-specific today. Pageflex products offer output to several of the digital presses on the market, as well as output of Personalized Print Markup Language (PPML). As the PPML standard becomes more widely accepted, output to multiple vendor presses will be possible by all page creators. Pageflex competitors in this regard include Creo Scitex Darwin, Indigo Yours Truly, Barco VIP Designer, Xeikon PersonalizerX, Banta DesignMerge, and Atlas Printshop Mail. Pageflex believes it competes favorably in this market because of robust functionality and strong relationships with resellers, partners, and market influencers.

Pageflex Mpower and .EDIT are server-based enterprise applications targeted at the customized print or Web-to-print segment of the on-demand publishing market. This market is characterized by rapid technological developments and frequent product introductions. Participants in this market compete based on functionality, price, service, customizability, and interoperability with other e-publishing solutions and components. Pageflex faces competition from vendors offering end-to-end solutions and integration services that include on-demand publishing tools like Mpower. These solutions in turn compete with solutions created by Pageflex customers. These competitors include Banta, DeskNet, Digital VIP, Saepio, XMPie, Quark DDS and 3B2 Online. In addition, Pageflex may face new competition from emerging products and technologies. Pageflex believes it can compete favorably here based on the reliability and richness of the Mpower application suite and the strengths of the underlying NuDoc composition engine.

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INTELLECTUAL PROPERTY

The Company relies on a combination of trade secret, copyright, patent, and trademark laws and contractual restrictions to establish and protect proprietary rights in its technology. The Company has entered into confidentiality and invention assignment agreements with its employees, and when obtainable, enters into non-disclosure agreements with its suppliers, distributors and others so as to limit access to and disclosure of its proprietary information. There can be no assurance that these statutory and contractual arrangements will prove sufficient to deter misappropriation of the Company's technologies or that the Company's competitors will not independently develop non-infringing technologies that are substantially similar to or superior to the Company's technology. The laws of certain foreign countries in which the Company's products are or may be developed, manufactured or licensed may not protect the Company's products or intellectual property rights to the same extent as do the laws of the United States and thus make the possibility of piracy of the Company's technology and products more likely. The Company believes that, because of the rapid pace of technological change in the software and electronic commerce markets, legal protection for its products will be a less significant factor in the Company's future success than the knowledge, ability and experience of the Company's employees, the frequency of product enhancements and the ability of the Company to satisfy its customers.

The Company's policy is to apply for U.S. patents with respect to its technology and seek copyright registration of its technology and trademark registration of its marks from time to time when management determines that it is competitively advantageous and cost effective to do so. The Company has been granted four patents by the United States Patent and Trademark Office, three of which are directed to certain aspects or applications of the Company's TrueDoc technology and one of which is directed to the Company's DocLock technology. Additionally, the Company has sought foreign patent rights to certain aspects of its TrueDoc technology by filing foreign applications in several countries, which have already resulted in two patents from each of the United Kingdom and Canada. Furthermore, multiple U.S. and PCT applications are pending on some of the Company's newer technologies. The Company is currently in the process of registering several trademarks and preparing a variety of patent applications relating to MyFonts.com and its Pageflex software. Bitstream®, TrueDoc®, T2K® and Cyberbit® are federally registered trademarks of the Company. All other trademarks, service marks or tradenames referred to in this Annual Report on Form 10-K are the property of their respective owners.

EMPLOYEES

As of March 14, 2003, the Company employed 55 persons, including 13 in sales and marketing, 29 in research and development, and 13 in general and administrative functions. Of the Company's 55 employees, 53 are full time and 2 are part time. The Company also retains consultants from time to time to assist it with particular projects for limited periods of time. The Company believes that its future success will depend in part on its ability to attract, motivate and retain highly qualified personnel. None of the Company's employees is represented by a labor union and the Company has not experienced any work stoppages. The Company considers its employee relations to be good.

EXECUTIVE OFFICERS OF THE REGISTRANT

The Company's executive officers and their ages as of March 26, 2003 are as follows:

| Name | Age | Position |
|-----------------|------------|--|
| Charles Ying | 56 | Chairman of the Board and Chief Executive Officer |
| Anna M. Chagnon | 36 | President, Chief Operating Officer and General Counsel |
| John S. Collins | 63 | Vice President and Chief Technology Officer |
| Sampo Kaasila | 42 | Vice President, Research and Development |
| Costas Kitsos | 42 | Vice President of Engineering |
| David Frenkel | 55 | Vice President and General Manager, Pageflex, Inc. |
| James P. Dore | 44 | Vice President and Chief Financial Officer |

Charles Ying has been Chief Executive Officer of the Company since May 1997 and Chairman of the Board of Directors since April 1997. From January 1992 to January 1996, Mr. Ying served as Chief Executive Officer of Information International Inc., a corporation engaged in the business of designing, manufacturing and marketing computer-based systems that automate document production and publishing.

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Mr. Ying also serves as a member of the Board of Directors of NodeWarrior Networks Inc., an Internet Service Provider located in Los Angeles, California. Mr. Ying holds a B.S. and M.S. in Electrical Engineering from the Massachusetts Institute of Technology.

Anna M. Chagnon has served as President of the Company since June 2000 and as Chief Operating Officer, Chief Financial Officer and General Counsel of the Company since August 1998. She previously served as Executive Vice President from August 1998 to June 2000 and Chief Financial Officer from August 1998 to March 2003. From July 1997 to August 1998, she served in various positions at the Company including Vice President, Finance and Administration, Chief Financial Officer and General Counsel, and Vice President and General Counsel. From November of 1996 to July 1997, Ms. Chagnon was Counsel to Progress Software Corporation, a developer and worldwide supplier of solutions to build, deploy and manage applications across Internet, client/server and host/terminal computing environments. From August 1994 to November 1996 she was an attorney for the Boston law firm of Peabody & Arnold LLP where she specialized in corporate, securities, finance and intellectual property law. She holds a Bachelor of Science degree, summa cum laude, from Northeastern University, a Juris Doctor degree from Boalt Hall School of Law of the University of California at Berkeley, and a Master of Business Administration, summa cum laude, from Babson College.

John S. Collins has been Vice President and Chief Technology Officer since August 1998. From 1988 to August 1998, he served as Vice President of Engineering. Mr. Collins was the inventor or a co-inventor of a number of the patents held by the Company relating to font imaging technology. He is the principal inventor of the Company's TrueDoc technology. Mr. Collins holds a B.Sc. and a Ph.D. in Electrical Engineering from the University of London.

Sampo Kaasila has served as Vice President, Research and Development, of the Company since November 2001. Mr. Kaasila serves as the principal architect of the Company's Font Fusion and ThunderHawk products. From November 1998, when Mr. Kaasila joined Bitstream upon the acquisition of Type Solutions, Inc., to November 2001, he served as Director of Research and Development, Type Solutions. From August 1989 to November 1998, he was a founder and President of Type Solutions, Inc., a leading developer of font technologies including T2K, a font renderer which provides an object oriented design, advanced architecture and algorithms, and a clean API resulting in maximum reliability, performance, and easy integration. From August 1987 to August 1989, Mr. Kaasila worked at Apple Computer, Inc. and was the lead engineer and inventor of the True Type technology now part of every Macintosh and Windows PC. Mr. Kaasila holds a Masters degree in Electrical Engineering from the Royal Institute of Technology in Stockholm, Sweden where he graduated first in his class in January 1983.

Costas Kitsos has been Vice President of Engineering since November 1999. Mr. Kitsos serves as principal architect of the Pageflex Mpower and Persona products, and is also the technical lead for the Company's end user type application products. From October 1998 to November 1999, he served as Director of Research and Development of the Company. From November 1996 to October 1998, he was a Senior Software Engineer at the Company. Mr. Kitsos is a veteran software developer with over ten years experience in type and publishing application development. From May 1987 to November 1996, Mr. Kitsos headed IconWorks, which developed award winning type applications and offered consulting services on end user programs and graphical user interfaces. He holds a Masters degree from the University of California, Los Angeles.

David Frenkel has been General Manager of Pageflex since August 2002. From October 2001 to July 2002, he was COO of Media Command Americas, a systems integrator and software vendor for newspaper advertising, circulation, accounting, editorial, and data mining and

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customer relationship management systems. From April 1993 to October 2001, Mr. Frenkel was the founder and CEO of Pentawave, which pioneered database and Web-to-print publishing solutions for automotive, employment, and real estate advertising, primarily in newspapers. He has also held senior executive roles in several Fortune 500 companies and founded two other publishing automation companies. Mr. Frenkel holds a B.S. Degree in Physics from the University of Melbourne, Australia.

James P. Dore was named a Vice President and the Company's Chief Financial Officer in March 2003. From June 1999 to March 2003, he served as the Corporate Controller for the Company. From January 1997 to June 1999, Mr. Dore served as Corporate Controller at Celerity Solutions Inc. (bulletin board CLTY), a developer and marketer of supply chain and warehouse management business software, he also served as Celerity's Chief Financial Officer and Treasurer from April 1999 to June of 1999. Mr. Dore has over twenty

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years of service in various senior financial positions, holds a C.P.A. certificate and a B.S. degree, with distinction, from Clarkson University.

ITEM 2. Properties

The Company's corporate headquarters is located in Cambridge, Massachusetts where it currently leases approximately 27,500 square feet under a lease expiring in October 2003. Management believes that these facilities are adequate for the Company's current needs and that suitable additional space, should it be needed, will be available on commercially reasonable terms.

The Company also has an operating lease for small engineering office in Plaistow, New Hampshire.

ITEM 3. Legal Proceedings

The Company is not a party to any material litigation.

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 the fiscal year ended December 31, 2002.

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PART II

ITEM 5. Market for Registrant's Common Equity and Related Stockholder Matters

MARKET INFORMATION

At December 31, 2002 the Company's Common Stock traded on the Nasdaq National Market System. Effective February 28, 2003 the Company's Common Stock was transferred from the Nasdaq National Market to the Nasdaq Small Cap market. The application to transfer to the Nasdaq Small Cap Market was made in response to a notice from Nasdaq that the Company was not compliant with Nasdaq's new continuing listing requirement, which became effective November 1, 2002. Nasdaq changed its National Market System continued listing standard from a minimum \$4,000,000 net tangible asset requirement to a minimum \$10,000,000 stockholders' equity requirement. Bitstream did not comply with the \$10,000,000 stockholders equity requirement, as its stated equity as of December 31, 2002 was \$6,000,000. Upon consideration of the factors involved, the Company elected to transfer from the Nasdaq National Market. Bitstream's common stock will continue trading under its current symbol BITS.

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The Class A Common Stock of the Company began trading publicly on the Nasdaq National Market tier of The Nasdaq Stock Market on October 30, 1996 under the symbol "BITS". Prior to October 30, 1996, there was no public market for Bitstream's Class A Common Stock. The following table sets forth the high and low closing sale prices of the Company's Class A Common Stock as reported on the Nasdaq National Market for the periods commencing January 1, 2001 through December 31, 2002. Such information reflects interdealer prices, without retail markup, markdown, or commission, and may not represent actual transactions.

| | 2002 | | 2001 | |
|----------------|-------|-------|-------|-------|
| | High | Low | High | Low |
| First Quarter | 7.100 | 3.350 | 3.250 | 1.750 |
| Second Quarter | 4.720 | 2.750 | 3.550 | 1.540 |
| Third Quarter | 2.940 | 1.850 | 4.600 | 2.500 |
| Fourth Quarter | 2.090 | 1.470 | 6.930 | 2.300 |

As of March 14, 2003, the Company's Class A Common Stock was held by approximately 100 holders of record and the Company believes that the Company's Class A Common Stock was beneficially held by more than 500 holders. The Company's Class B Common Stock was not held by any holders of record.

DIVIDENDS

The Company has never declared or paid cash dividends on its capital stock. The Company currently intends to retain earnings, if any, to support its growth strategy and does not anticipate paying cash dividends on its capital stock in the foreseeable future.

RECENT SALES OF UNREGISTERED SECURITIES

During the years ended December 31, 2002, 2001, and 2000, the Company issued an aggregate of 46,832, 499,117, and 302,333 shares, respectively, of Class A Common Stock in connection with the exercise of vested options and warrants issued under the Company's 1994 Stock Plan, 1996 Stock Plan, 1997 Stock Plan, and 2000 Stock Plan. During the year ended December 31, 2000, the Company also issued 51,317 shares of Class A Common Stock in connection with the April 1997 acquisition of Archetype that had not previously been issued. There were no unregistered securities sold by the Company during the three years ended December 31, 2002. The sales and issuances of securities in the transactions described above were deemed to be exempt from registration under the Securities Act of 1933, as amended, by virtue of Rule 701 promulgated thereunder, in that they were issued either pursuant to written compensatory benefits plans or pursuant to a written contract relating to compensation, as provided by Rule 701. In addition, on October 25, 2001, the Company filed a Registration Statement on Form S-8 under the Securities Act of 1933, as amended, registering up to an aggregate of 1,000,000 shares of the Company's Class A Common Stock, par value \$0.01 per share, which may be issued upon exercise of stock options and warrants granted or which may be granted under the Company's 2000 Stock Plan.

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PART II, ITEM 6. Selected Consolidated Financial Data

The selected consolidated financial data presented below as of December 31, 2002 and 2001, and for the three years then ended has been derived from, and are qualified by reference to, the Company's consolidated financial statements, which have been audited by independent accountants, whose reports thereon are included elsewhere in this Report. The selected consolidated financial data presented below as of December 31, 2000, 1999, 1998, and for the two years ended December 31, 1999 and 1998 have been derived from, and are qualified by reference to, the Company's audited financial statements, which are not included in this Report. The selected consolidated financial data set forth below should be read in conjunction with, and are qualified by reference to, the Consolidated Financial Statements of the Company and Notes thereto, "Management's Discussion and Analysis of Financial Condition and Results of Operations" included elsewhere in this Report, and other financial data appearing elsewhere herein.

SELECTED CONSOLIDATED FINANCIAL DATA, (in thousands, except per share amounts).

| Years Ended December 31, | | | | |
|--------------------------|------|------|------|---------|
| 2002 | 2001 | 2000 | 1999 | 1998(2) |
| | | | | |

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Years Ended December 31,

| Operations: | | | | | |
|---|----------|----------|----------|----------|----------|
| Revenue | \$ 8,467 | \$ 7,968 | \$ 8,982 | \$ 8,921 | \$ 8,870 |
| (Loss) income before provision (benefit) for income taxes | (1,067) | (3,314) | (2,894) | (3,052) | 3,609 |
| Net (loss) income | (1,022) | (3,481) | (3,139) | (4,042) | 2,834 |
| Net (loss) income per share(1) | | | | | |
| Basic | (0.12) | (0.43) | (0.41) | (0.56) | 0.42 |
| Diluted | (0.12) | (0.43) | (0.41) | (0.56) | 0.38 |
| Financial Position: | | | | | |
| Cash and cash equivalents | 4,828 | 5,716 | 7,149 | 9,037 | 14,252 |
| Working capital | 3,718 | 4,688 | 7,371 | 9,668 | 12,638 |
| Total assets | 7,964 | 8,839 | 12,107 | 14,603 | 20,711 |
| Long-term obligations | | | | | 27 |
| Stockholders' equity | 6,000 | 6,996 | 10,049 | 12,742 | 16,275 |

The consolidated financial statements for fiscal years 1998 through 2001 were audited by Arthur Andersen LLP, which has ceased operations. A copy of the report previously issued by Arthur Andersen on the Company's financial statements as of December 31, 2001, and December 31, 2000, and for each of the three years in the period ended December 31, 2001, is included elsewhere in this document. Such report has not been reissued by Arthur Andersen.

(1) Calculated on the basis described in Note 2 of Notes to the Consolidated Financial Statements.

(2) In August 1998, the Company sold substantially all of the assets relating to its MediaBank and InterSep OPI product lines for approximately \$11,430 in cash and recorded a gain on sale of assets of approximately \$10,317. The Company also recorded severance and other non-recurring compensation charges totaling \$2,647.

PART II, ITEM 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

CRITICAL ACCOUNTING POLICIES

The Company has identified the policies below as critical to its business operations and the understanding of its results of operations. The impact and any associated risks related to these policies on our business operations is discussed throughout Management's Discussion and Analysis of Financial Condition and Results of Operations where such policies affect the Company's reported and expected financial results. Note that the Company's preparation of this Annual Report on Form 10-K requires it to make estimates and assumptions that affect the reported amount of assets and liabilities, disclosure of contingent assets and liabilities at the date of our financial statements, and the reported amounts of revenue and expenses during the reporting period. There can be no assurance that actual results will not differ from those estimates.

Revenue Recognition

The Company derives revenues from the sale of its software products, professional consulting, and support and maintenance services. License revenue is recognized when persuasive evidence of an agreement exists, the product has been delivered or services have been provided, the fee is fixed or determinable, and collection of the fee is probable. From time to time the Company will enter into extended payment programs with creditworthy customers. Revenue related to extended payment programs is recognized when payment becomes due to the Company. In making its decision to recognize revenue the Company must make a determination of the credit worthiness of its customer. This determination involves management judgment and while management believes that it can make reliable judgments, there is no guarantee that the revenue recognized will be collected. The credit worthiness of customers is further analyzed in connection with the Company's accounts receivable.

