



2002 Annual Report

Dear Fellow Investors,

In 2002, Wave Systems continued to progress with its vision and industry position as a leading innovator in the field of trusted computing systems and services, even as we were faced with the persistent global slowdown in technology markets. Our progress reflects the substantial investments we have made to develop and introduce trusted computing services and infrastructure, an approach that is now being embraced by leading companies in the technology industry. The progress made also underscores our company-wide commitment to ensuring our commercial vision is realized.

Wave's Trusted Computing Vision is Embraced by Industry Leaders

Influential companies including IBM, Microsoft, Intel, Hewlett-Packard, AMD, National Semiconductor and Infineon Technologies made historic commitments in 2002 to hardware-based trusted computing through the creation of the Trusted Computing Group. Earlier, the Trusted Computing Platform Alliance (TPCA) defined a semiconductor device known as the Trusted Platform Module (TPM) to serve as a root of trust for the PC platform. The Trusted Computing Group has adopted the TPCA specifications and is now positioned to drive a broader set of trustworthy computing initiatives across multiple platforms aimed at unleashing the next generation of Internet opportunities.

Wave Systems conceptualized and developed many of the key elements of a comprehensive trusted computing eco-system with its EMBASSY® Trust System. The EMBASSY Trust System introduced the industry's first architecture for an open, programmable security solution supporting multiple trusted services and applications in a shared platform. As a leader in delivering trusted computing applications, services, and infrastructures across multiple trusted platforms, Wave's business objective is to prioritize and exploit its unique portfolio of assets based on the industry's accelerating adoption of trusted computing. Today, through a growing range of strategic relationships with major industry leaders, Wave is delivering its EMBASSY Trust Suite of applications and services, first to enterprises and eventually across all customer segments. Supporting the growing deployment of TPM enabled platforms from multiple OEMs, the EMBASSY Trust Suite will evolve to help drive the broader industry trusted computing initiatives for creating services-rich computing platforms.

EMBASSY Trust Suite – Wave's Service Delivery Model

Wave has identified the need for an initial set of enterprise applications and services for the corporate desktop and mobile platforms to help initialize trustworthy computing. The company has developed the EMBASSY Trust Suite as a core set of secure client applications and infrastructure services that introduce the user to trusted applications in a manner that is intuitive and simple, yet provides tangible value. The suite is capable of directing the IT manager or corporate user to new offerings of secure services as they become available, ensuring that the corporate environment is always providing the greatest level of security and usability to the user community. The EMBASSY Trust Suite provides the industry's only multi-vendor TPM based applications.

By adhering to a standards and cross-platform-based approach to trusted computing, Wave plans to assist its customers with evolutionary growth relying on broadly supported industry initiatives. This philosophy will allow the enterprise users to leverage their training and knowledge to not only be productive, but also to be secure, as they embark on the digital commerce revolution which awaits the availability of trusted computing platforms. Wave's ongoing commitment and pioneering role in helping to define hardware and services-secured trusted computing have put us in an anchor position in the evolution of this substantial market opportunity.

Throughout our history, we have continually fine-tuned our strategy, goals and tactics to best leverage the shifting currents within the industry. Our ability to exploit trusted platform modules (TPMs) now being announced and deployed by PC OEMs is an example of Wave's capability of quickly adapting its inventory of trusted computing assets to capture the emerging market opportunities. This was accomplished by utilizing the open, flexible EMBASSY system architecture to secure a key license agreement with National Semiconductor that we expect to begin to generate license revenue in the later half of 2003. We have also made excellent progress in developing very important joint marketing and technology relationships with other chip providers including Germany's Infineon as well as multiple additional TCG companies.

National Semiconductor

Building on important work done in 2002, in March 2003 Wave entered a licensing agreement with National Semiconductor to bundle Wave's EMBASSY® Trust Suite of applications and services with National's SafeKeeper™ TPMs. National's TPMs are expected to commence shipments in the latter half of calendar 2003, at which point Wave will be entitled to per-unit license fees on each TPM shipped. Wave's solution, when combined with National's SafeKeeper technology, provides PC platforms with a suite of secure services, privacy options and applications that add value and new revenue opportunities to the PC platform. Given that our business model is principally focused not

on chip sales but on applications and services, it is significant that National chose our services suite for bundling with its TPM shipments.

Trusted Computing in Europe

The year 2002 was highlighted by a significant new market introduction for Wave Systems as we initiated a launch of our technology in consumer PCs in Europe. The debut of trusted consumer PCs was accomplished with our partner NEC Computers International (NEC CI), Europe's fifth largest manufacturer of personal computers, via their Packard Bell brand, Europe's home PC leader in 2001.

Wavexpress

In mid-November, our Wavexpress subsidiary launched TVTonic.com, a broadband content delivery service that delivers full-screen, DVD-quality video content and a "no-wait" user experience to consumer and enterprise PCs. Since the launch, Wavexpress has continued to expand the range of content on the TVTonic.com service, including news from The Associated Press; motion picture previews and interviews via Hollywood.com and French cultural and entertainment programming produced in conjunction with Paris Première International.

Extending the revenue potential from Wavexpress's proprietary technologies, in May 2003 Wavexpress packaged its unique technology into a product form and launched TVTonic Direct, aimed at film, television and entertainment companies seeking to improve the quality and presentation of their online video content. Wavexpress is also targeting enterprise applications such as distance learning and corporate communications. While it is still a little early to accurately assess market demand, we believe that with the rapid evolution of the Internet that it is inevitable that online users will come to expect TV-quality video, causing content owners to seek efficient distribution solutions such as ours to efficiently accomplish what is an enormous and highly complex function.

While the formation of Wavexpress was intended to leverage core Wave technologies, the company has taken on an exciting life of its own, now led by Wave's co-founder and former Chairman, Peter Sprague. Given its unique technology and service offerings, combined with increasing challenges in sourcing working capital, we now look to Wavexpress to become an independently-funded entity. Accordingly, we have charged Peter and his team to pursue both revenue and investment in order to fully support Wavexpress' capital requirements. We are very pleased with the progress being achieved to date.