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The Company recognizes revenue under multiple-element arrangements using the residual method when vendor-specific objective evidence ("VSOE") of fair value exists for all of the undelivered elements under the arrangement. The Company has established sufficient VSOE for the value of its consulting, training, and other services, based on the price charged when these elements are sold separately. Accordingly, software license revenues are recognized under the residual method in arrangements in which software is licensed with consulting, training or other services. The Company's products and the industries in which they compete are not static and the determination of VSOE involves judgment. Management believes that it will continue to be able to use the residual method for recognizing license revenue under multiple-element arrangements. If the Company was unable to use the residual method, it could affect the timing of revenue recognition and thus the trends that the Company is currently experiencing.

Professional services include custom design and development and training. The Company recognizes professional services revenue under software development contracts as services are provided for per diem contracts or by using the percentage-of-completion method of accounting for long-term fixed price contracts. Provisions for any estimated losses on contracts in progress are made in the period in which such losses become probable. The Company had no long-term contracts in progress as of December 31, 2002.

Revenue from end user product sales is recognized upon delivery of the software, net of estimated returns and allowances, and if collection is probable. The Company estimates returns and allowances based on historical rates and has reduced revenue recognized for estimated future returns at the time the related revenue is recorded. The estimates for returns are adjusted periodically based upon historical rates of return. While management believes that it can make reliable estimates, it is possible that these estimates will change in the future or that actual amounts could vary materially from our estimates.

The Company generally warrants that its products will function substantially in accordance with documentation provided to customers for approximately 90 days following initial delivery. As of December 31, 2002, the Company had not incurred any expense related to warranty claims. The Company estimates reserves based on historical rates and accordingly has not recorded a warranty reserve. While management believes that it can make reliable estimates, it is possible that these estimates will change in the future or that actual amounts could vary materially from our estimates.

Please refer to Note 1 of the Company's Notes to Consolidated Financial Statements for further information on its revenue recognition policies.

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Impairment of Long-Lived Assets

In accordance with the Statement of Financial Accounting Standards ("SFAS") No. 142, *Goodwill and Other Intangible Assets*, the Company is required to perform an initial impairment review of its goodwill in 2002 and an annual impairment review thereafter. The Company tested recorded goodwill attributable to each reporting unit for impairment. Management conducted impairment testing as of January 1, 2002 and as of December 31, 2002 and determined that the fair value of its reporting units were greater than the carrying values for those units. Though none of the unamortized goodwill was impaired as of the initial impairment test, there can be no assurance that when a future review is completed a material impairment charge will not be recorded. SFAS No. 142 required certain disclosures upon adoption that the Company has included in Note 1(j) in the Notes to the Consolidated Financial Statements included herewith.

Accounts receivable

The Company performs ongoing credit evaluations of its customers and adjusts credit limits based upon payment history and the customer's current credit worthiness, as determined by the Company's review of their current credit information. The Company continuously monitors collections and payments from customers and maintains a provision for estimated credit losses based on its historical experience and any specific customer collection issues that the Company has identified. While such credit losses have historically been within the Company's expectations and appropriate reserves have been established, the Company cannot guarantee that it will continue to experience the same credit loss rates that it has experienced in the past.

Income taxes

As part of the process of preparing consolidated financial statements the Company is required to estimate its income taxes in each of the jurisdictions in which it operates. This process involves estimating actual current tax exposure together with assessing temporary differences resulting from differing treatment of items, such as deferred revenue, for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are included within its consolidated balance sheet. The Company must then assess the likelihood that its deferred tax assets will be recovered from future taxable income and to the extent the Company believes that recovery is not likely, it must establish a

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valuation allowance. To the extent the Company establishes a valuation allowance or increases this allowance in a period, it must include an expense within the tax provision in the statement of operations. Significant management judgment is required in determining the Company's provision for income taxes, the Company's deferred tax assets and liabilities and any valuation allowance recorded against the Company's net deferred tax assets. The Company has fully reserved against its tax asset. The valuation allowance is due to uncertainties related to the Company's ability to utilize its deferred tax assets, primarily consisting of certain net operating losses carried forward and foreign tax credits, before they expire. The valuation allowance is based on the Company's estimates of taxable income by jurisdiction in which the Company operates and the period over which its deferred tax assets will be recoverable. The determination of the valuation allowance requires the Company to make estimates, which the Company cannot guarantee will prove to be accurate.

OVERVIEW

Bitstream Inc. ("Bitstream" or the "Company"), headquartered in Cambridge, Massachusetts, is composed of three separate and distinct businesses: (1) Type, in which Bitstream develops and licenses its ThunderHawk browser, which has been designed specifically for browsing on handheld devices using the Company's font technology, to end users and wireless carriers, and its font technology, fonts, and custom font designs to manufacturers of information appliances, wireless devices, set-top boxes, embedded systems, printers, and personal digital assistants; (2) MyFonts.com, a showcase of the world's fonts in one easy-to-use e-commerce Web site operated by Bitstream's wholly-owned subsidiary, MyFonts.com, Inc. ("MyFonts"); and (3) Pageflex, in which the Company's wholly-owned subsidiary Pageflex, Inc. ("Pageflex") develops, markets and supports personal and enterprise server-based composition software for customizing template-based designs from Web forms or Pageflex's. EDIT interactive WYSIWYG browser-based Webtop publishing software or databases.

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FORWARD LOOKING STATEMENTS

Except for the historical information contained herein, this Annual Report on Form 10-K may contain 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. Investors are cautioned that forward-looking statements are inherently uncertain. Actual performance and results of operations may differ materially from those projected or suggested in the forward-looking statements due to certain risks and uncertainties, including, without limitation, market acceptance of the Company's products, competition and the timely introduction of new products. Additional information concerning certain risks and uncertainties that would cause actual results to differ materially from those projected or suggested in the forward-looking statements is contained in the Company's filings with the Securities and Exchange Commission, including those risks and uncertainties discussed in the Company's final Prospectus, dated October 30, 1996, included as part of the Company's Registration Statement on Form S-1 (333-11519), in the section entitled "Risk Factors." The forward-looking statements contained herein represent the Company's judgment as of the date of this report, and the Company cautions readers not to place undue reliance on such statements. Management undertakes no obligation to publicly release any revisions to the forward-looking statements or reflect events or circumstances after the date of this document.

RESULTS OF OPERATIONS

Certain prior year account balances have been reclassified to be consistent with the current year's presentation. The following table sets forth the percentage of revenue represented by certain items reflected in the Company's Statements of Operations Data for the periods presented:

| | Years Ended December 31, | | |
|------------------------|--------------------------|-------|-------|
| | 2002 | 2001 | 2000 |
| Revenue | | | |
| Software licenses | 87.6% | 86.1% | 81.7% |
| Services | 12.4 | 13.9 | 18.3 |
| Total revenue | 100.0 | 100.0 | 100.0 |
| Cost of revenue | | | |
| Software licenses | 19.9 | 13.4 | 8.1 |
| Services | 4.4 | 4.5 | 7.4 |

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| | Years Ended December 31, | | |
|---|--------------------------|-------------|-------------|
| | 2002 | 2001 | 2000 |
| Total cost of revenue | 24.3 | 17.9 | 15.5 |
| Gross profit | 75.7 | 82.1 | 84.5 |
| Operating expenses: | | | |
| Marketing and selling | 26.3 | 36.8 | 41.0 |
| Research and development | 47.5 | 63.3 | 53.7 |
| General and administrative | 17.1 | 23.3 | 27.0 |
| Total operating expenses | 90.9 | 123.4 | 121.7 |
| Operating (loss) income | (15.2) | (41.3) | (37.2) |
| Other income (expense), net | 2.6 | (0.3) | 5.0 |
| Benefit from (Provision for) income taxes | 0.5 | (2.1) | (2.7) |
| Net (loss) income | (12.1)% | (43.7)% | (34.9)% |

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YEAR ENDED DECEMBER 31, 2002 COMPARED TO THE YEAR ENDED DECEMBER 31, 2001
(in thousands except percent amounts)

Consolidated Gross Profit:

| | DECEMBER 31, | | | | | |
|------------------------|-----------------|--------------|-----------------|--------------|-----------------|---------------|
| | 2002 | | 2001 | | Change | |
| | Dollars | % of Revenue | Dollars | % of Revenue | Dollars | Percent |
| Revenue | | | | | | |
| Software licenses | \$ 7,415 | 87.6% | \$ 6,859 | 86.1% | \$ 556 | 8.1% |
| Services | 1,052 | 12.4 | 1,109 | 13.9 | (57) | (5.1) |
| Total revenue | 8,467 | 100.0 | 7,968 | 100.0 | 499 | 6.3 |
| Cost of Revenue | | | | | | |
| Software licenses | 1,682 | 22.7 | 1,071 | 15.6 | 611 | 57.1 |
| Services | 372 | 35.4 | 356 | 32.1 | 16 | 4.5 |
| Total cost of revenue | 2,054 | 24.3 | 1,427 | 17.9 | 627 | 43.9 |
| Gross Profit | \$ 6,413 | 75.7% | \$ 6,541 | 82.1% | \$ (128) | (2.0)% |

The increase in revenue for the year ended December 31, 2002 as compared to the year ended December 31, 2001 was attributable to an increase in revenue in the Company's MyFonts and Pageflex segments of \$868 and \$378, respectively, partially offset by a decrease in Type segment revenue of \$747. The increase in cost of revenue for the same periods was due to increased royalty expense for the Company's MyFonts segment resulting from increased sales. Cost of revenue for the Company includes royalties and fees paid to third parties for the development or

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license of rights to technology and/or unique typeface designs, costs incurred in the fulfillment of custom orders, and costs associated with the duplication, packaging and shipping of product. Gross profit generated by each segment is discussed in more detail below.

Type Gross Profit:

| | DECEMBER 31, | | | | | |
|------------------------------|-----------------|----------------------|-----------------|----------------------|-----------------|----------------|
| | 2002 | % of Segment Revenue | 2001 | % of Segment Revenue | Change | |
| | | | | | Dollars | Percent |
| Revenue | | | | | | |
| Software licenses | \$ 4,249 | 92.4% | \$ 4,886 | 91.4% | \$ (637) | (13.0)% |
| Services | 352 | 7.6 | 462 | 8.6 | (110) | (23.8) |
| Total revenue | 4,601 | 100.0 | 5,348 | 100.0 | (747) | (14.0) |
| Percentage of total revenue | 54.3% | | 67.1% | | | |
| Cost of Revenue | | | | | | |
| Software licenses | 477 | 11.2 | 516 | 10.6 | (39) | (7.6) |
| Services | 150 | 42.6 | 204 | 44.2 | (54) | (26.5) |
| Total cost of revenue | 627 | 13.6 | 720 | 13.5 | (93) | (12.9) |
| Gross Profit | \$ 3,974 | 86.4% | \$ 4,628 | 86.5% | \$ (654) | (14.1)% |

The decrease in revenue for the year ended December 31, 2002 as compared to the year ended December 31, 2001 was primarily the result of a decrease in OEM license revenue of \$619, a decrease in retail product sales of \$17 and a decrease in revenue from custom design services of \$110. Retail sales of the Company's Type products and custom design work have decreased during the past year because of consumer concerns about the economy and decreases in spending, on development efforts by high-technology customers. Cost of revenue for the same periods has decreased primarily because of the decrease in revenue.

MyFonts Gross Profit:

| | DECEMBER 31, | | | | | |
|-----------------------------|--------------|----------------------|------------|----------------------|------------|--------------|
| | 2002 | % of Segment Revenue | 2001 | % of Segment Revenue | Change | |
| | | | | | Dollars | Percent |
| Revenue | | | | | | |
| Software licenses | \$ 1,378 | 100.0% | \$ 510 | 100.0% | \$ 868 | 170.2% |
| Total revenue | 1,378 | 100.0 | 510 | 100.0 | 868 | 170.2 |
| Percentage of total revenue | 16.3% | | 6.4% | | | |
| Cost of Revenue | | | | | | |

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| DECEMBER 31, | | | | | | |
|------------------------------|---------------|--------------|---------------|--------------|---------------|---------------|
| Software licenses | 1,121 | 81.4 | 395 | 77.5 | 726 | 183.8 |
| Total cost of revenue | 1,121 | 81.4 | 395 | 77.5 | 726 | 183.8 |
| Gross Profit | \$ 257 | 18.6% | \$ 115 | 22.5% | \$ 142 | 123.5% |

MyFonts has been successfully increasing the number of fonts available on its site and the number of foundries participating. In August 2002, MyFonts enhanced its Web site making it easier for customers to navigate within the site and find the fonts in which they are interested. Myfonts has attracted new purchasers while also retaining existing customers. Existing customers accounted for approximately 25% to 30% of orders during 2002. Inter-company sales, which MyFonts generated from the resale of Bitstream fonts, have been excluded. Cost of revenue increased primarily due to an increase in sales of fonts from non-affiliated foundries, increased referrer fees and expenses associated with the implementation of selling products that must be physically shipped on the Company's Web site. Royalties payable to non-affiliated foundries on sales of their fonts are approximately 80% of the revenue generated.

Pageflex Gross Profit:

| DECEMBER 31, | | | | | | |
|------------------------------|-----------------|----------------------|-----------------|----------------------|---------------|--------------|
| | 2002 | % of Segment Revenue | 2001 | % of Segment Revenue | Change | |
| | | | | | Dollars | Percent |
| Revenue | | | | | | |
| Software licenses | \$ 1,788 | 71.9% | \$ 1,463 | 69.3% | \$ 325 | 22.2% |
| Services | 700 | 28.1 | 647 | 30.7 | 53 | 8.2 |
| Total revenue | 2,488 | 100.0 | 2,110 | 100.0 | 378 | 17.9 |
| Percentage of total revenue | 29.4% | | 26.5% | | | |
| Cost of Revenue | | | | | | |
| Software licenses | 84 | 4.7 | 160 | 10.9 | (76) | (47.5) |
| Services | 222 | 31.7 | 152 | 23.5 | 70 | 46.1 |
| Total cost of revenue | 306 | 12.3 | 312 | 14.8 | (6) | (1.9) |
| Gross Profit | \$ 2,182 | 87.7% | \$ 1,798 | 85.2% | \$ 384 | 21.4% |

The increase in Pageflex revenue for the year ended December 31, 2002 as compared to the year ended December 31, 2001 was due to increases in direct and reseller license sales and services of \$390 and \$199, respectively, partially offset by decreases in OEM related sales and services of \$65 and \$146, respectively. Since late in 2001 Pageflex has focused on product sales and services rather than OEM sales and related non-recurring development revenue. The decrease in cost of revenue for the year ended December 31, 2002 as compared to the year ended December 31, 2001 was primarily attributable to a decrease in direct costs of \$85 partially offset by increased payroll costs resulting from the reassignment of two employees to provide support and infrastructure to the Company's increased customer base during the first quarter of 2002.

Marketing and Selling:

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DECEMBER 31,

| | 2002 | | 2001 | | Change | |
|---------------------------------------|----------|----------------------|----------|----------------------|----------|---------|
| | Dollars | % of Segment Revenue | Dollars | % of Segment Revenue | Dollars | Percent |
| Type | \$ 1,218 | 26.5% | \$ 1,507 | 28.2% | \$ (289) | (19.2)% |
| MyFonts | 39 | 2.8 | 64 | 12.5 | (25) | (39.1) |
| Pageflex | 972 | 39.1 | 1,356 | 64.3 | (384) | (28.3) |
| Consolidated marketing And selling | \$ 2,229 | 26.3% | \$ 2,927 | 36.8% | \$ (698) | (23.8)% |

The decrease in marketing and selling expenses for the year ended December 31, 2002 as compared to the year ended December 31, 2001 reflects expense reductions implemented by management in the fourth quarter of 2001. Type marketing and selling expenses decreased primarily due to a decrease in trade show expenses of \$45, a decrease in miscellaneous advertising and printing costs of \$20, and a decrease in employee-related costs of \$167, combined with a currency exchange gain from the sales office in the UK of \$48. Pageflex marketing and selling expenses decreased primarily due to decreases in employee head-count related expenses, outside consulting expenses, and trade show expenses of \$272, \$34 and \$44, respectively. Myfonts marketing and selling expenses decreased primarily due to a decrease in print advertising expenses of \$25 for the year ended December 31, 2002 as compared to the year ended December 31, 2001.

Research and Development ("R&D"):

DECEMBER 31,

| | 2002 | | 2001 | | Change | |
|--|----------|----------------------|----------|----------------------|------------|---------|
| | Dollars | % of Segment Revenue | Dollars | % of Segment Revenue | Dollars | Percent |
| Type | \$ 1,868 | 40.6% | \$ 1,776 | 33.2% | \$ 92 | 5.2% |
| MyFonts | 503 | 36.5 | 706 | 138.4 | (203) | (28.8) |
| Pageflex | 1,657 | 66.6 | 2,562 | 121.4 | (905) | (35.3) |
| Consolidated research and development | \$ 4,028 | 47.5% | \$ 5,044 | 63.3% | \$ (1,016) | (20.1)% |

The decrease in R&D expenses for the year ended December 31, 2002 as compared to the year ended December 31, 2001 is primarily attributable to cost reductions adopted during the fourth quarter of 2001. This decrease was partially offset by an increase Type R&D expense, which was primarily due to an increase in internally allocated resources and outside consulting fees for product development, relating to the Company's new ThunderHawk wireless browser, of \$160, and increased facility charges of \$92. This increase was partially offset by a decrease in goodwill amortization associated with the acquisition of Type Solutions, Inc. of \$119, resulting from the Company's adoption of SFAS No. 142 effective January 1, 2002. See Note 1(j) in the Notes to the Consolidated Financial Statements included herewith. The decrease in MyFonts R&D expense for the year ended December 31, 2002 as compared to the year ended December 31, 2001 was primarily the result of the decreased use of outside consultants and the absorption of that work by Company employees which resulted in savings of approximately \$257 partially offset by increased facility-related charges of \$27 over the same period. The decrease in Pageflex R&D expense over the same periods was primarily attributable to employee headcount reductions, which resulted in savings of \$531. The Pageflex segment reassigned two employees to customer support positions, which are included in cost of revenue, and decreased R&D expense over the same periods by \$106. Pageflex also decreased the outsourcing of engineering projects, which resulted in savings of \$122 for the year ended December 31, 2002 as compared to the year ended December 31, 2001.

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General and Administrative ("G&A"):

| | DECEMBER 31, | | | | | |
|---|--------------|----------------------|----------|----------------------|----------|---------|
| | 2002 | % of Segment Revenue | 2001 | % of Segment Revenue | Change | |
| | | | | | Dollars | Percent |
| Type | \$ 839 | 18.2% | \$ 980 | 18.3% | \$ (141) | (14.4)% |
| MyFonts | 90 | 6.5 | 69 | 13.5 | 21 | 30.4 |
| Pageflex | 517 | 20.8 | 808 | 38.3 | (291) | (36.0) |
| Consolidated general and administrative | \$ 1,446 | 17.1% | \$ 1,857 | 23.3% | \$ (411) | (22.1)% |

The decrease in G&A expenses for the year ended December 31, 2002 as compared to the year ended December 31, 2001 is primarily attributable to cost reductions adopted during the fourth quarter of 2001. These reductions resulted in decreases in Type G&A expenses of \$75 in salaries, and \$84 in outside professional services. Type G&A expenses for the year ended December 31, 2002 as compared to the year ended December 31, 2001 also decreased due to a \$118 change in an estimate associated with the Company's sale of two product lines to Inso Corporation in August 1998, and \$90 in goodwill amortization related to the acquisition of Mainstream Software Solutions, Ltd., which was fully amortized as of December 31, 2001. These decreases were partially offset by increases in facility costs of \$39, commercial insurance costs of \$52, and a decrease in the amount of administrative expense allocated to Pageflex of \$109. MyFonts G&A expense increased because of increased internally- allocated expenses from the Company's Type segment. Pageflex G&A expenses decreased for the year ended December 31, 2002 as compared to the year ended December 31, 2001 reflecting decreased employee insurance costs of \$137, and administrative expense allocations of \$109 attributable to the headcount reduction completed as part of the Company's restructuring in the fourth quarter of 2001. Pageflex also benefited from decreased goodwill amortization in connection with the Alaras acquisition of \$260 over the same periods resulting from the Company's adoption of SFAS No. 142 effective January 1, 2002. These Pageflex decreases were partially offset by a net recovery of bad debts for the year ended December 31, 2001 of \$(229), which decreased G&A expense for that year.

Gain (loss) on Investment in DiamondSoft, Inc.:

| | DECEMBER 31, | | | | | |
|--|--------------|--------------|----------|--------------|---------|---------|
| | 2002 | % of Revenue | 2001 | % of Revenue | Change | |
| | | | | | Dollars | Percent |
| Gain (loss) on investment in DiamondSoft, Inc. | \$ 149 | 1.8% | \$ (260) | 3.3% | \$ 409 | 157.3% |

In March 1998 the Company made a \$500 equity investment in DiamondSoft, Inc. ("DiamondSoft") representing a 25% ownership interest. During the year ended December 31, 2001, the Company made additional investments totaling \$410 in DiamondSoft, resulting in an increase in Bitstream's ownership percentage to 31.7% at December 31, 2001 and 2002. The gain (loss) above represents the Company's pro rata share of DiamondSoft's net income (loss). Further discussion can be found in Note 3 in the Notes to the Consolidated Financial Statements included herewith.

Interest income, net:

| | DECEMBER 31, | | | | | |
|----------------------|--------------|--------------|--------|--------------|----------|---------|
| | 2002 | % of Revenue | 2001 | % of Revenue | Change | |
| | | | | | Dollars | Percent |
| Interest income, net | \$ 74 | .9% | \$ 233 | 2.9% | \$ (159) | (68.2)% |

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DECEMBER 31,

Interest income consists primarily of income earned on cash and money market instruments and has decreased as the Company has used cash to fund operations and also as interest rates have decreased.

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Provision for income taxes:

DECEMBER 31,

| | 2002 | % of Revenue | 2001 | % of Revenue | Change | |
|--------------------------------|---------|--------------|--------|--------------|----------|----------|
| | | | | | Dollars | Percent |
| Income tax (benefit) provision | \$ (45) | (0.5)% | \$ 167 | 2.1% | \$ (212) | (126.9)% |

The Company's tax benefit for the year ended December 31, 2002 resulted from US federal and state refunds of \$141 from prior years taxes paid. This benefit was partially offset by foreign taxes totaling \$96. The Company's tax provision for the year ended December 31, 2001 consisted primarily of foreign taxes totaling \$154. Foreign taxes vary with Type OEM license royalties from customers in countries who have signed tax conventions with the United States including Japan, Korea, and Poland, and also with the results of operations from the Company's location in the United Kingdom.

YEAR ENDED DECEMBER 31, 2001 COMPARED TO THE YEAR ENDED DECEMBER 31, 2000
(in thousands except percent amounts)

Consolidated Gross Profit:

DECEMBER 31,

| | 2001 | % of Revenue | 2000 | % of Revenue | Change | |
|------------------------|----------|--------------|----------|--------------|------------|---------|
| | | | | | Dollars | Percent |
| Revenue | | | | | | |
| Software licenses | \$ 6,859 | 86.1% | \$ 7,341 | 81.7% | \$ (482) | (6.6)% |
| Services | 1,109 | 13.9 | 1,641 | 18.3 | (532) | (32.4) |
| Total revenue | 7,968 | 100.0 | 8,982 | 100.0 | (1,014) | (11.3) |
| Cost of Revenue | | | | | | |
| Software licenses | 1,071 | 15.6 | 730 | 9.9 | 341 | 46.7 |
| Services | 356 | 32.1 | 663 | 40.4 | (307) | (46.3) |
| Total cost of revenue | 1,427 | 17.9 | 1,393 | 15.5 | 34 | 2.4 |
| Gross Profit | \$ 6,541 | 82.1% | \$ 7,589 | 84.5% | \$ (1,048) | (13.8)% |

The decrease in revenue for the year ended December 31, 2001 as compared to the year ended December 31, 2000 was due to decreases of \$849 and \$625 for the Type and Pageflex business segments, respectively, partially offset by an increase of \$460 for the MyFonts business segment. The decrease in the gross profit for the year ended December 31, 2001 as compared to the year ended December 31, 2000 is primarily

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attributable to the decrease in revenue for those periods. Cost of revenue increased \$34 to \$1,427 for the year ended December 31, 2001 from \$1,393 for the year ended December 31, 2000. Cost of services decreased \$307 primarily because of the decrease in Pageflex's service related revenue, while cost of license fees increased \$341. The increase in cost of license fee revenue was primarily due to the increase in royalties paid by the Myfonts business segment for the year ended December 31, 2001. Myfonts typically pays a royalty to third party foundries of 80% of the revenue generated. This cost represents a higher percentage of revenue than that realized by the Type and Pageflex business segments resulting in a decrease in the gross margin percentage for the year ended December 31, 2001 as compared to the year ended December 31, 2000. These segments are discussed in detail below.

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Type Gross Profit:

| | DECEMBER 31, | | | | | |
|-----------------------------|--------------|----------------------|----------|----------------------|----------|---------|
| | 2001 | % of Segment Revenue | 2000 | % of Segment Revenue | Change | |
| | | | | | Dollars | Percent |
| Revenue | | | | | | |
| Software licenses | \$ 4,886 | 91.4% | \$ 5,820 | 93.9% | \$ (934) | (16.1)% |
| Services | 462 | 8.6 | 377 | 6.1 | 85 | 22.6 |
| Total revenue | 5,348 | 100.0 | 6,197 | 100.0 | (849) | (13.7) |
| Percentage of total revenue | 67.1% | | 69.0% | | | |
| Cost of Revenue | | | | | | |
| Software licenses | 516 | 10.6 | 627 | 10.8 | (111) | (17.7) |
| Services | 204 | 44.2 | 252 | 66.8 | (48) | (19.1) |
| Total cost of revenue | 720 | 13.5 | 879 | 14.2 | (159) | (18.1) |
| Gross Profit | \$ 4,628 | 86.5% | \$ 5,318 | 85.8% | \$ (690) | (13.0)% |

The decrease in Type revenue for the year ended December 31, 2001 versus the year ended December 31, 2000 was the result of a decrease in end user sales, including end user sales by Bitstream's resellers of approximately \$674, and a decrease in OEM revenue of approximately \$175. The decrease in retail revenue was primarily caused by decreases in corporate and consumer spending during 2001 because of concerns over the economy. These same concerns caused OEM customers to ship less units and postpone deployment of new technologies that included our Font Fusion product. Sales increased towards the end of the year and during the fourth quarter of 2001, the Company saw an increase in OEM license revenue of \$440 or 53.7% as compared to the fourth quarter of 2000. The decrease in cost of revenue and gross profit for the year ended December 31, 2001 as compared to the year ended December 31, 2000 is primarily attributable to the decrease in revenue for those periods.

MyFonts Gross Profit:

| | DECEMBER 31, | | | | | |
|-------------------|--------------|----------------------|-------|----------------------|---------|---------|
| | 2001 | % of Segment Revenue | 2000 | % of Segment Revenue | Change | |
| | | | | | Dollars | Percent |
| Revenue | | | | | | |
| Software licenses | \$ 510 | 100.0% | \$ 50 | 100.0% | \$ 460 | 920.0% |

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| DECEMBER 31, | | | | | | |
|-----------------------------|--------|-------|-------|-------|-------|--------|
| | | | | | | |
| Total revenue | 510 | 100.0 | 50 | 100.0 | 460 | 920.0 |
| Percentage of total revenue | 6.4% | | 0.6% | | | |
| Cost of Revenue | | | | | | |
| Software licenses | 395 | 77.5 | 34 | 68.0 | 361 | 1061.8 |
| Total cost of revenue | 395 | 77.5 | 34 | 68.0 | 361 | 1061.8 |
| Gross Profit | \$ 115 | 22.5% | \$ 16 | 32.0% | \$ 99 | 618.8% |

MyFonts began selling through its Web site at the end of the first quarter of 2000. The Company has excluded inter-company sales, which MyFonts generated from the resale of Bitstream fonts. Total MyFonts revenue including revenue from inter-company sales was \$702 and \$96 for the years ended December 31, 2001 and 2000, respectively. The increase in cost of license fee revenue was due to the \$361 increase in royalties paid by the Myfonts business segment for the year ended December 31, 2001. Myfonts typically pays a royalty to third party foundries of 80% of the revenue generated.

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Pageflex Gross Profit:

| DECEMBER 31, | | | | | | |
|-----------------------------|----------|----------------------|----------|----------------------|----------|---------|
| | | | | | Change | |
| | 2001 | % of Segment Revenue | 2000 | % of Segment Revenue | Dollars | Percent |
| Revenue | | | | | | |
| Software licenses | \$ 1,463 | 69.3% | \$ 1,471 | 53.8% | \$ (8) | (0.5)% |
| Services | 647 | 30.7 | 1,264 | 46.2 | (617) | (48.8) |
| Total revenue | 2,110 | 100.0 | 2,735 | 100.0 | (625) | (22.9) |
| Percentage of total revenue | 26.5% | | 30.4% | | | |
| Cost of Revenue | | | | | | |
| Software licenses | 160 | 10.9 | 69 | 4.7 | 91 | 131.9 |
| Services | 152 | 23.5 | 411 | 32.5 | (259) | (63.0) |
| Total cost of revenue | 312 | 14.8 | 480 | 17.6 | (168) | (35.0) |
| Gross Profit | \$ 1,798 | 85.2% | \$ 2,255 | 82.4% | \$ (457) | (20.3)% |

Pageflex revenue for the years ended December 31, 2001 and 2000 includes non-recurring engineering and license fees. Revenue for the year ended December 31, 2001, excluding these transactions, which are discussed below, increased \$565 or 39% from \$1,460 for the year ended December 31, 2000 to \$2,025 for the year ended December 31, 2001. This increase was primarily the result of sales of the Company's Mpower product and an increase in usage fees generated by an increased customer base for the Company's products. Including the non-recurring engineering and license fees revenue from services decreased \$617 or 48.8%. The non-recurring fees for year ended December 31, 2001 were

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\$85 in exclusivity fees related to the Company's NuDoc OEM relationship with Atex Media Solutions, Inc. ("Atex"). Included in Pageflex revenue for the year ended December 31, 2000 were non-recurring fees of \$435 in service revenue from a software development and licensing agreement with Xerox Corporation as well as license revenue of \$420 and service revenue of \$419 from Atex. The decrease in cost of revenue and gross profit for the year ended December 31, 2001 as compared to the year ended December 31, 2000 is primarily attributable to the decrease in revenue for those periods. Costs of software license revenue increased due to an increase in direct costs attributable to creating new designs, packaging and shipping for the Mpower and Persona products which were not incurred in connection with the large amount of OEM related revenue in prior years.

Marketing and Selling:

| | DECEMBER 31, | | | | | |
|------------------------------------|--------------|----------------------|----------|----------------------|----------|---------|
| | 2001 | % of Segment Revenue | 2000 | % of Segment Revenue | Change | |
| | | | | | Dollars | Percent |
| Type | \$ 1,507 | 28.2% | \$ 1,607 | 25.9% | \$ (100) | (6.2)% |
| MyFonts | 64 | 12.5 | 16 | 32.0 | 48 | 300.0 |
| Pageflex | 1,356 | 64.3 | 2,057 | 75.2 | (701) | (34.1) |
| Consolidated marketing and selling | \$ 2,927 | 36.8% | \$ 3,680 | 41.0% | \$ (753) | (20.5)% |

The decrease in marketing and selling expenses in absolute dollars and as a percentage of revenue for the year ended December 31, 2001 as compared to the year ended December 31, 2000 reflects expense reductions in the Pageflex and the Type business segments partially offset by an increase in marketing and selling expense for the Myfonts business segment. The decrease in Type marketing expenses was primarily due to reductions in advertising and commission expense. The decrease in Pageflex expenses included reductions in employee related salary, benefits and travel expenses of \$108, advertising and marketing expenses for tradeshows, product branding, and printing of \$348, and professional fees and marketing consultant fees of \$94.

Research and Development ("R&D"):

| | DECEMBER 31, | | | | | |
|---------------------------------------|--------------|----------------------|----------|----------------------|---------|---------|
| | 2001 | % of Segment Revenue | 2000 | % of Segment Revenue | Change | |
| | | | | | Dollars | Percent |
| Type | \$ 1,776 | 33.2% | \$ 1,754 | 28.3% | \$ 22 | 1.3% |
| MyFonts | 706 | 138.4 | 396 | 792.0 | 310 | 78.3 |
| Pageflex | 2,562 | 121.4 | 2,671 | 97.7 | (109) | (4.1) |
| Consolidated research and development | \$ 5,044 | 63.3% | \$ 4,821 | 53.7% | \$ 223 | 4.6% |

The increase in R&D expenses in absolute dollars and as a percentage of revenue for the year ended December 31, 2001 as compared to the year ended December 31, 2000 reflects increases in the Type and Myfonts business segments partially offset by expense reductions at the Pageflex business segment. The Type segment increase reflects reductions in engineering costs incurred on customer specific projects, which are charged to cost of revenue of \$103, partially offset by a decrease in the outsourcing of engineering projects of approximately \$80. The decrease in R&D expense for Pageflex was primarily due to further decreases in the outsourcing of engineering projects and the absorption of those

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projects by current staff. The increase in R&D expenses for the MyFonts segment is attributable to increases in internal engineering costs and the outsourcing of engineering costs for continued development of the MyFonts.com Web site.

General and Administrative ("G&A"):

| | DECEMBER 31, | | | | | |
|--|--------------|----------------------------|----------|----------------------------|----------|---------|
| | 2001 | % of Segment Revenue | 2000 | % of Segment Revenue | Change | |
| | | | | | Dollars | Percent |
| Type | \$ 980 | 18.3% | \$ 1,048 | 16.9% | \$ (68) | (6.5)% |
| MyFonts | 69 | 13.5 | 36 | 72.0 | 33 | 91.7 |
| Pageflex | 808 | 38.3 | 1,348 | 49.3 | (540) | (40.1) |
| Consolidated general and administrative | \$ 1,857 | 23.3% | \$ 2,432 | 27.0% | \$ (575) | (23.6)% |

The decrease in G&A expenses in dollars and as a percentage of revenues for the year ended December 31, 2001 versus the year ended December 31, 2000 is primarily due to decreases in bad debt reserves of \$809. Bad debt expense for the Type segment decreased \$320 from \$323 to \$3. Bad debt expense for the Pageflex segment decreased \$489 from \$260 for the year ended December 31, 2000 to a net recovery of \$(229) for the year ended December 31, 2001. The decrease in bad debt expense was partially offset by increases in professional service fees and facilities costs of \$154 and \$104, respectively.