In taking on Wavexpress as his full-time charge, Peter has resigned from his position as Chairman of Wave Systems. We thank Peter for his tremendous dedication and leadership over the past fifteen years and look to his irrepressible creativity and innovation to be important catalysts at Wavexpress.

SignOnline

Wave's SignOnline unit made steady progress in 2002 with the introduction of the SignOnline eSign Transaction Management (eTM) Suite to allow organizations to manage business processes and digital transactions entirely online. With this capability, the newly named eSign Solutions partnered with the Comodo Group to offer solutions for managing processes and transactions securely online. Comodo offers X509 certificate services to enterprises. Comodo is reselling Wave's eTM Suite portfolio as a part of their growing range of products, services and applications. This summer eTM Suite v3.0 supporting key new government and industry standards will be delivered. Marketing programs in finance, insurance, mortgage, healthcare and government with key business partners and reseller channels is aimed at achieving financial independence of this business unit.

In Conclusion

No annual review would be complete without our sincere thanks to our very talented and committed group of employees and partners who work tirelessly in supporting Wave to achieve its goals. We also thank our patient and loyal shareholders for their continued support of our vision, goals and progress. As the pioneering company in trusted computing, we continue to target major opportunities that we believe have the potential to add substantial shareholder value, and we appreciate your confidence and patience. We look forward to updating you on our continued progress.

Sincerely,



Steven K. Sprague
President and Chief Executive Officer
June 12, 2003

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

FORM 10-K/A

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

For the fiscal year ended December 31, 2002

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

For the transition period from _____ to _____

Commission File Number 0-24752

Wave Systems Corp.

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

13-3477246
(I.R.S. Employer
Identification No.)

480 Pleasant Street
Lee, Massachusetts
(Address of principal executive offices)

01238
(Zip Code)

413-243-1600

(Registrant's telephone number, including area code)

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, \$.01 par value
(Title of Class)

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

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). YES NO

The aggregate market value of the shares of Common Stock of the registrant held by non-affiliates as of March 31, 2003 was \$54,254,603 (For purposes of this calculation, the market value of a share of Class B Common Stock was assumed to be the same as a share of Class A Common Stock, into which it is convertible.)

As of June 12, 2003 there were 51,781,918 shares of the registrant's Class A Common Stock and 314,225 shares of the registrant's Class B Common Stock outstanding.

EXCEPT FOR HISTORICAL INFORMATION CONTAINED HEREIN, THIS FORM 10-K CONTAINS FORWARD-LOOKING STATEMENTS WITHIN THE MEANING OF THE U.S. SECURITIES LITIGATION REFORM ACT OF 1995. THESE STATEMENTS INVOLVE KNOWN AND UNKNOWN RISKS AND UNCERTAINTIES THAT MAY CAUSE WAVE'S ACTUAL RESULTS OR OUTCOMES TO BE MATERIALLY DIFFERENT FROM THOSE ANTICIPATED AND DISCUSSED HEREIN. FURTHER, WAVE OPERATES IN AN INDUSTRY SECTOR WHERE SECURITIES VALUES MAY BE VOLATILE AND MAY BE INFLUENCED BY REGULATORY AND OTHER FACTORS BEYOND WAVE'S CONTROL. IMPORTANT FACTORS THAT WAVE BELIEVES MIGHT CAUSE SUCH DIFFERENCES ARE DISCUSSED IN THE CAUTIONARY STATEMENTS ACCOMPANYING THE FORWARD-LOOKING STATEMENTS AND IN THE RISK FACTORS DETAILED IN WAVE'S OTHER FILINGS WITH THE COMMISSION DURING THE PAST 12 MONTHS. IN ASSESSING FORWARD-LOOKING STATEMENTS CONTAINED HEREIN, READERS ARE URGED TO READ CAREFULLY ALL RISK FACTORS AND CAUTIONARY STATEMENTS CONTAINED IN THIS FORM 10-K AND IN THOSE OTHER FILINGS WITH THE COMMISSION.

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PART I

Item 1. Business

Wave Systems Corp., a development stage company, develops, produces and markets hardware and software based digital security products for the Internet and e-commerce. Wave's operations to date have consisted primarily of product development; performance under contract to develop products and preliminary marketing. Wave's most significant customer contract was cancelled earlier this year. We have not successfully completed commercial marketing of the products that our business model relies upon.

Wave's technology involves the use of encryption, which is the process of making data indecipherable. At the heart of Wave's technology is the EMBASSY (EMBEDDED APPLICATION SECURITY SYSTEM) Trust System (the "ETS"). The ETS is a combination of client hardware and software and a back-office infrastructure that manages its security functions. The client hardware consists of the EMBASSY 2100 security chip (the "EMBASSY chip"). EMBASSY chips may be embedded in such user devices as computer keyboards, smart card readers, PC motherboards, PC and/or cable modems, personal digital assistants, cable set-top boxes and potentially a wide variety of other user devices. The EMBASSY chip is used to securely store the user's personal information such as usernames, passwords, personal identification numbers, credit card information and personal information such as social security number, name and address. In addition, the EMBASSY system stores encrypted software applications that can be called upon to perform a variety of secure functions such as strong authentication, e-commerce and digital rights management, electronic payments, metering of digital content and other functions.