A significant portion of the Company's operating expenses are fixed, and planned expenditures in any given quarter are based on sales and revenue forecasts. Accordingly, if products are not completed and/or shipped on schedule and revenues do not meet the Company's expectations in any given quarter, the Company's operating results and financial condition could be adversely affected.

Gain (loss) on Investment in DiamondSoft, Inc.:

| | DECEMBER 31, | | | | | |
|---|--------------|-----------------|---------|-----------------|----------|-----------|
| | 2001 | % of Revenue | 2000 | % of Revenue | Change | |
| | | | | | Dollars | Percent |
| Gain (loss) on investment in DiamondSoft, Inc. | \$ (260) | (3.3)% | \$ (13) | (0.1)% | \$ (247) | (1900.0)% |

In March 1998 the Company made a \$500 equity investment in DiamondSoft, Inc. ("DiamondSoft") representing a 25% ownership interest. During the year ended December 31, 2001 the Company made additional investments totaling \$410 in DiamondSoft, resulting in an increase in Bitstream's ownership percentage to 31.7% at December 31, 2001. DiamondSoft is a California corporation primarily engaged in

the business of developing, marketing and distributing software tools to a variety of professional markets. The Company's pro rata share of DiamondSoft's loss was \$(260) for the year ended December 31, 2001 versus \$(13) for the year ended December 31, 2000.

Interest income, net:

DECEMBER 31,

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| | DECEMBER 31, | | | | | |
|----------------------|--------------|--------------|--------|--------------|----------|---------|
| | 2001 | | 2000 | | Change | |
| | 2001 | % of Revenue | 2000 | % of Revenue | Dollars | Percent |
| Interest income, net | \$ 233 | 2.9% | \$ 463 | 5.2% | \$ (230) | (49.7)% |

Interest income consists primarily of income earned on cash and money market instruments and has decreased as the Company has used cash to fund operations and also as interest rates have decreased.

Provision for income taxes:

| | DECEMBER 31, | | | | | |
|--------------------|--------------|--------------|--------|--------------|---------|---------|
| | 2001 | | 2000 | | Change | |
| | 2001 | % of Revenue | 2000 | % of Revenue | Dollars | Percent |
| Income Tax Expense | \$ 167 | 2.1% | \$ 245 | 2.7% | \$ (78) | (31.8)% |

The Company recorded a tax provision of \$167 for the year ended December 31, 2001, which includes \$13 in various state minimum taxes and \$154 in foreign income taxes. The Company recorded a tax provision of \$245 for the year ended December 31, 2000, which included \$23 in various state minimum taxes and \$222 in foreign income taxes.

LIQUIDITY AND CAPITAL RESOURCES
(in thousands, except share amounts)

The Company has funded its operations primarily through the public sale of equity securities, cash flows from operations and cash received from the sale of the Company's MediaBank and InterSep OPI product lines to Inso Providence Corporation in August of 1998. As of December 31, 2002, the Company had net working capital of \$3,718 versus \$4,688 at December 31, 2001.

The Company used cash of approximately \$752 and \$1,063 to fund its operations during the years ended December 31, 2002 and 2001, respectively. The cash was used primarily to fund the Company's net losses. The net losses after adjustment for non-cash expenses resulted in the use of \$825 and \$2,294 in cash during the years ended December 31, 2002 and 2001, respectively. Changes in operating assets and liabilities resulted in cash savings of \$73 and \$1,231 for the years ended December 31, 2002 and 2001, respectively. During the year ended December 31, 2002, the change in operating assets and liabilities was primarily the result of an increase in accounts payable of \$152 and collections of accounts receivable which decreased the receivable balance by \$77, partially offset by an increase in income tax receivables of \$134. During the year ended December 31, 2001, the primary change in operating assets and liabilities was the collection of accounts receivable, which resulted in a \$1,364 decrease in outstanding accounts receivable.

The Company's investing activities used cash of \$189 and \$769 for the years ended December 31, 2002 and 2001, respectively. Additions of property and equipment and intangible assets used \$189 and \$359 in cash for the years ended December 31, 2002 and 2001, respectively. During the year ended December 31, 2001 the Company also increased its investment in DiamondSoft, Inc. by \$410.

The Company's financing activities provided cash of \$53 and \$399 for the years ended December 31, 2002 and 2001, respectively from the exercise of stock options.

The Company believes its current cash and cash equivalent balances will be sufficient to meet the Company's operating and capital requirements for at least the next 12 months. There can be no assurance, however, that the Company will not require additional financing in the future. If the Company were required to obtain additional financing in the future, there can be no assurance that sources of capital will be available on terms favorable to the Company, if at all.

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As of December 31, 2002, the Company had no material commitments for capital expenditures. From time to time, the Company evaluates potential acquisitions of products, businesses and technologies that may complement or expand the Company's business. Any such transactions consummated may use a portion of the Company's working capital or require the issuance of equity or debt. As of December 31, 2002, the Company had future minimum annual lease payments under the Company's leased facilities of \$301 for the year ended December 31, 2003.

NASDAQ LISTING REQUIREMENTS

At December 31, 2002 the Company's Common Stock traded on the Nasdaq National Market System. Effective February 28, 2003 the Company's Common Stock was transferred from the Nasdaq National Market to the Nasdaq Small Cap market. The application to transfer to the Nasdaq Small Cap Market was made in response to a notice from Nasdaq that the Company is not compliant with Nasdaq's new continuing listing requirement, which became effective November 1, 2002. Nasdaq changed its National Market System continued listing standard from a minimum \$4,000,000 net tangible asset requirement to a minimum \$10,000,000 stockholders' equity requirement. Bitstream did not comply with the \$10,000,000 stockholders equity requirement, as its stated equity as of December 31, 2002 was \$6,000,000. Upon consideration of the factors involved, the Company elected to transfer from the Nasdaq National Market. Bitstream's common stock will continue trading under its current symbol BITS.

RECENT ACCOUNTING PRONOUNCEMENTS

In June 2002, the FASB issued SFAS No. 143, *Accounting for Asset Retirement Obligations*. This Statement addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. This Statement applies to legal obligations associated with the retirement of long-lived assets that result from the acquisition, construction, development, or normal use of the asset. SFAS No. 143 is effective for fiscal years beginning after June 15, 2002. The Company does not expect SFAS No. 143 to have a material impact on its financial position or results of operations upon its adoption on January 1, 2003.

In June 2002, the FASB issued SFAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*, which supercedes EITF 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)*. The provisions of this Statement are required to be adopted for exit or disposal activities that are initiated after December 31, 2002. Under this standard, a liability for a cost associated with an exit or disposal activity formerly recognized upon the entity's commitment to an exit plan is now recognized when the liability is incurred. The Company does not expect SFAS No. 146 to have a material impact on its financial position or results of operations upon its adoption on January 1, 2003.

In November 2002, the FASB issued Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, including Indirect Guarantees of Indebtedness of Other* (FIN No.45). FIN No. 45 requires that a guarantor is required to recognize, at the inception of the guarantee, a liability for the fair value of the obligation undertaken by issuing the guarantee. The interpretation also requires additional disclosure to be made by a guarantor in its financial statements about its obligations under certain guarantees it has issued. The accounting requirements for the initial recognition of guarantees are applicable on a prospective basis for guarantees issued or modified after December 31, 2002. The disclosure requirements are effective for all guarantees outstanding, regardless of when they were issued or modified, for financial statement periods that end after December 15, 2002. The adoption of FIN 45 did not have a material effect on the Company's consolidated financial statements.

In December 2002, the FASB issued SFAS No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure an amendment of FAS 123*. This Statement amends SFAS No. 123, *Accounting for Stock-Based Compensation*, to provide alternative methods of transition for an entity that voluntarily changes to the fair value based method of accounting for stock-based employee compensation. It also amends the disclosure provisions of SFAS No. 123 to require prominent disclosure about the effects on reported net income of an entity's accounting policy decisions with respect to stock-based employee compensation. This Statement also amends Accounting Principles Board Opinion No. 28, *Interim Financial Reporting* ("APB No. 28"), to require disclosure about those effects in interim financial statements. The amendments to SFAS No. 123 are generally effective for financial statements for fiscal years ending after December 15, 2002. The amendment to APB No. 28 is effective for financial reports containing condensed financial statements for

interim periods beginning after December 15, 2002. The Company's adoption of SFAS No. 148 has not had, and is not expected to have, a significant effect on its financial position or its results of operations.

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In January 2003, the FASB issued FIN No. 46, *Consolidation of Variable Interest Entities, an Interpretation of ARB 51*. The primary objectives of FIN No. 46 are to provide guidance on the identification of entities for which control is achieved through means other than through voting rights ("variable interest entities" or "VIEs") and how to determine when and which business enterprise should consolidate the VIE. This new model for consolidation applies to an entity for which either: (a) the equity investors (if any) do not have a controlling financial interest; or (b) the equity investment at risk is insufficient to finance that entity's activities without receiving additional subordinated financial support from other parties. In addition, FIN No. 46 requires that both the primary beneficiary and all other enterprises with a significant variable interest in a VIE make additional disclosures. The Company is required to apply FIN No. 46 to all new variable interest entities created or acquired after January 31, 2003. For variable interest entities created or acquired prior to February 1, 2003, the Company is required to apply FIN No. 46 on July 1, 2003. The Company does not expect FIN No. 46 will have a material effect on its financial position or its results of operations.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

DERIVATIVE FINANCIAL INSTRUMENTS, OTHER FINANCIAL INSTRUMENTS, AND DERIVATIVE COMMODITY INSTRUMENTS

As of December 31, 2002, the Company did not participate in any derivative financial instruments or other financial and commodity instruments for which fair value disclosure would be required under SFAS No. 107. All of the Company's investments are short-term, investment-grade commercial paper, and money market accounts that are carried on the Company's books at amortized cost, which approximates fair market value. Accordingly, the Company has no quantitative information concerning the market risk of participating in such investments.

PRIMARY MARKET RISK EXPOSURES

The Company's primary market risk exposures are in the areas of interest rate risk and foreign currency exchange rate risk. The Company's investment portfolio of cash equivalent and short-term investments is subject to interest rate fluctuations, but the Company believes this risk is immaterial due to the short-term nature of these investments. The Company's exposure to currency exchange rate fluctuations has been and is expected to continue to be modest due to the fact that the operations of its international subsidiaries are almost exclusively conducted in their respective local currencies. International subsidiary operating results are translated into U.S. dollars and consolidated for reporting purposes. The impact of currency exchange rate movements on inter-company transactions was immaterial for the year ended December 31, 2002. Currently, the Company does not engage in foreign currency hedging activities.

ITEM 8. Financial Statements and Supplementary Data

The index to Financial Statements appears on page F-1, the Independent Auditors' Reports appears on page F-2 to F-3, and the Financial Statements and Notes to Financial Statements appear on pages F-4 to F-27.

ITEM 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

In April 2002, we changed our independent accountants as reported in our Current Report on Form 8-K dated April 30, 2002.

Our consolidated financial statements for each of the two years ended December 31, 2001 and 2000, were audited by Arthur Andersen LLP, independent accountants. On August 31, 2002, Arthur Andersen ceased practicing before the SEC. Therefore, Arthur Andersen did not participate in the preparation of this Form 10-K, did not reissue its audit report with respect to the financial statements included in this Form 10-K, and did not consent to the inclusion of its audit report in this Form 10-K. As a result, holders of our securities may have no effective remedy against Arthur Andersen in connection with a material misstatement or omission in the financial statements to which its audit report relates. In addition, even if such holders were able to assert such a claim, because it has ceased operations, Arthur Andersen may fail or otherwise have insufficient assets to satisfy claims made by holders of our securities that might arise under federal securities laws or otherwise with respect to Arthur Andersen's audit report.

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Certain information required by Part III is omitted from this Report in that the Company will file a definitive Proxy Statement pursuant to Regulation 14A not later than 120 days after the end of the fiscal year covered by this Report and certain information included therein is incorporated herein by reference. Only those sections of the Company's definitive Proxy Statement for its Annual Meeting of Stockholders to be held on May 20, 2003 that specifically address the items set forth herein are incorporated by reference. Such incorporation does not include the Compensation Committee Report or the Performance Graph included in the Company's definitive Proxy Statement for its Annual Meeting of Stockholders to be held on May 20, 2003.

ITEM 10. Directors and Executive Officers of the Registrant

The information required by this Item concerning directors is incorporated by reference to the section entitled "Proposal No. 1 Election of Directors Nominees for Directors" in the Company's definitive Proxy Statement for its Annual Meeting of Stockholders to be held on May 20, 2003 and which will be filed with the Securities and Exchange Commission on or before April 30, 2003. The information concerning the executive officers of the Company required by this Item is contained in the "Executive Officers of the Registrant" section of Item 1 hereof and is incorporated by reference in this Part III.

There is incorporated herein by reference to the discussion under "Principal and Management Stockholders Section 16(a) Beneficial Ownership Reporting Compliance" in the Company's definitive Proxy Statement for its Annual Meeting of Stockholders to be held on May 20, 2003 the information with respect to any delinquent filings of reports pursuant to Section 16(a) of the Securities Exchange Act of 1934.

ITEM 11. Executive Compensation

Information required by this Item is incorporated herein by reference to the information appearing in the Company's definitive Proxy Statement for its Annual Meeting of Stockholders to be held on May 20, 2003 under the heading "Executive Compensation."

ITEM 12. Security Ownership of Certain Beneficial Owners and Management

Information required by this Item is incorporated herein by reference to the information appearing in the Company's definitive Proxy Statement for its Annual Meeting of Stockholders to be held on May 20, 2003 under the heading "Principal and Management Stockholders."

ITEM 13. Certain Relationships and Related Transactions

Information required by this Item, if any, is incorporated herein by reference to the information appearing in the Company's definitive Proxy Statement for its Annual Meeting of Stockholders to be held on May 20, 2003 under the heading "Certain Relationships and Related Transactions".

ITEM 14. Controls and Procedures

Based on the evaluation of the Company's disclosure controls and procedures as of a date within 90 days of the filing date of this quarterly report, each of Charles Ying, the Chief Executive Officer of the Company, Anna Chagnon, the Chief Financial Officer of the Company through March 2003, and James Dore, the Chief Financial Officer of the Company as of March 2003, have concluded that the Company's disclosure controls and procedures are effective in ensuring that information required to be disclosed by the Company in the reports that it files or submits under the Securities and Exchange Act of 1934, as amended, is recorded, processed, summarized and reported, within the time period specified by the Securities and Exchange Commission's rules and forms.

There were no significant changes in the Company's internal controls or in other factors that could significantly affect these controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

PART IV

ITEM 15. Exhibits, Financial Statement Schedules, and Reports on Form 8-K

1.

Financial Statements.

(a)

The following documents are included as part of this report:

(1)

Financial Statements

Reports of Independent Accountants
Consolidated Balance Sheets
Consolidated Statements of Operations
Consolidated Statements of Stockholders' Equity
Consolidated Statements of Cash Flows
Notes to Consolidated Financial Statements

(2)

Financial Statement Schedules
NONE

(3)

Exhibits.

Certain of the exhibits listed hereunder have been previously filed with the Commission as exhibits to certain registration statements and periodic reports as indicated in the footnotes below and are incorporated herein by reference pursuant to Rule 411 promulgated under the Securities Act and Rule 24 of the Commission's Rules of Practice. The location of each document so incorporated by reference is indicated in parenthesis.

3 Certificate of Incorporation and Bylaws

- 3.1.1 Restated Certificate of Incorporation of the Company (incorporated by reference to Exhibit 3.1 to the Company's Registration Statement on Form S-1, Registration No. 333-11519, filed on September 6, 1996).
- 3.1.2 Certificate of Amendment to Restated Certificate of Incorporation of the Company (incorporated by reference to Exhibit 3.1.2 to the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 1996).
- 3.2.1 Bylaws of the Company (incorporated by reference to Exhibit 3.2 to the Company's Registration Statement on Form S-1, Registration No. 333-11519, filed on September 6, 1996).
- 3.2.2 By-law Amendments adopted by the Board of Directors of the Company on November 6, 1998 (incorporated by reference to Exhibit 2 to the Company's current report on Form 8-K filed on November 16, 1998).

4 Instruments Defining the Rights of Security Holders

- 4.1 Specimen Common Stock Certificate (incorporated by reference to Exhibit 4.1 to the Company's Registration Statement on Form S-1, Registration No. 333-11519, filed on September 6, 1996).
- 4.2 Rights Agreement dated as of November 12, 1998 between the Company and BankBoston N.A., as Rights Agent, which includes: as Exhibit A thereto, the form of Certificate of Designation of Series A Junior Participating, Preferred Stock of the Company; as Exhibit B thereto, the Form of Right Certificate; and as Exhibit C thereto, the summary of Rights to Purchase Preferred Shares. (incorporated by reference to Exhibit 3 to the Company's Current Report on Form 8-K filed on November 16, 1998).

10 Material Contracts

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- 10.1 1996 Stock Plan (incorporated by reference to Exhibit 10.1 to the Company's Registration Statement on Form S-1, Registration No. 333-11519, filed on September 6, 1996).
- 10.2 1994 Stock Plan (incorporated by reference to Exhibit 10.2 to the Company's Registration Statement on Form S-1, Registration No. 333-11519, filed on September 6, 1996).

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- 10.3 Agreement and Plan of Recapitalization dated October 28, 1994 (incorporated by reference to Exhibit 10.3 to the Company's Registration Statement on Form S-1, Registration No. 333-11519, filed on September 6, 1996).
- 10.4 Lease between Athenaeum Group and the Company dated March 17, 1992 (incorporated by reference to Exhibit 10.4 to the Company's Registration Statement on Form S-1, Registration No. 333-11519, filed on September 6, 1996).
- 10.4.1 First Amendment to Lease between Athenaeum Group and the Company dated September 7, 1993 (incorporated by reference to Exhibit 10.4.1 to the Company's Registration Statement filed on Form S-1, Registration No. 333-11519, on September 6, 1996).
- 10.4.2 Second Amendment to Lease between Athenaeum Group and the Company dated July 13, 1994 (incorporated by reference to Exhibit 10.4.2 to the Company's Registration Statement on Form S-1, Registration No. 333-11519, filed on September 6, 1996).
- 10.4.3 Third Amendment to Lease between Athenaeum Group and the Company dated July 15, 1996 (incorporated by reference to Exhibit 10.4.3 to the Company's Registration Statement on Form S-1, Registration No. 333-11519, filed on September 6, 1996).
- 10.4.4 Fourth Amendment to Lease between Athenaeum Property LLC and the Company dated March 3, 1997 (incorporated by reference to Exhibit 10.4.4 to the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 1996).
- 10.4.5 Fifth Amendment to Lease between Athenaeum Property LLC and the Company dated April 15, 1997 (incorporated by reference to Exhibit 10.4.5 to the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 1997).
- 10.4.6 Sixth Amendment to Lease between Athenaeum Property LLC and the Company dated June 6, 1997 (incorporated by reference to Exhibit 10.4.6 to the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 1997).
- 10.4.7 Seventh Amendment to Lease between Athenaeum Property LLC and the Company dated October 1, 1998 (incorporated by reference to Exhibit 10.4.7 to the Company's Annual Report on Form 10-K for the year ended December 31, 1998).
- 10.5 Form of Indemnification Agreement between the Company, its directors and certain of its officers (incorporated by reference to Exhibit 10.9 to Pre-effective Amendment No. 1 to the Company's Registration Statement on Form S-1, Registration No. 333-11519, filed on October 15, 1996).
- 10.6 Agreement and Plan of Merger dated as of March 27, 1997 among the Company, Archetype Acquisition Corporation and Archetype, Inc. (incorporated by reference to Exhibit 10.10 to the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 1996).
- 10.7 1997 Stock Plan (incorporated by reference to Exhibit 10.11 to the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 1996).
- 10.8 Asset Purchase Agreement among the Company, Archetype, Inc., Inso Corporation and Inso Providence Corporation dated August 28, 1998 (incorporated by reference to Exhibit 99(a) to the Company's Form 8-K filed on September 14, 1998).

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- 10.9 Bitstream, Inc. 2000 Stock Plan (incorporated by reference to Exhibit 4.1 to the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2000).
- 10.10 Pageflex, Inc. 2000 Stock Plan (incorporated by reference to Exhibit 4.2 to the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2000).
- 10.11 MyFonts.com, Inc. 2000 Stock Plan (incorporated by reference to Exhibit 4.3 to the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2000).

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- 16.1 Letter from Arthur Andersen LLP to the Securities and Exchange Commission, dated June 25, 2002 (filed as Exhibit 16.1 to the Registrant's Current Report on Form 8-K filed on April 30, 2002) and incorporated in this document by reference.

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21 Subsidiaries of Registrant

- *21.1 Subsidiaries of the Registrant

23 Consents

- *23.1 Consent of PricewaterhouseCoopers LLP
- *23.2 Limitations of Remedies Against Arthur Andersen LLP (Reference is made to Item 9 of this Report).

99 Additional Exhibit

- *99.1 Certification Pursuant to 18 U.S.C. Section 1350 as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
-

*

Filed herewith.

(b)

REPORTS ON FORM 8-K

NONE

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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, in the City of Cambridge, Commonwealth of Massachusetts on this 26th day of March, 2003.

BITSTREAM INC.

By:

/s/ CHARLES YING

Charles Ying
Chief Executive Officer

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

| SIGNATURE | TITLE | DATE |
|---|---|----------------|
| <u>/s/ CHARLES YING</u> Charles Ying | Chairman of the Board, Director and Chief Executive Officer (Principal Executive Officer) | March 26, 2003 |
| <u>/s/ ANNA M. CHAGNON</u> Anna M. Chagnon | President, Chief Operating Officer, Treasurer and Secretary (Principal Financial Officer) | March 26, 2003 |
| <u>/s/ JAMES P. DORE</u> James P. Dore | Vice President, Chief Financial Officer and Controller (Principal Financial and Accounting Officer) | March 26, 2003 |
| <u>/s/ AMOS KAMINSKI</u> Amos Kaminski | Director | March 26, 2003 |
| <u>/s/ DAVID G. LUBRANO</u> David G. Lubrano | Director | March 26, 2003 |
| <u>/s/ GEORGE B. BEITZEL</u> George B. Beitzel | Director | March 26, 2003 |
| <u>/s/ MICHAEL LANG</u> Michael Lang | Director | March 26, 2003 |

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CERTIFICATION

I, Charles Ying, Chief Executive Officer of Bitstream Inc., certify that:

1. I have reviewed this annual report on Form 10-K of Bitstream Inc.;
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 are 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;

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4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:
- a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this 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 the registrant's Board of Directors:
- 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.

| SIGNATURE | TITLE | DATE |
|---------------------------|-------------------------|----------------|
| <hr/> /s/ CHARLES YING | Chief Executive Officer | March 26, 2003 |
| Charles Ying | | |

CERTIFICATION

I, Anna Chagnon, President and Chief Operating Officer of Bitstream Inc., certify that:

- 1.

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I have reviewed this annual report on Form 10-K of Bitstream Inc.;

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 are 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 we have:
 - a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this 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 the registrant's Board of Directors:
 - 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.

SIGNATURE

TITLE

DATE

/s/ ANNA M. CHAGNON

Anna M. Chagnon

President, Chief Operating Officer, and General Counsel

March 26, 2003

CERTIFICATION

I, James Dore, Chief Financial Officer of Bitstream Inc., certify that:

2. I have reviewed this annual report on Form 10-K of Bitstream Inc.;
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 are 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 we 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 the registrant's Board of Directors:
 - c) 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
 - d) 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.

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| SIGNATURE | TITLE | DATE |
|-------------------|-------------------------|----------------|
| /s/ JAMES P. DORE | Chief Financial Officer | March 26, 2003 |
| James P. Dore | 45 | |

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

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REPORT OF INDEPENDENT ACCOUNTANTS

To the Board of Directors and Stockholders,
Bitstream Inc.:

In our opinion, the accompanying consolidated balance sheet as of December 31, 2002 and the related consolidated statements of operations, of stockholders' equity and comprehensive net loss, and of cash flows present fairly, in all material respects, the financial position of Bitstream Inc. and its subsidiaries at December 31, 2002, and the results of their operations and their cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America. 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 audit. We conducted our audit of these statements in accordance with auditing standards generally accepted in the United States of America, which 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, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion. The consolidated financial statements of Bitstream Inc. as of December 31, 2001, and for each of the two years in the period ended December 31, 2001, prior to the revisions discussed in Note 1, were audited by other independent accountants who have ceased operations. Those independent accountants expressed an unqualified opinion on those financial statements in their report dated February 13, 2002.

As disclosed in Note 1 to the consolidated financial statements, the Company changed the manner in which it accounts for goodwill and other intangible assets upon adoption of Statement of Financial Accounting Standards No. 142, *Goodwill and other Intangible Assets* on January 1, 2002.

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As discussed above, the consolidated financial statements of Bitstream Inc. as of December 31, 2001, and for each of the two years in the period ended December 31, 2001, were audited by other independent accountants who have ceased operations. As described in Note 1, these financial statements have been revised to include the transitional disclosures required by Statement of Financial Accounting Standards No. 142, *Goodwill and Other intangible Assets*, which was adopted by the Company on January 1, 2002. We audited the transitional disclosures for 2001 and 2000 described in Note 1. In our opinion, the transitional disclosures for 2001 and 2000 in Note 1 are appropriate. However, we were not engaged to audit, review, or apply any procedures to the 2001 or 2000 consolidated financial statements of the Company other than with respect to such disclosures and, accordingly, we do not express an opinion or any other form of assurance on the 2001 and 2000 consolidated financial statements taken as a whole.

/s/ PricewaterhouseCoopers LLP

Boston, Massachusetts
February 18, 2003

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REPORT OF INDEPENDENT PUBLIC ACCOUNTANTS

THE FOLLOWING REPORT IS A COPY OF A REPORT PREVIOUSLY ISSUED BY ARTHUR ANDERSEN LLP AND HAS NOT BEEN REISSUED BY ARTHUR ANDERSEN LLP.

AS DISCUSSED IN NOTE 1, BITSTREAM INC. HAS REVISED ITS FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2001 AND 2000, TO INCLUDE THE TRANSITIONAL DISCLOSURES REQUIRED BY STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 142, *GOODWILL AND OTHER INTANGIBLE ASSETS*. THE REVISIONS TO THE 2001 AND 2000 FINANCIAL STATEMENTS RELATED TO THESE TRANSITIONAL DISCLOSURES WERE REPORTED ON BY PRICEWATERHOUSECOOPERS LLP, AS STATED IN THEIR REPORT APPEARING HEREIN.

To Bitstream Inc.:

We have audited the accompanying consolidated balance sheets of Bitstream Inc. (a Delaware corporation) and subsidiaries as of December 31, 2001 and 2000, and the related consolidated statements of operations, stockholders' equity and comprehensive net loss and cash flows for each of the three years in the period 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. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Bitstream Inc. and subsidiaries as of December 31, 2001 and 2000, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2001, in conformity with accounting principles generally accepted in the United States.

/s/ Arthur Andersen LLP

Boston, Massachusetts
February 13, 2002

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BITSTREAM INC. AND SUBSIDIARIES

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CONSOLIDATED BALANCE SHEETS

(IN THOUSANDS, EXCEPT PER-SHARE AMOUNTS)

| | December 31, | |
|--|-----------------|-----------------|
| | 2002 | 2001 |
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 4,828 | \$ 5,716 |
| Accounts receivable, net of allowance of \$15 and \$53 at December 31, 2002 and 2001, respectively | 602 | 679 |
| Income tax receivable | 134 | |
| Prepaid expenses and other current assets | 112 | 122 |
| Total current assets | 5,676 | 6,517 |
| Property and equipment, net | 271 | 473 |
| Other assets: | | |
| Restricted cash | 300 | 300 |
| Goodwill | 727 | 727 |
| Investment in DiamondSoft, Inc. | 748 | 599 |
| Intangible assets | 236 | 218 |
| Other assets | 6 | 5 |
| Total other assets | 2,017 | 1,849 |
| Total assets | \$ 7,964 | \$ 8,839 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Accounts payable | \$ 245 | \$ 93 |
| Accrued expenses | 1,046 | 1,126 |
| Current portion of deferred revenue | 667 | 610 |
| Total current liabilities | 1,958 | 1,829 |
| Long-term deferred revenue | 6 | 14 |
| Total liabilities | 1,964 | 1,843 |
| Commitments (Note 6) | | |
| Stockholders' equity: | | |
| Preferred stock, \$0.01 par value | | |
| Authorized 6,000 shares | | |
| Issued and outstanding 0 at December 31, 2002 and 2001, respectively | | |
| Common stock, \$0.01 par value | | |
| Authorized 30,500 shares | | |
| Issued and outstanding 8,475 and 8,428 at December 31, 2002 and 2001, respectively | 85 | 84 |

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| | December 31, | |
|--|-----------------|-----------------|
| | 2002 | 2001 |
| Additional paid-in capital | 32,408 | 32,383 |
| Accumulated deficit | (26,133) | (25,111) |
| Treasury stock, at cost; 126 shares as of December 31, 2002 and 2001 | (360) | (360) |
| Total stockholders' equity | 6,000 | 6,996 |
| Total liabilities and stockholders' equity | \$ 7,964 | \$ 8,839 |

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

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BITSTREAM INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
(IN THOUSANDS, EXCEPT PER-SHARE AMOUNTS)

| | Years Ended December 31, | | |
|--|--------------------------|----------------|----------------|
| | 2002 | 2001 | 2000 |
| Revenue: | | | |
| Software licenses | \$ 7,415 | \$ 6,859 | \$ 7,341 |
| Services | 1,052 | 1,109 | 1,641 |
| Total revenue | 8,467 | 7,968 | 8,982 |
| Cost of revenue: | | | |
| Software licenses | 1,682 | 1,071 | 730 |
| Services | 372 | 356 | 663 |
| Cost of revenue | 2,054 | 1,427 | 1,393 |
| Gross profit | 6,413 | 6,541 | 7,589 |
| Operating expenses: | | | |
| Marketing and selling | 2,229 | 2,927 | 3,680 |
| Research and development | 4,028 | 5,044 | 4,821 |
| General and administrative | 1,446 | 1,857 | 2,432 |
| Total operating expenses | 7,703 | 9,828 | 10,933 |
| Operating loss | (1,290) | (3,287) | (3,344) |
| Gain (Loss) on investment in DiamondSoft, Inc. | 149 | (260) | (13) |
| Interest income, net | 74 | 233 | 463 |

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| | Years Ended December 31, | | |
|---|--------------------------|------------|------------|
| | 1999 | 2000 | 2001 |
| Loss before provision for income taxes | (1,067) | (3,314) | (2,894) |
| (Benefit from) provision for income taxes | (45) | 167 | 245 |
| Net loss | \$ (1,022) | \$ (3,481) | \$ (3,139) |
| Basic and diluted net loss per share | \$ (0.12) | \$ (0.43) | \$ (0.41) |
| Basic and diluted weighted average shares outstanding | 8,326 | 8,069 | 7,738 |

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

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BITSTREAM INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY AND COMPREHENSIVE NET LOSS
(IN THOUSANDS)

| | Common Stock \$.01 Par Value | | | Accumulated Deficit | Treasury Stock | | Total Stockholders' Equity | Comprehensive Net Loss |
|---|---------------------------------|-------|----------------------------------|------------------------|------------------------|----------|----------------------------------|---------------------------|
| | Number of Shares | \$ | Additional Paid-in Capital | | Number of Shares | Cost | | |
| BALANCE, DECEMBER 31, 1999 | 7,550 | \$ 75 | \$ 31,218 | \$ (18,491) | 39 | \$ (60) | \$ 12,742 | |
| Exercise of stock options and warrants | 302 | 3 | 468 | | | | 471 | |
| Issuance of common stock | 51 | 1 | (1) | | | | | |
| Advance received for stock option exercise | | | 225 | | | | 225 | |
| Compensation expense related to options | | | 50 | | | | 50 | |
| Treasury stock acquired | | | | | 87 | (300) | (300) | |
| Net loss | | | | (3,139) | | | (3,139) | (3,139) |
| Comprehensive net loss for the year ended December 31, 2000 | | | | | | | | \$ (3,139) |
| BALANCE, DECEMBER 31, 2000 | 7,903 | \$ 79 | \$ 31,960 | \$ (21,630) | 126 | \$ (360) | \$ 10,049 | |
| Exercise of stock options and warrants | 525 | 5 | 394 | | | | 399 | |
| Compensation expense related to options | | | 29 | | | | 29 | |
| Net loss | | | | (3,481) | | | (3,481) | (3,481) |
| Comprehensive net loss for the year ended December 31, 2001 | | | | | | | | \$ (3,481) |

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| | Common Stock \$.01 Par Value | | | Treasury Stock | | | |
|---|---------------------------------|-------|-----------|----------------|-----|----------|------------|
| BALANCE, DECEMBER 31, 2001 | 8,428 | \$ 84 | \$ 32,383 | \$ (25,111) | 126 | \$ (360) | 6,996 |
| Exercise of stock options and warrants | 47 | 1 | 52 | | | | 53 |
| Compensation expense related to options | | | (27) | | | | (27) |
| Net loss | | | | (1,022) | | | (1,022) |
| Comprehensive net loss for the year ended December 31, 2002 | | | | | | | \$ (1,022) |
| BALANCE, DECEMBER 31, 2002 | 8,475 | \$ 85 | \$ 32,408 | \$ (26,133) | 126 | \$ (360) | 6,000 |

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

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BITSTREAM INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(IN THOUSANDS)

| | Years Ended December 31, | | |
|---|--------------------------|------------|------------|
| | 2002 | 2001 | 2000 |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | | |
| Net loss | \$ (1,022) | \$ (3,481) | \$ (3,139) |
| Adjustments to reconcile net loss to net cash used in operating activities: | | | |
| Depreciation | 301 | 373 | 449 |
| Amortization | 72 | 525 | 525 |
| Stock based compensation | (27) | 29 | 50 |
| (Gain) Loss on investment in DiamondSoft, Inc. | (149) | 260 | 13 |
| Changes in operating assets and liabilities: | | | |
| Accounts receivable | 77 | 1,364 | 148 |
| Income tax receivable | (134) | | |
| Prepaid expenses and other assets | 9 | 82 | 136 |
| Accounts payable | 152 | (168) | (90) |
| Accrued expenses | (80) | (161) | 161 |
| Deferred revenue | 49 | 114 | 153 |
| Net cash used in operating activities | (752) | (1,063) | (1,594) |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | | |
| Purchases of property and equipment, net | (99) | (210) | (322) |
| Additions to intangible assets | (90) | (149) | (41) |

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| | Years Ended December 31, | | |
|--|--------------------------|----------|----------|
| | | | |
| Restricted cash | | | (300) |
| Investment in DiamondSoft, Inc. | | (410) | |
| | | | |
| Net cash used in investing activities | (189) | (769) | (663) |
| | | | |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | | |
| Payments on long-term capital lease obligations | | | (27) |
| Purchase of treasury stock | | | (300) |
| Advance from shareholder for stock option exercise | | | 225 |
| Proceeds from exercise of stock options/warrants | 53 | 399 | 471 |
| | | | |
| Net cash provided by financing activities | 53 | 399 | 369 |
| | | | |
| Net Decrease in Cash and Cash Equivalents | (888) | (1,433) | (1,888) |
| Cash and Cash Equivalents, beginning of period | 5,716 | 7,149 | 9,037 |
| | | | |
| Cash and Cash Equivalents, end of period | \$ 4,828 | \$ 5,716 | \$ 7,149 |

SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:

| | | | |
|----------------------------|-------|--------|--------|
| Cash paid for interest | \$ 1 | \$ | \$ 2 |
| Cash paid for income taxes | \$ 70 | \$ 235 | \$ 167 |

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

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BITSTREAM INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(1) Operations and Significant Accounting Policies

Bitstream Inc. and subsidiaries (the "Company") develop and market software products and technologies to enhance the creation, transport, viewing and printing of electronic documents.