Wave has not realized any significant revenues since we began our operations in 1988. We do not expect to begin to realize significant revenues until the latter part of 2003, or until we are successful with our strategy which is to achieve broad market acceptance of our technology as a standard platform for hardware based trusted computing. Revenues have been nominal in relation to our expenditures due to the highly complex nature of the technology that we are developing and the early stage nature of the market for products that utilize this technology. As a result, we have experienced a slow pattern of corporate development. As of December 31, 2002, we have working capital of approximately \$8.8 million. Considering our current cash balance and Wave's projected operating cash requirements, we anticipate that we will need \$11 million of additional cash to satisfy our current forecasted cash flow requirements for the twelve-month period ending December 31, 2003. In addition to what we are forecasting in gross margins for fiscal 2003, we estimate having to raise a minimum of approximately \$5 million in capital, in order to fund our operations through 2003. However, if we are unable to achieve the revenue targets in our business plan, the amount of capital that we will need to raise will be greater. In order to raise the additional cash required for Wave's operations, Wave has engaged an investment banking firm and is exploring a number of financing alternatives which include debt or equity financing (or a combination of both) or one or more commercial or strategic transactions. In the event that we are successful in executing this business plan for 2003, we will need to begin to generate sufficient sales to fund operations in future years, or we will be required to raise additional capital to continue beyond 2003. Due to our current cash position, our capital needs over the next year and beyond, the fact that we have not at this time secured additional financing and uncertainty as to whether we will achieve our sales forecast of our products and services, substantial doubt exists with respect to our ability to continue as a going concern.

EMBASSY Products and Services

The ETS has been designed to combine the security strength of hardware, with the flexibility of software, providing a distributed, open and fully programmable platform. Wave believes the flexibility of the ETS positions it to exploit future revenue opportunities as privacy and security requirements evolve and change. This flexibility allows EMBASSY to fulfill developing security requirements, while addressing a broad range of advanced applications such as content protection, user managed privacy, strong authentication of user identities, and distributed e-commerce. While single function security solutions are available, the architecture achieved by EMBASSY provides the capability for multiple entities, such as service providers, content owners and individuals to share a single device while trusting that their individual interests have been strongly protected from both local and network sources of attack.

Products that make up the ETS include hardware and software. The hardware products that make up this product group are the EMBASSY chip and secure user input devices such as EMBASSY Smart Card Readers and EMBASSY Smart Card Reader Keyboards. These devices are being marketed to PC manufacturers as part of Wave's Trusted PC product that combines a smartcard reader or keyboard with security software applications. In addition Wave offers a Hardware Developer's Kit and an Applet Developer's Kit that are used by device manufacturers to develop EMBASSY enabled hardware products and software developers to write EMBASSY

enabled software applications. The software products included in this product group are the Trust Assurance Network, which is the back office security infrastructure of the ETS, and Assistant, a client interface that allows the user to securely enter and store, their personal and financial data, personal identification numbers, passwords, digital certificates and other information that requires security. Wave also has several products within this category that are in various stages of development including its Cyber-Comm applet; a secure French banking application that runs on an EMBASSY chip, FINREAD; a JAVA interface for online transactions and Trusted Computing Platform Alliance (“TCPA”) Services; security applications that run on other chip manufacturers’ security chips known as Trusted Platform Modules (“TPM’s”). Expected planned technology development costs to complete these products are approximately \$4,500,000. However, we will continue to expend a significant amount of funds in the business development, marketing and sales areas in an effort to promote the market acceptance of these products.

Wave Commerce System

The Wave Commerce System (the “Commerce System”) comprises two main functions: authentication and commerce. Each of these functions provides multiple services enabled by the ETS. The authentication services component positively identifies the person wishing to access protected content. It accomplishes this through a protected applet in conjunction with the EMBASSY device. The goal of the Commerce System is to provide digital commerce, completely secure from unauthorized access. Web site owners would use authentication services to replace less secure username/password pairs with strong authentication. Content providers use commerce services to distribute digital content. The Commerce System allows flexible purchase models for the sale of digital content including rental, rent-to-own and event-based charges. This is accomplished using programs that decrypt the encrypted content to allow the user access on a time specific basis. This means that content, goods and services can be consumed with more efficient and flexible pricing, broader distribution opportunities and greater protection against unauthorized usage, with better privacy protection of the consumer's sensitive information.

The Commerce System consists of the Wavemeter, a chip that performs metering and security functions at the client level and the Wavenet back-office (“Wavenet”). Wavenet is a network of servers that supply full e-commerce functions, customer relationship management tools, security capabilities and digital rights management. Wavenet is transparent to the consumer. All of the account specific commerce functionality occurs at the user’s personal computer containing an EMBASSY device. Wavenet provides the back-office capabilities that support the following capabilities: content protection, content use metering, micro-transactions, Internet based communities, Internet based strong authentication and e-commerce. Development of these products is complete with respect to their current versions, although development work for new features and functionality may be required. Presently, no further development work is planned with respect to this product group.

Digital Signature and Electronic Document Management

On October 4, 2001 Wave acquired digital signature and electronic document management technology, SmartSignature and SmartSAFE from SignOnLine, Inc. (“SignOnLine”), a California-based company. This group now consists of four core products: SmartIdentity, SmartSignature, SmartSAFE and SmartConnect. SmartSignature Version 3.0 is a digital signature application that connects signers and institutions – banks, insurance companies, enterprises etc. – through a legally binding digital signature. SmartSAFE Version 3.0 is a web-based document management application where signed documents are archived and tracked. SmartSAFE provides an easy to use environment where a client institution can view, manage, store and transfer sensitive signed and unsigned documents. SmartSAFE also supports archival and management of unsigned documents in virtually any format. These products allow a document to be executed, verified, accepted and filed in minutes at a lower cost compared to traditional documentation methods. SmartSignature Version 3.0 and SmartSAFE Version 3.0 have been completed and Wave has commercially released these products in the first quarter of 2003. Additional development work for enhancements to these products has also commenced during the first quarter of 2003. SmartIdentity, an optional service to verify a signer’s identity through strong authentication methods, including issuing encrypted digital certificates based on public key infrastructure technology, is substantially complete and ready for release in the second quarter of 2003. Expected costs to complete development of the product enhancements referred to above are approximately \$300,000.

Data Broadcast

Wave offers its data broadcast products through WaveXpress Inc. (“WaveXpress”), a joint venture between Wave and Sarnoff Corporation. The joint venture was established on October 15, 1999.

Under the joint venture agreement, Sarnoff and its affiliates received a 40% equity stake in WaveXpress. Wave received a 53% equity interest; and its affiliates, who purchased founders stock in April 1999 for a nominal amount, owned the remaining 7% of the outstanding capital stock. The affiliates of Wave include Peter Sprague; former Chairman of Wave and Steven Sprague; Chief Executive Officer of Wave, certain members of the Board of Directors of Wave and certain Wave employees. WaveXpress' TVTonic software is designed to offer cable television multiple service operators ("MSOs") a complete solution for implementing Internet Protocol Multicast that allows the consumer to experience and manage rich digital content on their PC. TVTonic, which consists of a customized browser that allows a user to view and manage rich digital content, server applications that broadcast this content to the users, and administrative functions used for billing and tracking of usage, is being actively marketed to MSOs. Wave believes the benefits of this product to MSOs include: new incremental revenue streams from dormant, underutilized and off-peak bandwidth, service bundling opportunities, flexible content and pricing offerings, strength of the ETS security products and an advanced consumer experience. The product has been released on a trial basis to Internet users, however significant development is planned for the product to add additional features and functionality. Planned future development expenditures are expected to approximate \$1,000,000. As of December 31, 2002, Wave owned 69% of WaveXpress and Sarnoff owned 26%.

Wave was incorporated in Delaware under the name Indata Corp. on August 12, 1988. We changed our name to Cryptologics International, Inc. on December 4, 1989. We changed our name again to Wave Systems Corp. on January 22, 1993. Our principal executive offices are located at 480 Pleasant Street, Lee, Massachusetts 01238 and our telephone number is (413) 243-1600.

Wave, as well as WaveXpress, is a development stage company and has realized minimal operating revenues since our inception. Substantially all of Wave's revenues in each of the three years ended December 31, 2002 have been related to the ETS. For the years ended December 31, 2002, 2001, and 2000 Wave incurred losses to common shareholders of approximately \$43,467,000, \$48,701,000, and \$47,656,000, respectively. At December 31, 2002 we had an accumulated deficit of approximately \$233,092,000. There can be no assurance that we will ever be successful in achieving commercial acceptance of our products and services.

Markets and Business Strategy

Software has traditionally secured critical information on networks and PCs and allowed for user access to various applications. However, virus attacks and breaches of security have proven that software, on its own, is not capable of completely securing a users' PC. Instead, hardware-based security is also needed to assure that data and access is strongly protected. Only when a PC is secured with technology that lies on the hardware platform (i.e. the processor, keyboard, etc), in effect creating a self-contained "lock-box" of security tolls within the computer itself, will the information stored on the platform be truly secure. Wave is seeking to become a leader in hardware based digital security and e-commerce technology. Our objective is to make our EMBASSY Trust System the preferred infrastructure for security in the digital economy. Key components in achieving this goal include:

Capitalizing on Security Industry Trends

Wave believes that a key differentiator of the ETS is that it is open and programmable and combines the strong security of hardware with the flexibility of software. Wave believes that ultimately, a truly secure system must include hardware protection. Additionally, Wave foresees that single purpose hardware solutions will not be effective as the hardware will have to support multiple applications to be an effective solution. Therefore, in a business environment of evolving encryption algorithms, multiple digital rights management solutions, multiple platforms needing to be supported; Wave's open and programmable, hardware based solution will have significant advantages over software only, or single purpose hardware device solutions.

Capitalizing on E-Commerce Industry Trends

Wave has designed the ETS with features and functionality that it believes uniquely positions its platform to capitalize on e-commerce issues and trends. Wave sees these issues and trends as follows:

- Rampant piracy of digital goods including music, video, software, and the need for digital goods providers to securely distribute their content and prevent theft
- Mass media broadcast networks merging with the internet
- Rapid development of new business and distribution models
- Lack of adequate security for e-commerce and vulnerability to attacks
- Major privacy concerns

- Convergence of consumer electronics and PC's
- Legal status of digital identities and digital signatures
- Increased focus on security and privacy by government entities

Wave will continue to pursue strategic relationships with hardware manufacturers, systems integrators and companies involved in the development of commerce in electronic content and services to achieve broad market acceptance of its products as a distributed security platform for commerce performed in user devices.

Pursue Strategic Marketing and Distribution Alliances

We intend to continue to enter into strategic alliances with key partners that could distribute our products in enterprise, government and consumer markets, and to build upon our alliances with such industry leaders as Samsung Electro-Mechanics Co., Ltd, Maximus, and NEC Computers International. In addition, we are engaged in strategic activities with semi-conductor manufacturers National Semiconductor and Infineon Technologies to deploy EMBASSY services on their TCPA compliant TPMs.

Enhancing our Current Product Offerings and Products in Development

We intend to continue to develop and extend our existing product offerings to include features and functionality that will satisfy the changing needs in the computer security arena and the computing and e-commerce industries in general. Planned development efforts that enhance or utilize existing technologies include building upon and enhancing our Trusted PC product (a product being jointly marketed with NEC Computers International to consumers that bundles an NEC PC with an EMBASSY enabled device such as a smart card reader or smart card reader keyboard to deliver applications to make the PC more secure), the packaging of existing EMBASSY applications in an effort to license these applications to developers of TCPA compliant TPM's and to continue development efforts towards standards-based security platforms (such as the European Transactional IC Card Reader standard, FINREAD). We also intend to continue to develop enhancements to SmartSignature and SmartSAFE products that we acquired (see "Digital Signature and Electronic Document Management" above) and we have initiated development of enhancements to launch WaveXpress' TVTonic as an enterprise application. New products that Wave is planning on developing over the ensuing period will consist primarily of new TCPA software applications for generic non-EMBASSY TPM's. These development efforts will likely be significant, and Wave intends to expend a substantial portion of its research and development resources towards these enhancements as well as significant marketing and corporate development funds to introduce the products and build market demand. As a result, although Wave has reduced its research and development expenditures in 2002, the continued research and development efforts will require substantial capital resources, which will likely necessitate the need for further funding so that Wave may ultimately be able to capitalize on the future market opportunities for its products and services. It is expected that these product enhancements and new product development activities will continue, for at least until the end of calendar year 2003.