Bitstream Inc. ("Bitstream") together with its subsidiaries (collectively, the "Company"), headquartered in Cambridge, Massachusetts, is composed of three separate and distinct businesses: (1) its type and technology ("Type") business, which generates revenue primarily from the licensing of font rendering software and fonts to the embedded, set-top box, wireless device and information appliance markets; (2) MyFonts.com, a wholly owned subsidiary that was formed in late 1999 as the first e-commerce site to aggregate fonts from multiple vendors on one easy-to-use Web site ("MyFonts"); and (3) Pageflex, Inc., a wholly owned subsidiary that was formed in early 1999 to establish the Company as a leader in dynamic page composition technologies ("Pageflex").

The Company is subject to risks common to technology-based companies, including dependence on key personnel, rapid technological change, competition from alternative product offerings and larger companies, and challenges to the development and marketing of commercial products and services. The Company has also experienced net losses and as of December 31, 2002 has an accumulated deficit of \$26.1 million.

The accompanying consolidated financial statements reflect the application of certain accounting policies as described in this note and elsewhere in the accompanying consolidated financial statements and notes. The preparation of the accompanying consolidated financial statements required the use of certain estimates by management in determining the Company's assets, liabilities, revenues and expenses. Actual

results may differ from these estimates.

(a) Principles of Consolidation

The accompanying consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries: Bitstream World Trade, Inc. (a Delaware corporation), a holding company for Bitstream, B.V. (a Dutch corporation); Archetype, Inc. (a Delaware corporation); Pageflex, Inc. (a Delaware corporation) and MyFonts.com, Inc. (a Delaware corporation). All material intercompany transactions and balances have been eliminated in consolidation.

(b) Revenue Recognition

The Company recognizes revenue in accordance with Statement of Position 97-2 (SOP 97-2), *Software Revenue Recognition*, as modified by SOP 98-9, *Modifications of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions*. The Company derives revenues from the sale of its software products, professional consulting, and support and maintenance services. License revenue is recognized when persuasive evidence of an agreement exists, the product has been delivered or services have been provided, the fee is fixed or determinable, and collection of the fee is probable.

Licensing fees and royalty revenues include: (1) payments paid by Original Equipment Manufacturer ("OEM") and Independent Software Vendor ("ISV") customers for text imaging and page layout technologies; (2) direct and indirect sales of software publishing applications for the creation, enhancement, management, transport, viewing and printing of electronic information; (3) direct sales of custom and other type products to end users such as graphic artists, desktop publishers and corporations; and (4) sales of type products to foreign customers primarily through distributors. Certain OEM and ISV customers pay royalties only upon the sublicensing of the Company's products to end-users. License revenue is recognized when persuasive evidence of an agreement exists, the product has been delivered or services have been provided, the fee is fixed or determinable, and collection of the fee is probable.

The Company recognizes revenue under multiple-element arrangements using the residual method when vendor-specific objective evidence of fair value exists for all of the undelivered elements under the arrangement. Under the residual method, the arrangement consideration is first allocated to undelivered elements based on vendor-specific objective evidence of the fair value for each element and the residual amount is allocated to the delivered elements. Arrangement consideration allocated to undelivered elements

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is deferred and recognized as revenue when the elements are delivered, if all other revenue recognition criteria are met. The Company has established sufficient vendor-specific objective evidence for the value of its consulting, training, and other services, based on the price charged when these elements are sold separately. Accordingly, software license revenues are recognized under the residual method in arrangements in which software is licensed with consulting, training or other services.

Professional services include custom design and development and training. The Company recognizes professional services revenue under software development contracts as services are provided for per diem contracts or by using the percentage-of-completion method of accounting for long-term fixed price contracts. Provisions for any estimated losses on uncompleted contracts are made in the period in which such losses become probable.

The Company recognizes revenue from support and maintenance agreements ratably over the term of the agreement.

Revenue from guaranteed minimum royalty licenses is recognized upon delivery of the software license when no further obligations of the Company exist, while revenue on pay-as-you-go licenses is recognized in the period when sublicenses to end users are reported to the Company by the OEM or ISV customer. In certain guaranteed minimum royalty licenses, the Company will enter into extended payment programs with creditworthy customers. Revenue related to extended payment programs is recognized when payment becomes due to the Company.

Revenue from end user product sales is recognized upon delivery of the software, net of estimated returns and allowances, and if collection is probable. Provisions for any estimated losses on uncompleted contracts are made in the period in which such losses become probable. Revenue related to extended payment programs is recognized when payment becomes due to the Company.

Deferred revenue includes unearned software maintenance revenue, certain prepaid royalties and advance billings under software development contracts.

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Cost of revenue from software licenses consists primarily of royalties paid to third party developers and foundries whose products the Company sells, and costs to distribute the product, including the cost of the media on which it is delivered. Cost of revenue from services consists primarily of costs associated with consulting and custom product development services.

The Company generally warrants that its products will function substantially in accordance with documentation provided to customers for approximately 90 days following initial delivery. The Company had not incurred any expenses related to warranty claims.

(c) Research and Development Expenses

The Company has evaluated the establishment of technological feasibility of its products in accordance with Statement of Financial Accounting Standards (SFAS) No. 86, *Accounting for the Costs of Computer Software To Be Sold, Leased or Otherwise Marketed*. The Company sells products in a market that is subject to rapid technological change, new product development and changing customer needs. The time period during which costs could be capitalized from the point of reaching technological feasibility until the time of general product release is very short, and consequently, the amounts that could be capitalized are not material to the Company's financial position or results of operations. Therefore, the Company has charged all of such costs to research and development in the period incurred.

(d) Stock-Based Compensation

SFAS No. 123, *Accounting for Stock-Based Compensation*, permits a company to choose either a new fair-value based method prescribed by SFAS No. 123 or Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*, which prescribes an intrinsic value based method of accounting for its employee stock based compensation arrangements. The Company elected to continue to account for its employee stock-based compensation plans utilizing the provisions of APB Opinion No. 25 and the disclosure only option under SFAS No. 123, which requires disclosure of pro forma information regarding net loss and

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net loss per share based on fair value accounting for stock based compensation plans. Additional discussion can be found in Note 7.

The following table sets forth the pro forma amounts of net loss and net loss per share that would have resulted if the Company accounted for its employee stock plans under the fair value recognition provisions of SFAS 123, *"Accounting for Stock-Based Compensation"* (in thousands, except per share amounts):

| | Years Ended December 31, | | |
|--|--------------------------|------------|------------|
| | 2002 | 2001 | 2000 |
| Net loss: | | | |
| As reported | \$ (1,022) | \$ (3,481) | \$ (3,139) |
| Pro forma | \$ (2,189) | \$ (4,669) | \$ (4,306) |
| Basic and diluted net loss per share: | | | |
| As reported | \$ (0.12) | \$ (0.43) | \$ (0.41) |
| Pro forma | \$ (0.26) | \$ (0.58) | \$ (0.56) |

(e) Cash and Cash Equivalents

As of December 31, 2002, cash and cash equivalents included bank deposits and money market instruments. The Company considers all highly liquid investments with original maturities of three months or less at the time of acquisition to be cash equivalents and records such investments at cost, which approximates market value.

(f) Property and Equipment

Property and equipment are stated at cost, less accumulated depreciation and amortization. Property and equipment consists of the following (in thousands):

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| | December 31, | |
|--|---------------|---------------|
| | 2002 | 2001 |
| Equipment and computer software | \$ 2,511 | \$ 2,413 |
| Purchased software | 352 | 351 |
| Furniture and fixtures | 372 | 372 |
| Leasehold improvements | 659 | 659 |
| | <u>3,894</u> | <u>3,795</u> |
| Less Accumulated depreciation and amortization | 3,623 | 3,322 |
| | <u>\$ 271</u> | <u>\$ 473</u> |

Depreciation is provided on a straight-line basis over the estimated useful lives of the related assets as follows:

| Asset Classification | Estimated Useful Life |
|---------------------------------|-----------------------|
| Equipment and computer software | 3 Years |
| Purchased software | 3 Years |
| Equipment under capital lease | Life of lease |
| Furniture and fixtures | 5 Years |
| Leasehold improvements | Life of lease |

(g) Fair Value of Financial Instruments

The Company's financial instruments consist of cash equivalents, accounts receivable, restricted cash, accounts payable and capital leases. The estimated fair value of these financial instruments approximates their carrying value at December 31, 2002 and 2001 due to the short-term nature of these instruments.

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(h) Foreign Currency Translation

The Company considers the functional currency of its foreign subsidiaries to be the U.S. dollar, and accordingly, their financial information is translated into U.S. dollars using exchange rates in effect at period end for monetary assets and liabilities, historical rates for non-monetary assets and liabilities and average exchange rates during each reporting period for the results of operations. Gains (losses) resulting from translation of foreign subsidiary financial statements, as well as transaction gains (losses), are charged to operations.

(i) Off-Balance Sheet Risk and Concentration of Credit Risk

Financial instruments that potentially expose the Company to concentrations of credit risk consist primarily of cash and cash equivalents and trade accounts receivable. The Company places a majority of its cash investments in one highly-rated financial institution. The Company has not experienced significant losses related to receivables from any individual customers or groups of customers in any specific industry or by geographic area. Due to these factors, no additional credit risk beyond amounts provided for collection losses is believed by management to be inherent in the Company's accounts receivable. At December 31, 2002, two customers accounted for 16% and 10% of the Company's accounts receivable. The Company does not have any off-balance sheet risks as of December 31, 2002. At December 31, 2001, two customers accounted for 18% and 17% of the Company's accounts receivable. For the years ended December 31, 2002, and December 31, 2001, no single customer accounted for 10% or greater of the Company's revenues. For the year ended December 31, 2000, one customer accounted for 10% of the Company's revenue.

(j) Goodwill and other intangible assets (in thousands, except per share amounts)

Goodwill is stated at the unamortized cost as of December 31, 2002 and 2001, less impairment adjustments if applicable, and consists of the following:

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| | December 31, | |
|--|-----------------|-----------------|
| | 2002 | 2001 |
| Acquisition of Type Solutions, Inc. | \$ 228 | \$ 228 |
| Acquisition of Alaras Corporation | 499 | 499 |
| Goodwill | 727 | 727 |
| Embedded goodwill from equity investment in DiamondSoft, Inc. (Note 3) | 557 | 557 |
| Total Goodwill | \$ 1,284 | \$ 1,284 |

In June 2001, the FASB issued SFAS No. 142, *Goodwill and Other Intangible Assets*. The Company adopted SFAS No. 142, effective January 1, 2002, which establishes new accounting and reporting requirements for goodwill and other intangible assets. Under SFAS No. 142, goodwill and indefinite-lived intangible assets are no longer amortized, but are required to be reviewed annually for impairment, or more frequently if impairment indicators arise. Separable intangible assets that have finite lives will continue to be amortized over their useful lives. In addition, under the new pronouncement, the Company is required to establish reporting units and allocate goodwill to each of these reporting units. The Company has established the following reporting units: Type, MyFonts, and Pageflex.

The Company ceased all goodwill amortization effective January 1, 2002. In addition, the Company tested recorded goodwill attributable to each reporting unit for impairment. Management conducted impairment testing as of January 1, 2002 and as of December 31, 2002 and determined that the fair value of its reporting units were greater than the carrying values for those units. The Company has recorded goodwill embedded in its equity investment in DiamondSoft, Inc. of \$557 as of December 31, 2002 and 2001, which is not attributable to a reporting unit.

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The carrying amounts of goodwill attributable to each reporting unit are as follows:

| | December 31, | |
|----------|--------------|--------|
| | 2002 | 2001 |
| Type | \$ 228 | \$ 228 |
| MyFonts | | |
| Pageflex | 499 | 499 |
| | \$ 727 | \$ 727 |

Had the Company applied the non-amortization provisions of SFAS No. 142 as of January 1, 2000, results of operations for the year ended December 31, 2002, 2001 and 2000, would have been as follows (in thousands, except per share amounts):

| | The Year ended December 31, | | |
|--|-----------------------------|-------------------|-------------------|
| | 2002 | 2001 | 2000 |
| Reported net loss | \$ (1,022) | \$ (3,481) | \$ (3,139) |
| Add: | | | |
| Goodwill amortization, net of tax | | 469 | 469 |
| Embedded goodwill amortization, net of tax | | 114 | |
| Adjusted net loss | \$ (1,022) | \$ (2,898) | \$ (2,670) |
| Basic and diluted loss per share as reported | \$ (0.12) | \$ (0.43) | \$ (0.41) |

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| | The Year ended December 31, | | |
|--|-----------------------------|-----------|-----------|
| | 2003 | 2002 | 2001 |
| Basic and diluted pro forma loss per share | \$ (0.12) | \$ (0.36) | \$ (0.35) |

In connection with its adoption of SFAS 142, the Company reassessed the useful lives and the classification of its identifiable intangible assets and determined that they continue to be appropriate. The components of the Company's amortized intangible assets follow:

| | December 31, 2002 | | December 31, 2001 | |
|-------------------|-----------------------|--------------------------|-----------------------|--------------------------|
| | Gross Carrying Amount | Accumulated Amortization | Gross Carrying Amount | Accumulated Amortization |
| Marketing-related | \$ 76 | \$ (40) | \$ 70 | \$ (27) |
| Technology-based | 373 | (173) | 289 | (114) |
| Total | \$ 449 | \$ (213) | \$ 359 | \$ (141) |

Amortization expense for finite-lived intangible assets for the years ended December 31, 2002, 2001 and 2000 was \$72, \$56 and \$56, respectively. Estimated amortization for the five succeeding years follows:

Estimated Amortization Expense:

| | |
|------|---------------|
| 2003 | \$ 75 |
| 2004 | 70 |
| 2005 | 53 |
| 2006 | 30 |
| 2007 | 8 |
| | \$ 236 |

(k) Reclassifications

Certain prior year account balances have been reclassified to be consistent with the current year's presentation.

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(l) Recently Issued Accounting Standards

In June 2002, the FASB issued SFAS No. 143, *Accounting for Asset Retirement Obligations*. This Statement addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. This Statement applies to legal obligations associated with the retirement of long-lived assets that result from the acquisition, construction, development, or normal use of the asset. SFAS No. 143 is effective for fiscal years beginning after June 15, 2002. The Company does not expect SFAS No. 143 to have a material impact on its financial position or results of operations upon its adoption on January 1, 2003.

In June 2002, the FASB issued SFAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*, which supercedes EITF 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)*. The provisions of this Statement are required to be adopted for exit or disposal activities that are initiated after December 31, 2002. Under this standard, a liability for a cost associated with an exit or disposal activity formerly recognized upon the entity's commitment to an exit plan is now recognized when the liability is incurred. The Company does not expect SFAS No. 146 to have a material impact on its financial position or results of operations upon its adoption on January 1, 2003.

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In November 2002, the FASB issued Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, including Indirect Guarantees of Indebtedness of Other* (FIN No.45). FIN No. 45 requires that a guarantor is required to recognize, at the inception of the guarantee, a liability for the fair value of the obligation undertaken by issuing the guarantee. The interpretation also requires additional disclosure to be made by a guarantor in its financial statements about its obligations under certain guarantees it has issued. The accounting requirements for the initial recognition of guarantees are applicable on a prospective basis for guarantees issued or modified after December 31, 2002. The disclosure requirements are effective for all guarantees outstanding, regardless of when they were issued or modified, for financial statement periods that end after December 15, 2002. The adoption of FIN 45 did not have a material effect on the Company's consolidated financial statements.