Marketing, Sales and Customers

Because Wave's technology involves a new approach to conducting business and exchanging information using computer systems, as it will require that traditional software-based security be replaced with next generation hardware-based security, intensive marketing and sales efforts have been and will continue to be necessary in order to increase recognition of and generate demand for products using Wave's technology, and to ensure that Wave's solution is accepted in this emerging market.

Wave's business model targets revenues from various sources including: licensing of our technology including EMBASSY and its supporting software infrastructure; fees from entities who use EMBASSY to secure their applets on PCs; and usage and transaction-based fees from content management, e-commerce and other services enabled by EMBASSY. In addition, we derive revenue from outright sales of hardware and development contracts.

Wave has identified four key markets where we believe the EMBASSY Trust System provides unique benefits:

- Banking and Finance - in addition to our European initiatives to be a leader in delivering FINREAD-standard devices, we are aggressively cultivating interest and support from U.S. financial institutions.
- Broadband Media - through our WaveXpress joint venture, we are developing a broadband architecture for persistent protection of content to the hard disk at home.

- PCs - Wave-sponsored market research strongly confirms the existence of substantial consumer demand for PC trust and security and a willingness to pay for such features. We are aggressively targeting a PC manufacturer deployment opportunity.
- Government and Enterprise - the market for electronic security systems in governmental units and large business enterprises is growing and Wave believes this market represents a key opportunity.

Directly and through our partners, Wave is aggressively targeting opportunities in these markets, as we believe the ETS provides a wide range of security and trust capabilities not offered in any other single solution.

The following is a list of Wave's customers that made up 10% of revenue or greater, including the type of sale and market segment :

<u>Customer</u>	<u>Product or Service Sold</u>	<u>Market Segment</u>	<u>Percentage of Total Revenue in 2002</u>
SSP Solutions, Inc.	Development contract	Government	44%
CIBC World Markets Corp.USA	Services contract	Banking and Finance	21%
BV Hagenuk CPS	Hardware	Device Manufacturer	14%

Wave does not anticipate significant recurring sales from the customers identified above. All of our Sales were derived from within our ETS product group.

Our sales force will focus on business development opportunities in these key markets and others. Within these key markets we will focus on closing business with large systems integrators, financial institutions, Cable MSOs, personal computer manufacturers, and government and enterprise customers.

Backlog

Wave's backlog as of December 31, 2002 and December 31, 2001 totaled \$0 and \$243,000, respectively. Wave's backlog as of December 31, 2001 consisted of hardware sales and development contract revenue that was recognized in 2002. Backlog can fluctuate greatly based upon, among other matters, the timing and receipt of orders. Therefore, backlog may not represent a fair indication of future business trends.

Competition

We operate in a highly competitive and fragmented environment that is characterized by rapidly evolving technology. Many of our competitors and potential competitors have substantially greater financial, technical and marketing resources than us. Also, many current and potential competitors have greater name recognition and more extensive customer bases that could be leveraged, thereby they can gain market share or product acceptance to our detriment. In addition, the rate of market acceptance of content protection solutions has remained slow. The markets for our products are developing and have not yet established clearly defined industry standards. Wave's primary competitors include security solutions providers such as Checkpoint Software Technologies Ltd, Verisign, Inc., RSA Security, Inc., Aladdin Knowledge Systems, Inc. and Baltimore Technologies plc as well as digital certificate authorities including Geotrust, Inc. and Entrust, Inc. In addition we compete with manufacturers of secure input devices including SCM Microsystems, Inc., Covadis SA and SafeNet, Inc.

The competitive factors defining these evolving markets include product performance, compatibility, standards compliance, quality and reliability, ease of use, client services and support, distribution and price. Wave believes its products meet the requirements to be successful viable products in these markets. Wave's features that should allow its products to compete favorably include product differentiation of a combined software/hardware solution, system integrity, secure communication, fault tolerance, data privacy, and independent customer operation. In addition, Wave may have the opportunity to be "first to market" with its data broadcasting and digital signature products.

One of the market challenges facing Wave is the establishment of a newly defined market category for multifunction security devices that includes a more complex business model for adoption. While Wave has developed a very complex cryptographic system that required significant skills and resources, the market for security solutions that are as complex as those developed by Wave has not materialized. As a result, Wave has been unable to commercialize the technology it has developed. It is also possible for other competitors to develop similar offerings to compete with the ETS, or new technologies may emerge that could

replace existing technology that our products rely on, thereby making our products non-competitive or obsolete. We can offer no assurances that Wave's products will become industry standards or become widely accepted by the marketplace.

International Market

Most of our products and many components of the ETS are controlled under various United States export control laws and regulations and may require export licenses for certain exports of the products and components outside of the United States and Canada. We have received full export license from the U.S. Department of Commerce for the sale and export of our single-key Data Encryption Standard ("DES") products. We have also received an export license for our triple-key DES chips under the provisions of License Exceptions KMI or ECN, granted by the Bureau of Export Administration of the U.S. Department of Commerce ("BXA"). The remainder of our products and components of the ETS are generally exportable to any end-user in any country throughout the world with the exception of Cuba, Iran, Iraq, Libya, North Korea, Sudan and Syria.

We can provide no assurance that we will have patent protection or that we will not infringe patents of other parties in foreign jurisdictions. Because electronic monitoring and the transmission of audited usage and financial information on end users or payment instructions may be subject to varying statutory or regulatory controls in foreign jurisdictions, the use of all portions of the ETS may not be permitted in any particular foreign jurisdiction.

Proprietary Rights and Licenses and Intellectual Property

Our success depends, in part, on our ability to enjoy or obtain protection for our products and technologies under United States and foreign patent laws, copyright laws and other intellectual property laws, to preserve our trade secrets and to operate without infringing the proprietary rights of third parties. Any issued patent owned or licensed by us may not, however, afford adequate protection to us and may be challenged, invalidated, infringed upon or circumvented. Furthermore, you should understand that our activities may infringe upon patents owned by others.

In addition, we may be required to obtain licenses to patents or other proprietary rights of other parties. Licenses required under any such patents or proprietary rights may not be made available on terms acceptable to us, if at all. If we are required to and do not obtain such licenses, we would be prevented from or encounter delays in the development and marketing of our products and technologies while we attempt to design around such patents or other rights. Such attempts may not be successful. Failure to obtain such licenses or to design around such patents or other rights would have a material adverse effect on us.

We hold non-exclusive patent rights relating to the metered use of encrypted data in local memory under a limited license from Titan Corporation to a patent jointly held by Titan and a third party (the "Licensed Patent"). This license agreement restricts us from metering information produced and used solely by a government entity or producing products that meter this information. In addition, this license agreement is subject to the rights of the joint owners of this patent, who have the right to exploit, or to license this patent to third parties in a manner that may be competitive with us. The joint owners of this patent may compete with us or license this patent to a competitor of ours, or our business may exceed the scope of this license agreement. Pursuant to this license agreement, we are obligated to pay certain royalties to Titan. Pursuant to this license agreement, we have granted to Titan the exclusive right to use our patents for products distributed to government entities. On February 28, 1997 Wave and Titan executed an addendum to this license agreement whereby we received a sole license to this patent to develop and distribute products to the in-home consumer microcomputer market segment. Under this addendum to this license agreement, Titan waived any and all defaults by us under this license agreement occurring prior to February 28, 1997.

We are aware of four United States patents (the "Third Party Patents") each having some claims that are similar to some of the claims in the Licensed Patent. Based upon information currently known to us, some of the claims of both the Licensed Patent and the Third Party Patents cover certain material aspects of our technology. Therefore, the commercialization of our technology would be subject to the rights of the holder of the Third Party Patents unless we are able to invalidate such claims or license such technology. Also, the holder of the Third Party Patents or a licensee of the Third Party Patents could seek to invalidate such claims of the Licensed Patent and therefore be able to commercialize a technology similar to our technology. In either case, in order to invalidate the other party's patent rights, the party claiming invalidity might need to prove that it invented the claimed subject matter prior to the other party. We cannot provide any assurance that we would be successful in invalidating such claims of the Third Party Patents or that the holder of the Third Party Patents or a licensee of the Third Party Patents would not be successful in invalidating the claims of the Licensed Patent. Furthermore, we cannot provide any assurance that the Third Party Patents

could be proven to be invalid on any other basis. Any proceeding involving the validity of the Licensed Patent and the Third Party Patents would be protracted and costly. In any suit contesting the validity of a patent, the patent being contested would be entitled to a presumption of validity and the contesting party would be required to demonstrate invalidity of such patent by clear and convincing evidence.

If the Third Party Patents are not invalid insofar as their claims relate to our technology, then we would require a license from the holder of the Third Party Patents to commercialize our technology and make, use, or sell products or practice methods, or license others to sell products or use methods, utilizing this technology in the United States. Due to the uncertainty as to whether the Third Party Patents could be proved to be invalid, we engaged in negotiations with the holder of the Third Party Patents to obtain a license under the Third Party Patents. As a result of these negotiations, Wave has entered into a license of limited rights to use the Third Party Patents in connection with certain uses. Wave did not obtain, however, a general license to use such patents in connection with activities not connected with the licensor.

Wave has been issued eleven (11) United States patents relating to encryption and to our proprietary EMBASSY and Wave Commerce technology. We also have six (6) patents pending before the United States Patent Office. In addition, we have filed foreign patent applications for seven patents. Our patents are material to protecting some of our technology.

Some of our patent rights derive from a license from Wave's former Chairman, Mr. Peter J. Sprague, of his rights in these patents, and several agreements with former officers regarding their rights in these patents. The license agreement with Mr. Sprague requires us to make royalty payments to him and Dr. John R. Michener, a former officer, in a total amount equal to two percent of gross revenues less certain adjustments. This royalty payment is apportioned 75 percent to Mr. Sprague and 25 percent to Dr. Michener. The payment of royalties is secured by a security interest in and to our patents. We believe that these agreements as a whole provide us with exclusive rights under our patents. There can be no assurance that we will enjoy exclusive rights to these patents under such agreements.

We rely on trade secrets and proprietary know-how, which we protect, in part, by confidentiality agreements with our employees and contract partners. However, we caution you that our confidentiality agreements may be breached and we may not have adequate remedies if such a breach occurs. Furthermore, we can provide no assurance that our trade secrets will not otherwise become known or be independently discovered by competitors.

We also rely on copyright law to prevent the unauthorized duplication of our software and hardware products. We have and will continue to protect our software and our copyright interest therein through agreements with our consultants. We can provide no assurance that copyright laws will adequately protect our technology.

We have registered trademark and service mark registrations with the United States Patent and Trademark Office for the marks WaveMeter and WaveNet, EMBASSY, Great Stuff Network, Second Shift (the Wave juggler logo), WaveCommerce, Wave Interactive Network, WaveDirect, WINPublish, WINPurchase, CablePC, iShopHere and Face/Eye logo (iShopHere.com face logo). We have submitted trademark registrations for, EMBASSY System, Netpass, CharityWave and Trust @ the Edge, Signon-line, Inc., Smartsignature, Smartsafe and others. Wave intends to apply for additional name and logo marks in the United States and foreign jurisdictions as appropriate. No assurance can be given that federal registration of any of these trademarks in the United States will be granted. We have abandoned our prior applications for DataWave, InfoWave, and WaveTrac.