In December 2002, the FASB issued SFAS No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure an amendment of FAS 123*. This Statement amends SFAS No. 123, *Accounting for Stock-Based Compensation*, to provide alternative methods of transition for an entity that voluntarily changes to the fair value based method of accounting for stock-based employee compensation. It also amends the disclosure provisions of SFAS No. 123 to require prominent disclosure about the effects on reported net income of an entity's accounting policy decisions with respect to stock-based employee compensation. This Statement also amends Accounting Principles Board Opinion No. 28, *Interim Financial Reporting* ("APB No. 28"), to require disclosure about those effects in interim financial statements. The amendments to SFAS No. 123 are generally effective for financial statements for fiscal years ending after December 15, 2002. The amendment to APB No. 28 is effective for financial reports containing condensed financial statements for interim periods beginning after December 15, 2002. The Company's adoption of SFAS No. 148 has not had, and is not expected to have, a significant effect on its financial position or its results of operations.

In January 2003, the FASB issued FIN No. 46, *Consolidation of Variable Interest Entities, an Interpretation of ARB 51*. The primary objectives of FIN No. 46 are to provide guidance on the identification of entities for which control is achieved through means other than through voting rights ("variable interest entities" or "VIEs") and how to determine when and which business enterprise should consolidate the VIE. This new model for consolidation applies to an entity for which either: (a) the equity investors (if any) do not have a controlling financial interest; or (b) the equity investment at risk is insufficient to finance that entity's activities without receiving additional subordinated financial support from other parties. In addition, FIN No. 46 requires that both the primary beneficiary and all other enterprises with a significant variable interest in a VIE make additional disclosures. The Company is required to apply FIN No. 46 to all new variable interest entities created or acquired after January 31, 2003. For variable interest entities created or acquired prior to February 1, 2003, the Company is required to apply FIN No. 46 on July 1, 2003. The Company does not expect FIN No. 46 will have a material effect on its financial position or its results of operations.

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(m) Impairment of Long-Lived Assets

The Company reviews its long-lived assets (which include intangible assets and property and equipment) for impairment as events and circumstances indicate the carrying amount of an asset may not be recoverable. The Company evaluates the realizability of its long-lived assets based on profitability and cash flow expectations for the related asset or subsidiary. Management believes that, as of each of the balance sheet dates presented, none of the Company's long-lived assets was impaired. (See Note 1(j))

(n) Comprehensive Loss

SFAS No. 130, *Reporting Comprehensive Income*, establishes standards for the reporting and display of comprehensive (loss) income and its components in a full set of general purpose financial statements. The Company's comprehensive loss is equal to the Company's net loss for all periods presented.

(2) Loss Per Share (in thousands)

Basic earnings or loss per share is determined by dividing the net loss by the weighted average number of shares of common stock outstanding during the period. Diluted earnings per share reflect the effect of the conversion of potentially dilutive securities, such as stock options, based on the treasury stock method. In computing diluted earnings per share, common stock equivalents are not considered in periods in which a net loss is reported, as the inclusion of the common stock equivalents would be antidilutive. As a result there is no difference between the Company's basic and diluted loss per share for the three years ended December 31, 2002.

If the Company had reported a profit for these periods, the potential common shares would have increased the weighted average shares outstanding by 975, 1,198 and 1,819 shares for the years ended December 31, 2002, 2001 and 2000, respectively. In addition, there were warrants and options outstanding to purchase 576, 112, and 123 shares for the years ended December 31, 2002, 2001, and 2000, respectively, that were not included in the potential common share computations because their exercise prices were greater than the market price of the

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Company's common stock. These common stock equivalents are antidilutive even when a profit is reported in the numerator.

(3) Investment (in thousands, except percentages)

On March 13, 1998, the Company made a \$500 or 25% equity investment, accounted for under the equity method, in DiamondSoft, Inc. ("DiamondSoft"), a California corporation primarily engaged in the business of developing, marketing and distributing software tools to a variety of professional markets. During the year ended December 31, 2001 the Company made additional investments totaling \$410 in DiamondSoft, resulting in an increase in Bitstream's ownership percentage to 31.7% at December 31, 2001, which remained unchanged as of December 31, 2002.

Gains (losses) for the years ended December 31, 2002, 2001, and 2000 related to the Company's investment in DiamondSoft totaled approximately \$149, \$(260) and \$(13), respectively, and are included in the accompanying consolidated statements of operations. The Company has recorded goodwill related to this investment equal to the difference between the amount paid for the investment and the Company's share of DiamondSoft's underlying net assets at the time of each investment. Losses for the years ended December 31, 2001, and 2000 included \$114 and \$0, respectively, in amortization. This goodwill amortization ceased in accordance with the Company's adoption of SFAS No. 142 on January 1, 2002. (See Note 1(j))

On June 19, 2000, the Company deposited \$300 into a money market account at Wells Fargo Bank to secure a \$300 line of credit granted DiamondSoft by that bank. This cash, which continues to secure the line of credit, is presented on the Company's consolidated balance sheet as restricted cash.

(4) Income Taxes (in thousands, except percent amounts)

The Company accounts for income taxes in accordance with SFAS No. 109, *Accounting for Income Taxes*. Under the liability method in accordance with SFAS No. 109, a deferred tax asset or liability is determined

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based on the difference between the financial statement and the tax bases of assets and liabilities, as measured by enacted tax rates in effect when these differences are expected to reverse.

A reconciliation between the provision for income taxes computed at statutory rates and the amount reflected in the accompanying consolidated statements of operations as a percentage of pre-tax income is as follows:

| | Years Ended December 31, | | |
|--|--------------------------|---------|---------|
| | 2002 | 2001 | 2000 |
| Computed expected federal tax benefit | (34.0)% | (34.0)% | (34.0)% |
| State income taxes, net of federal benefit | (6.0) | (6.0) | (6.0) |
| Foreign income/losses | | 0.4 | 4.5 |
| Foreign taxes, including withholding taxes | 9.0 | 4.6 | (2.4) |
| Nondeductible goodwill amortization | | 4.6 | 13.2 |
| Change in valuation allowance | 26.8 | 35.4 | 33.2 |
| | (4.2)% | 5.0% | 8.5% |
| Provision for income taxes per accompanying consolidated statement of operations | (4.2)% | 5.0% | 8.5% |

The Company's tax benefit for the year ended December 31, 2002 resulted from US federal and state refunds of \$141 from prior years taxes paid. The following is a summary of the components of the (benefit from) or provision for income taxes:

| | Year Ended December 31, | | |
|--|-------------------------|------|------|
| | 2002 | 2001 | 2000 |
| | | | |

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| | Year Ended December 31, | | |
|--------------|-------------------------|---------------|---------------|
| Current: | | | |
| Federal | \$ (134) | \$ | \$ |
| State | (7) | 13 | 23 |
| Foreign | 96 | 154 | 222 |
| Total | \$ (45) | \$ 167 | \$ 245 |

The significant items composing the deferred tax asset are as follows:

| | December 31, | |
|----------------------------------|--------------|----------|
| | 2002 | 2001 |
| Net operating loss carryforwards | \$ 6,308 | \$ 6,003 |
| Tax credit carryforwards | 1,480 | 2,793 |
| Other temporary differences | 539 | 1,304 |
| Gross deferred tax asset | 8,327 | 10,100 |
| Valuation allowance | (8,327) | (10,100) |
| Net deferred tax asset | \$ | \$ |

The following is a summary of foreign and domestic pretax (loss) income:

| | Years Ended December 31, | | |
|--------------------------|--------------------------|-------------------|-------------------|
| | 2002 | 2001 | 2000 |
| Foreign | \$ (26) | \$ (210) | \$ 129 |
| Domestic | (1,041) | (3,104) | (3,023) |
| Total pretax loss | \$ (1,067) | \$ (3,314) | \$ (2,894) |

At December 31, 2002, the Company has available federal and state net operating loss ("NOLs") carryforwards for income tax purposes and federal and state tax credit carryforwards to reduce future federal

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income taxes, if any. Utilization of these NOLs is subject to certain annual limitations in accordance with certain tax laws and regulations. These net operating loss and tax credit carryforwards are subject to review and possible adjustment by the Internal Revenue Service. As of December 31, 2002 the Company has federal and state tax NOL carryforwards of \$ 16,535 and \$12,143, respectively. These NOL carryforwards begin to expire in 2007 and 2004, respectively. As of December 31, 2002 the company has federal and state research and development tax credit carryforwards of \$485 and \$296, respectively. These research and development tax credit carryforwards begin to expire in 2009. As of December 31, 2002 the company has foreign tax credit carryforwards of \$800. These foreign tax credit carryforwards begin to expire in 2003.

The Company has established a valuation allowance against its deferred tax asset to the extent that it believes it is more likely than not these assets will not be realized. In determining the amount of valuation allowance required, the Company considers numerous factors, including historical profitability, estimated future taxable income and the volatility of the industry in which it operates. As of December 31, 2002 the Company has fully reserved its deferred tax asset primarily due to losses in each of the last three years.

(5) Accrued Expenses, (in thousands)

Accrued expenses consist of the following:

| | December 31, | |
|--|-----------------|-----------------|
| | 2002 | 2001 |
| Accrued royalties | \$ 210 | \$ 226 |
| Payroll and other compensation | 597 | 510 |
| Accrued professional and consulting services | 165 | 197 |
| Other | 74 | 193 |
| Total | \$ 1,046 | \$ 1,126 |

(6) Commitments, (in thousands)

The Company conducts its operations in leased facilities and is obligated to pay monthly rent plus real estate taxes and certain operating expenses through October 1, 2003. Rent expense charged to operations for the years ended December 31, 2002, 2001 and 2000 was approximately \$859, \$730, and \$515, respectively. The Company subleased approximately 4.7 square feet of its leased facilities to a third party for a two year period commencing on January 15, 1999 for \$78 per annum, which was netted against rent expense in 2000. The future minimum annual lease payments, as of December 31, 2002, under the Company's leased facilities is \$301 due during the year ended December 31, 2003, for the lease expiring on October 1, 2003.

(7) Stockholders' Equity, (number of shares in thousands)**(a) General**

The Company has the following authorized capital: 30,500 shares of Common Stock, \$0.01 par value, (30,000 of which are shares of Class A Common Stock and 500 of which are shares of Class B Common Stock), and 6,000 shares of preferred stock, \$0.01 par value. Class A Common stockholders have voting rights. Class A Common stockholders have the option, at any time, to convert any or all shares of Class A Common Stock held into an equal number of shares of Class B Common Stock. The Class B Common Stock has rights similar to Class A Common Stock, except Class B Common Shares are nonvoting. The Class B Common stockholders have the option to convert any or all shares of Class B Common Stock held into an equal number of shares of Class A Common Stock, to the extent such stockholder and its affiliates shall be permitted to own, control or have the power to vote such Class A Common Stock under any law, rule or regulation at the time applicable to such stockholder or its affiliates. All outstanding shares of Common Stock as of December 31, 2002 and 2001 represent Class A Common Stock.

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(b) Stock Option Plans

On December 7, 1992, the Company adopted the 1993 Nonqualified Stock Option Plan (the "1993 Plan"), under which the Company is authorized to grant options to purchase shares of Class A Common Stock. Options outstanding under the 1993 Plan as of December 31, 2001 are exercisable immediately, expire no later than 10 years from the date of grant and were granted at no less than the fair market value on the date of grant, as determined by the Board of Directors. In 2002, 2001 and 2000, the Company had not granted, and does not intend to grant, any additional options under the 1993 Plan.

On November 21, 1994, the Board of Directors approved the 1994 Stock Plan (the "1994 Plan") under which the Company is authorized to grant incentive stock options and nonqualified stock options (including warrants) to purchase up to 1,833 shares of Class A Common Stock. Incentive stock options granted under the 1994 Plan must be granted at no less than fair market value of the shares at the date of grant, expire no later than 10 years from the date of grant and vest over periods of up to three years. As of December 31, 2002, the Company had available for issuance stock options to purchase 161 shares of Class A Common Stock pursuant to the 1994 Plan.

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On May 1, 1996, the Board of Directors adopted the 1996 Stock Plan (the "1996 Plan") under which the Company is authorized to grant incentive stock options and nonqualified stock options to purchase shares of Class A Common Stock. Options granted under this plan are exercisable at such price as shall be determined by the Board of Directors at the time of grant which, in the case of incentive stock options, shall be no less than 100% of the fair market value of the shares on the date of grant and expire no later than 10 years from the date of grant. In addition, the 1996 Plan provides that options granted thereunder, subject to future vesting, shall immediately vest upon the occurrence of certain events, such as the sale of all or substantially all of the assets of the Company or a change in control of the Company. A total of 775 shares of Class A Common Stock have been reserved for issuance under the 1996 Plan. As of December 31, 2002, the Company had 33 stock options available for issuance to purchase shares of Class A Common Stock pursuant to the 1996 Plan.

On March 10, 1997, the Board of Directors adopted the 1997 Stock Plan (the "1997 Plan") under which the Company is authorized to grant warrants, incentive stock options and nonqualified stock options to purchase shares of Class A Common Stock. Options granted under this plan are exercisable at such price as shall be determined by the Board of Directors at the time of grant which, in the case of incentive stock options, shall be no less than 100% of the fair market value of the shares on the date of grant and expire no later than 10 years from the date of grant. In addition, the 1997 Plan provides that options granted thereunder, subject to future vesting, shall immediately vest upon the occurrence of certain events, such as the sale of all or substantially all of the assets of the Company or a change in control of the Company. A total of 1,391 shares of Class A Common Stock have been reserved for issuance under the 1997 Plan. As of December 31, 2002, the Company had available for issuance, stock options to purchase 229 shares of Class A Common Stock pursuant to the 1997 Plan.

On February 11, 2000, the Board of Directors adopted the 2000 Stock Plan (the "2000 Plan") under which the Company is authorized to grant warrants, incentive stock options and nonqualified stock options to purchase up to 1,000 shares of Class A Common Stock. Options granted under this plan are exercisable at such price as shall be determined by the Board of Directors at the time of grant which, in the case of incentive stock options, shall be no less than 100% of the fair market value of the shares on the date of grant and expire no later than 10 years from the date of grant. In addition, the 2000 Plan provides that options granted thereunder, subject to future vesting, shall immediately vest upon the occurrence of certain events, such as the sale of all or substantially all of the assets of the Company or a change in control of the Company. As of December 31, 2002, the Company had available for issuance, stock options to purchase 181 shares of Class A Common Stock pursuant to the 2000 Plan.

On February 11, 2000, the Board of Directors also adopted the Pageflex, Inc. and MyFonts.com, Inc. 2000 Stock Plans. Under these Plans, the Company is authorized to grant warrants, incentive stock options and nonqualified stock options to purchase up to 3,000 shares of Common Stock in each of these two subsidiaries. Options granted under this plan are exercisable at such price as shall be determined by the

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Board of Directors at the time of grant which, in the case of incentive stock options, shall be no less than 100% of the fair market value of the shares on the date of grant and expire no later than 10 years from the date of grant. In addition, the 2000 Stock Plans provide that options granted thereunder, subject to future vesting, shall immediately vest upon the occurrence of certain events, such as the sale of all or substantially all of the assets of the subsidiary or a change in control of the subsidiary. As of December 31, 2002, the Company had available for issuance, stock options to purchase 1,689 and 1,297 shares of Pageflex, Inc. and MyFonts.com, Inc. Common Stock, respectively, pursuant to the 2000 Stock Plans.

Stock option activity under all Bitstream, Inc. stock plans for the years ended December 31, 2002, 2001 and 2000 is as follows:

| | Number of Shares | Weighted Average Exercise Price |
|--------------------------------|-----------------------------|--|
| Outstanding, December 31, 1999 | 2,617 | 1.89 |
| Exercised | (227) | 1.66 |
| Canceled | (99) | 4.70 |
| Granted | 527 | 2.80 |
| | 2,818 | 1.98 |
| Outstanding, December 31, 2000 | 2,818 | 1.98 |
| Exercised | (318) | 1.38 |
| Canceled | (185) | 3.59 |
| Granted | 423 | 3.88 |
| | 2,738 | 2.00 |

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| | Number of Shares | Weighted Average Exercise Price |
|--------------------------------|---------------------|---------------------------------------|
| Outstanding, December 31, 2001 | 2,738 | \$ 2.23 |
| Exercised | (47) | 1.11 |
| Canceled | (177) | 3.85 |
| Granted | 167 | 3.49 |
| <hr/> | | |
| Outstanding, December 31, 2002 | 2,681 | \$ 2.22 |
| <hr/> | | |
| Exercisable, December 31, 2002 | 2,110 | \$ 1.94 |
| <hr/> | | |

| Range of Exercise Prices | Weighted Average Remaining Contractual Life in Years | Options Outstanding | | Options Exercisable | |
|-----------------------------|---|---------------------|---------------------------------------|---------------------|---------------------------------------|
| | | Number | Weighted Average Exercise Price | Number | Weighted Average Exercise Price |
| \$0.90 - \$1.38 | 2.83 | 261 | \$ 1.00 | 261 | \$ 1.00 |
| 1.50 - 2.70 | 6.13 | 1,941 | 1.90 | 1,686 | 1.86 |
| 3.00 - 3.96 | 8.73 | 359 | 3.91 | 126 | 3.89 |
| 4.56 - 5.75 | 7.74 | 112 | 4.81 | 32 | 4.95 |
| 8.81 - 8.81 | 7.12 | 8 | 8.81 | 5 | 8.81 |
| <hr/> | | | | | |
| \$0.90 - \$8.81 | 6.93 | 2,681 | \$ 2.22 | 2,110 | \$ 1.94 |
| <hr/> | | | | | |

During 2000, the Company issued options to purchase 7 shares of common stock to non-employee consultants in exchange for services. The Company recorded these transactions at fair value, which was \$13,000 for the year ended December 31, 2000. The compensation expense is recorded over the three year vesting period and is subject to variable accounting treatment prior to vesting, whereby the Company remeasures the fair value of the options at the end of each reporting period. Compensation expense related to these options was \$(27,000), \$29,000, and \$8,000 for the years ended December 31, 2002, 2001 and 2000, respectively.