Research and Development

Wave's products incorporate semiconductor, encryption/decryption, software transaction processing and other technologies in which we have made a substantial investment in research and development. We will likely be required to continue to make substantial investments in the design of trusted computing applications and services, including the EMBASSY trust platform, the Commerce System our SmartSignature and SmartSAFE products, and IP Multicasting products. For the years ended December 31, 2002, 2001, and 2000 we expended approximately \$12 million, \$17.7 million, and \$20.9 million, respectively, on research and development activities. Planned development expenditures for the year ended December 31, 2003 are expected to approximate \$9,000,000. A substantial portion of this expenditure will be used to package existing EMBASSY applications and developing new applications in an effort to license these applications to developers of TCPA compliant TPM's that compete with EMBASSY as a standard trust platform for secure computing. In addition, we continue to pursue deployment of EMBASSY in conjunction with the introduction by NEC Computers International of a trusted PC offering that utilizes the EMBASSY Smartcard reader and EMBASSY applications.

Recent Developments

Contract with SSP Solutions, Inc.

On September 30, 2002, Wave and SSP Solutions, Inc. executed a Termination Agreement and Mutual Release whereby Wave was issued an additional 1,600,000 shares of SSP Class A Common Stock and a \$270,000 non-negotiable, non-interest bearing, subordinated convertible promissory note due December 31, 2005 (the "Note") as a fee for the termination by SSP of a software development contract. In exchange, Wave was released from its obligation to provide any further services under the development contract as amended. The contract, entered into October of 2000, was originally for \$10 million to integrate Wave's EMBASSY Trusted Client technology into SSP's suite of products for deployment into 5 million digital set top boxes and integrated gateway products such as cable and DSL modems. It was subsequently amended in May of 2001, whereby the parties agreed to a \$5 million development services contract pursuant to which Wave agreed to port its EMBASSY platform to run in a Linux environment. In addition, SSP agreed to place with Wave an open \$5 million purchase order for EMBASSY products. Wave received \$555,556 in cash for payment of services performed pursuant to the contract. The shares that Wave received were recorded on its balance sheet at estimated fair value of \$1,680,000. A termination fee of \$1,680,000 was recognized in Wave's statement of operations in connection with this transaction.

On December 13, 2002 SSP exercised its right to convert the Note into 200,000 shares of SSP common stock. The 200,000 shares that Wave received from the Note conversion were initially recorded on the balance sheet at \$0.69 per share, for an aggregate value of \$138,000.

Acquisition of 60% of GlobalWave Ltd

On July 24, 2002 Wave issued 1,700,000 shares of its Class A Common Stock in exchange for 60% of the remaining assets of GlobalWave Ltd, a joint venture that was previously 40% owned by Wave, for a total purchase price of approximately \$2,244,000. The purchase of the 60% of the remaining assets of GlobalWave was accounted for as an acquisition of assets and not considered a business combination, as GlobalWave had effectively ceased operations prior to the acquisition. In exchange for the 1,700,000 shares, Wave received approximately \$1,380,000 in cash, tangible fixed assets of approximately \$9,000 and the exclusive rights under the licenses that it had previously sold to GlobalWave, which granted GlobalWave the exclusive right to commercialize the Wave Commerce System in Europe, the Middle East and Africa. Wave incurred a charge to operations representing the amount by which the purchase price exceeded the tangible assets that Wave received of approximately \$855,000. In addition, GlobalWave forgave its receivable from Wave of \$189,000. The net charge of approximately \$666,000 has been presented in the statement of operations for the year ended December 31, 2002 as an impairment charge of the acquired license. Wave assumed no liabilities as a result of this transaction.

Introduction of TCPA Compliant Products

During 2002, several manufacturers of semiconductors for the PC industry announced products that have the capability to function as TPM's that meet the TCPA standard for trusted computing. (Compaq Computer, Hewlett-Packard, IBM, Intel and Microsoft established the TCPA in an effort to define and promote trusted computing. The TCPA has over 170 member companies, from various technology sectors. The TCPA has defined a device known as the Trusted Platform Module (TPM), a device that offers protected storage, platform authentication, protected cryptographic processes and attestable state capabilities to provide the first level of trust for the computing platform.) The offering of these products by major suppliers of semiconductors to the PC market is an important development in the creation of the market for hardware based trusted computing. As a result of this development, Wave has begun executing a strategy to leverage the work it has done in developing a hardware trusted computing platform towards becoming a major developer of services to this market, the development of which is beginning to be driven by some of the major suppliers of semiconductors to the PC industry. Wave is actively pursuing business relationships with these companies in an effort to become a developer of applications that will be essential to the deployment of these new products, thereby creating a substantial new revenue opportunity for Wave. For example, we've engaged in joint promotional activities with both National Semiconductor and Infineon Technologies to promote each other's products and services and we have demonstrated the enabling of Wave's EMBASSY suite of secure services on both the National and Infineon TPM.

Employees

As of December 31, 2002, we employed 126 full-time employees, 49 of whom were involved in sales, marketing and administration and 77 of whom were involved in research and development (including 21

employed by WaveXpress, 6 of whom were in sales, marketing and administration and 15 of whom were involved in research and development.) As of December 31, 2002 we retained the services of 6 full-time consultants, 1 of whom was retained by WaveXpress. We believe our employee relations are satisfactory.

Item 2. Properties

Summarized below is a listing of properties leased by Wave. Our principal research and development activities are conducted at the Princeton and Cupertino facilities.