During 2000 and 2001, the Company granted stock options to employees to purchase 1,983 and 1,846 shares of Common Stock at a fair value of \$0.40 per share in its wholly owned subsidiaries Pageflex Inc. and Myfonts.com, Inc., respectively. During 2002, the Company did not grant stock options for stock in its subsidiaries. Stock options outstanding at December 31, 2002 for the Pageflex, Inc. and MyFonts.com, Inc. Common Stock, was 1,309 and 1,703, respectively. Stock options exercisable at December 31, 2002 for the Pageflex, Inc. and MyFonts.com, Inc. Common Stock, was 859 and 1,117, respectively.

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(c) Warrants

Warrant activity for the three years ended December 31, 2002 is as follows:

| Stock Class | Number of Shares Purchasable | Number of Warrants Exercisable | Weighted Average Exercise Price |
|--------------------------------|------------------------------------|--------------------------------------|---------------------------------------|
| Outstanding, December 31, 1999 | 444 | 412 | \$ 5.99 |
| Exercised | (74) | | 1.26 |
| Canceled | (10) | | 5.97 |
| <hr/> | | | |
| Outstanding, December 31, 2000 | 360 | 360 | 6.60 |

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| Stock Class | Number of Shares Purchasable | Number of Warrants Exercisable | Weighted Average Exercise Price |
|--------------------------------|------------------------------|--------------------------------|---------------------------------|
| Exercised | (181) | | 0.90 |
| Canceled | (2) | | 100.88 |
| Outstanding, December 31, 2001 | 177 | 177 | 11.45 |
| Canceled | (34) | | 23.24 |
| Outstanding, December 31, 2002 | 143 | 143 | \$ 8.67 |

In 1997, the Company issued warrants under the 1994 Plan for the purchase of 150 shares of Class A Common Stock at \$0.90 - \$4.94 per share, which vest in annual increments over a three-year period, to several members of the Company's management team and Board of Directors and an affiliate to the Board of Directors. The Company recognized compensation expense associated with the warrants over the three-year vesting period ending in the year ended December 31, 2000. During 2000, the Company recognized \$9,000 in compensation expense related to these warrants.

| Range of Exercise Prices | Weighted Average Remaining Contractual Life, in Years | Warrants Outstanding and Exercisable | Weighted Average Exercise Price |
|--------------------------|---|--------------------------------------|---------------------------------|
| \$ 0.90 - \$ 0.90 | 1.38 | 40 | \$ 0.90 |
| 3.00 - 3.00 | 2.83 | 3 | 3.00 |
| 4.94 - 4.94 | 4.19 | 60 | 4.94 |
| 22.50 - 22.50 | 0.88 | 40 | 22.50 |
| \$ 3.00 - \$22.50 | 2.30 | 143 | \$ 8.67 |

(d) Stock-Based Compensation

The Company accounts for its employee stock plans using the intrinsic value method. The following table sets forth the pro forma amounts of net loss and net loss per share that would have resulted if the Company accounted for its employee stock plans under the fair value recognition provisions of SFAS 123, "Accounting for Stock-Based Compensation" (in thousands, except per share amounts):

| | Years Ended December 31, | | |
|---------------------------------------|--------------------------|------------|------------|
| | 2002 | 2001 | 2000 |
| Net loss: | | | |
| As reported | \$ (1,022) | \$ (3,481) | \$ (3,139) |
| Pro forma | \$ (2,189) | \$ (4,669) | \$ (4,306) |
| Basic and diluted net loss per share: | | | |
| As reported | \$ (0.12) | \$ (0.43) | \$ (0.41) |
| Pro forma | \$ (0.26) | \$ (0.58) | \$ (0.56) |

For purposes of computing pro forma net loss, the Company estimates the fair value of all option or warrant grants granted to employees as of December 31, 2002 using the Black Scholes option pricing model prescribed by SFAS No. 123.

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| | Years Ended December 31, | | |
|--|--------------------------|--------------|---------------|
| | 2002 | 2001 | 2000 |
| Risk-free interest rates | 4.00% to 5.17% | 4.7% to 5.3% | 5.00% to 5.6% |
| Expected dividend yield | | | |
| Expected lives | 5 Years | 10 Years | 10 Years |
| Expected volatility | 99.6% | 97.6% | 140.6% |
| Weighted average exercise price | \$2.58 | \$2.82 | \$2.88 |
| Weighted average remaining contractual life of options outstanding | 6.10 | 6.73 | 6.80 |
| Weighted average fair value per Share of options granted | \$2.83 | \$3.50 | \$2.74 |

(8) *Employee Benefit Plan*

The Company has an employee benefit plan under Section 401(k) of the Internal Revenue Code. The plan allows employees to make contributions up to a specified percentage of their compensation. Under the plan, the Company may, but is not obligated to, match a portion of the employee's contribution up to a defined maximum. The Company contributed \$59,000, \$144,000, and \$150,000 for the years ended December 31, 2002, 2001, and 2000, respectively.

(9) *Segment Reporting*

The Company's reportable segments are strategic business units that sell the Company's products through distinct distribution channels. They are managed separately as each business requires different marketing strategies. The Company's approach is based on the way that management organizes the segments within the enterprise for making operating decisions and assessing performance. The e-commerce segment's revenues include revenue from products it purchases from the type and technology segment. The inter-segment revenues created by these transactions have been eliminated from the e-commerce segmented revenue below, as well as from the Company's consolidated financial statements. The Company evaluates performance based on profit or loss from operations before income taxes, not including non-recurring gains and losses.

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The following tables sets forth the Company's statement of operations by segment with additional disclosures as required by SFAS No. 131 (in thousands):

| | Year Ended December 31, 2002 | | | |
|---------------------------------|------------------------------|------------|--------------|--------------|
| | Type | MyFonts | Pageflex | Combined |
| Revenue | | | | |
| Software licenses | \$ 4,249 | \$ 1,378 | \$ 1,788 | \$ 7,415 |
| Services | 352 | | 700 | 1,052 |
| Revenue from external customers | 4,601 | 1,378 | 2,488 | 8,467 |
| Cost of revenues | | | | |
| Software licenses | 477 | 1,121 | 84 | 1,682 |
| Services | 150 | | 222 | 372 |
| Cost of revenues | 627 | 1,121 | 306 | 2,054 |
| Gross profit | 3,974 | 257 | 2,182 | 6,413 |

Operating expenses:

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Year Ended December 31, 2002

| | | | | |
|-------------------------------|-------|----------|----------|------------|
| Marketing and selling | 1,218 | 39 | 972 | 2,229 |
| Research and development | 1,868 | 503 | 1,657 | 4,028 |
| General and administrative | 839 | 90 | 517 | 1,446 |
| Total operating expenses | 3,925 | 632 | 3,146 | 7,703 |
| Income (loss) from operations | \$ 49 | \$ (375) | \$ (964) | \$ (1,290) |

Supplemental segment disclosures:

| | | | | |
|---------------------------------------|--------|-------|-------|--------|
| Depreciation and amortization expense | \$ 241 | \$ 39 | \$ 93 | \$ 373 |
| Expenditures for long-lived assets | \$ 60 | \$ 36 | \$ 3 | \$ 99 |

Year Ended December 31, 2001

| | Type | MyFonts | Pageflex | Combined |
|--|----------|----------|------------|------------|
| Revenue | | | | |
| Software licenses | \$ 4,886 | \$ 510 | \$ 1,463 | \$ 6,859 |
| Services | 462 | | 647 | 1,109 |
| Revenue from external customers | 5,348 | 510 | 2,110 | 7,968 |
| Cost of revenues | | | | |
| Software licenses | 516 | 395 | 160 | 1,071 |
| Services | 204 | | 152 | 356 |
| Cost of revenues | 720 | 395 | 312 | 1,427 |
| Gross profit | 4,628 | 115 | 1,798 | 6,541 |
| Operating expenses: | | | | |
| Marketing and selling | 1,507 | 64 | 1,356 | 2,927 |
| Research and development | 1,776 | 706 | 2,562 | 5,044 |
| General and administrative | 980 | 69 | 808 | 1,857 |
| Total operating expenses | 4,263 | 839 | 4,726 | 9,828 |
| Income (loss) from operations | \$ 365 | \$ (724) | \$ (2,928) | \$ (3,287) |
| Supplemental segment disclosures: | | | | |
| Depreciation and amortization expense | \$ 464 | \$ 28 | \$ 406 | \$ 898 |
| Expenditures for long-lived assets | \$ 159 | \$ 8 | \$ 43 | \$ 210 |

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Year Ended December 31, 2000

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| | <u>Type</u> | <u>MyFonts</u> | <u>Pageflex</u> | <u>Combined</u> |
|--|-------------|----------------|-----------------|-----------------|
| Revenue | | | | |
| Software licenses | \$ 5,820 | \$ 50 | \$ 1,471 | \$ 7,341 |
| Services | 377 | | 1,264 | 1,641 |
| Revenue from external customers | 6,197 | 50 | 2,735 | 8,982 |
| Cost of revenues | | | | |
| Software licenses | 627 | 34 | 69 | 730 |
| Services | 252 | | 411 | 663 |
| Cost of revenues | 879 | 34 | 480 | 1,393 |
| Gross profit | 5,318 | 16 | 2,255 | 7,589 |
| Operating expenses: | | | | |
| Selling and marketing | 1,607 | 16 | 2,057 | 3,680 |
| Research and development | 1,754 | 396 | 2,671 | 4,821 |
| General and administrative | 1,048 | 36 | 1,348 | 2,432 |
| Total operating expenses | 4,409 | 448 | 6,076 | 10,933 |
| Income (loss) from operations | \$ 909 | \$ (432) | \$ (3,821) | \$ (3,344) |
| Supplemental segment disclosures: | | | | |
| Depreciation and amortization expense | \$ 525 | \$ 25 | \$ 424 | \$ 974 |
| Expenditures for long-lived assets | \$ 154 | \$ 52 | \$ 116 | \$ 322 |

The following tables set forth the Company's supplemental balance sheet information by segment:

| As Of December 31, 2002 | | | | |
|---|-------------|----------------|-----------------|-----------------|
| | <u>Type</u> | <u>MyFonts</u> | <u>Pageflex</u> | <u>Combined</u> |
| (In thousands) | | | | |
| ASSETS | | | | |
| Current assets | \$ 5,132 | \$ 107 | \$ 437 | \$ 5,676 |
| Property and equipment, net | 191 | 43 | 37 | 271 |
| Receivable from subsidiaries | 13,834 | | | 13,834 |
| Other assets | 1,488 | 11 | 518 | 2,017 |
| Total assets | \$ 20,645 | \$ 161 | \$ 992 | 21,798 |
| Consolidating elimination entry: | | | | |
| inter-company receivables | | | | (13,834) |
| Total consolidated assets | | | | \$ 7,964 |

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As Of December 31, 2002

| LIABILITIES AND STOCKHOLDERS' EQUITY | | | | |
|--|------------------|---------------|---------------|-----------------|
| Current liabilities | \$ 1,108 | \$ 142 | \$ 708 | \$ 1,958 |
| Long-term liabilities | | | 6 | 6 |
| Payable to parent company | | 1,841 | 11,993 | 13,834 |
| Total liabilities | 1,108 | 1,983 | 12,707 | 15,798 |
| Stockholders' equity (deficit): | 19,537 | (1,822) | (11,715) | 6,000 |
| Total liabilities and stockholders' equity | \$ 20,645 | \$ 161 | \$ 992 | 21,798 |
| Consolidating elimination entry: inter-company receivables | | | | (13,834) |
| Total consolidated liabilities and stockholder's equity | | | | \$ 7,964 |

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As Of December 31, 2001

| | Type | MyFonts | Pageflex | Combined |
|---|------------------|--------------|-----------------|-----------------|
| (In thousands) | | | | |
| ASSETS | | | | |
| Current assets | \$ 5,795 | \$ 29 | \$ 693 | \$ 6,517 |
| Property and equipment, net | 315 | 41 | 117 | 473 |
| Receivable from subsidiaries | 12,850 | | | 12,850 |
| Other assets | 1,309 | 14 | 526 | 1,849 |
| Total assets | \$ 20,269 | \$ 84 | \$ 1,336 | 21,689 |
| Consolidating elimination entry: inter-company receivables | | | | (12,850) |
| Total consolidated assets | | | | \$ 8,839 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | | | |
| Current liabilities | \$ 1,067 | \$ 61 | \$ 701 | \$ 1,829 |
| Long-term liabilities | 8 | | 6 | 14 |
| Payable to parent company | | 1,470 | 11,380 | 12,850 |
| Total liabilities | 1,075 | 1,531 | 12,087 | 14,693 |
| Stockholders' equity (deficit): | 19,194 | (1,447) | (10,751) | 6,996 |
| Total liabilities and stockholders' equity | \$ 20,269 | \$ 84 | \$ 1,336 | 21,689 |
| Consolidating elimination entry: inter-company receivables | | | | (12,850) |

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As Of December 31, 2001

| | |
|---|----------|
| Total consolidated liabilities and stockholder's equity | \$ 8,839 |
|---|----------|

(10) *Geographical Reporting*

The Company attributes revenues to different geographical areas on the basis of the location of the customer. All of the Company's product sales for the years ended December 31, 2002, 2001 and 2000 were shipped from its headquarters located in the United States or its office located in Cheltenham, England. Revenues by geographic area are as follows (in thousands):

| | Years Ended December 31, | | |
|--|--------------------------|-----------------|-----------------|
| | 2002 | 2001 | 2000 |
| Revenue: | | | |
| United States | \$ 5,688 | \$ 4,457 | \$ 5,752 |
| Canada | 462 | 345 | 315 |
| Japan | 848 | 1,037 | 1,205 |
| United Kingdom | 493 | 536 | 684 |
| Korea | 237 | 471 | |
| Other (Countries less than 5% individually, by Region) | | | |
| Europe, excluding UK | 696 | 870 | 832 |
| Asia, excluding Japan and Korea | 4 | 204 | 159 |
| Other | 39 | 48 | 35 |
| Total revenue | \$ 8,467 | \$ 7,968 | \$ 8,982 |

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Long-lived tangible assets by geographic area are as follows (in thousands):

| | December 31, 2002 | December 31, 2001 |
|---------------|----------------------|----------------------|
| United States | \$ 250 | \$ 452 |
| England | 21 | 21 |
| Total | \$ 271 | \$ 473 |

(11) *Quarterly Financial Data, (Unaudited)*

The following tables (presented in thousands, except per share amounts) set forth quarterly supplementary data for each of the years in the two year period ended December 31, 2002.

| | Year Ended December 31, 2002 | | | | |
|--------------|------------------------------|----------|----------|----------|----------|
| | First | Second | Third | Fourth | Total |
| Revenues | \$ 2,133 | \$ 2,213 | \$ 1,847 | \$ 2,274 | \$ 8,467 |
| Gross profit | \$ 1,718 | \$ 1,626 | \$ 1,313 | \$ 1,756 | \$ 6,413 |

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Year Ended December 31, 2002

| | | | | | |
|----------------------------|-----------|-----------|-----------|----------|------------|
| Loss from operations | \$ (178) | \$ (316) | \$ (634) | \$ (162) | \$ (1,290) |
| Net loss | \$ (187) | \$ (293) | \$ (616) | \$ 74 | \$ (1,022) |
| Basic net loss per share | \$ (0.02) | \$ (0.04) | \$ (0.07) | \$ 0.01 | \$ (0.12) |
| Diluted net loss per share | \$ (0.02) | \$ (0.04) | \$ (0.07) | \$ 0.01 | \$ (0.12) |

Year Ended December 31, 2001

| | First | Second | Third | Fourth | Total |
|--------------------------------------|------------|-----------|-----------|-----------|------------|
| Revenues | \$ 1,628 | \$ 1,871 | \$ 2,114 | \$ 2,355 | \$ 7,968 |
| Gross profit | \$ 1,344 | \$ 1,511 | \$ 1,642 | \$ 2,044 | \$ 6,541 |
| Loss from operations | \$ (1,221) | \$ (906) | \$ (705) | \$ (455) | \$ (3,287) |
| Net loss | \$ (1,258) | \$ (949) | \$ (785) | \$ (489) | \$ (3,481) |
| Basic and diluted net loss per share | \$ (0.16) | \$ (0.12) | \$ (0.10) | \$ (0.06) | \$ (0.43) |

(12) Valuation and qualifying accounts (in thousands)

| Accounts receivable reserves: | Balance at Beginning of Year | Additions | | Deductions | Balance at End of Year |
|-------------------------------|------------------------------|-------------------------------|---------------------------|-------------|------------------------|
| | | Charged to Costs and Expenses | Charged to Other Accounts | | |
| December 31, 2002 | \$ 53 | \$ (20) | \$ | \$ (18)(1) | \$ 15 |
| December 31, 2001 | \$ 663 | \$ (229) | \$ | \$ (381)(1) | \$ 53 |
| December 31, 2000 | \$ 1,042 | \$ 583 | \$ | \$ (962)(1) | \$ 663 |

(1) Uncollectible accounts written off, net of recoveries.

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