Facility	Sq. Ft.	Monthly Base Rent	Utility / Common Costs	Lease Expires
Lee, MA	16,548	\$ 8,356	\$ 4,247	Aug. 2004
New York, NY	4,500	7,500	0	Mar. 2003
Nashville, TN	5,757	3,512	545	Sept. 2003
Princeton, NJ	11,000	22,000	1,238	Jun. 2003
Cupertino, CA	10,028	14,039	8,019	Feb. 2008
New York, NY	7,169	25,360	4,936	Apr. 2006
Orvault, France	1,000	7,681	0	Sept. 2010

Item 3. Legal Proceedings

As of December 31, 2002 Wave was not involved in any material litigation, nor, to management's knowledge is any material litigation threatened against them or their properties other than routine litigation arising in the ordinary course of business.

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

None.

PART II

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

The Class A Common Stock trades on the Nasdaq National Market under the symbol "WAVX". The following table sets forth, for the periods indicated, the high and low closing sales prices per share for the Class A Common Stock. There is no established trading market for our Class B Common Stock.

	<u>High</u>	<u>Low</u>
Year Ended December 31, 2002		
First Quarter	\$2.92	\$1.58
Second Quarter	2.51	1.17
Third Quarter	2.08	1.18
Fourth Quarter	1.90	1.20
Year Ended December 31, 2001		
First Quarter	\$9.34	\$3.47
Second Quarter	5.37	3.26
Third Quarter	4.19	1.69
Fourth Quarter	3.48	1.52

As of March 20, 2003, there were approximately 28,000 holders of our Class A Common Stock. As of such date, there were 30 holders of our Class B Common Stock.

On March 20, 2003, the last sale price reported on the Nasdaq National Market for the Class A Common Stock was \$0.92.

We have never declared nor paid any cash dividends on our capital stock. We currently anticipate that we will retain all future earnings, if any, to fund the development and growth of our business and do not anticipate paying any cash dividends on our capital stock in the foreseeable future.

Item 6. Selected Financial Data

Statement of Operations Data

	Year-ended December 31,				
	2002	2001	2000	1999	1998
Revenues, Net	\$ 446,588	\$ 692,125	\$ 332,522	\$ 187,515	\$ 47,681
Cost of Sales	202,208	369,959	58,864	93,170	37,488
Gross Margin	<u>244,380</u>	<u>322,166</u>	<u>273,658</u>	<u>94,345</u>	<u>10,193</u>
Operating expenses:					
Selling, general and administrative.....	19,188,046	24,184,317	26,553,634	16,749,276	11,945,273
Research and development.....	12,009,713	17,691,051	20,866,055	10,697,971	6,247,105
Restructuring and other special charges	726,280	-	-	-	-
Acquisition Costs.....	-	-	-	1,494,000	-
Amortization of Goodwill.....	-	1,720,632	573,544	-	-
Write-off of Goodwill.....	-	2,284,570	-	-	-
Write-off Impaired Assets	1,571,031	1,761,917	-	-	-
In- Process Research & Development.....	-	-	2,176,000	-	-
	<u>33,495,070</u>	<u>47,642,487</u>	<u>50,169,233</u>	<u>28,941,247</u>	<u>18,192,378</u>
Other income (expense):					
ITG Technology License Fee..	-	-	-	1,250,000	2,750,000
License ITG Warrant Cost.....	-	-	-	-	(1,100,000)
Loss on Other than Temporary Decline in Equity Securities	(11,513,099)	(1,736,682)	-	-	-
Equity in net losses of GlobalWave.....	-	(2,332,159)	(3,406,491)	-	-
Gain on termination of development contract.....	1,818,000	-	-	-	-
Provision for loss on officer note receivable.....	(999,518)	-	-	-	-
Net interest and other income (expense).....	477,902	2,688,105	5,646,173	(455,670)	(53,842)
Net loss.....	<u>(43,467,405)</u>	<u>(48,701,057)</u>	<u>(47,655,893)</u>	<u>(28,052,572)</u>	<u>(16,586,027)</u>
Accrued dividends on preferred stock.....	-	-	-	13,239	108,863
Assured incremental yield.....	-	-	-	-	750,000
Net loss to common stockholders.....	<u>\$(43,467,405)</u>	<u>\$(48,701,057)</u>	<u>\$(47,655,893)</u>	<u>\$(28,065,811)</u>	<u>\$ (17,444,890)</u>
Weighted average number of common shares outstanding during the period.....	51,135,548	49,949,875	46,149,587	38,365,573	31,580,665
Loss per common share-basic and diluted.....	<u>\$ (0.85)</u>	<u>\$ (0.97)</u>	<u>\$ (1.03)</u>	<u>\$ (.73)</u>	<u>\$ (.55)</u>
Cash dividends declared per common share.....	-0-	-0-	-0-	-0-	-0-

See Notes to Financial Statements

Balance Sheet Data

	As of December 31				
	2002	2001	2000	1999	1998
Working capital (deficiency).	\$ 8,754,620	\$36,963,617	\$76,099,347	\$ 4,870,443	\$ (770,959)
Total assets.....	18,209,372	60,234,302	98,084,061	16,531,883	6,023,991
Long-term liabilities.....	-	-	-	-	-
Total Liabilities	3,667,533	6,428,896	7,870,009	6,823,643	5,289,634
Redeemable preferred stock..	-	-	-	-	493,201
Total stockholders' equity ...	\$14,541,839	\$53,805,406	\$90,214,452	\$ 9,708,240	\$ 241,156

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

Overview

Wave develops, produces and markets hardware and software based digital security products for the Internet and e-commerce. Since our inception in February of 1988, we have devoted substantially all of our efforts and resources to research, feasibility studies, design, development, and market testing of our products and technology. As our research and development activities matured, we have devoted increased resources to the creation of content distribution services, market development and the application of our technology to end-user products and services. However, the market for our products and services is still developing and is continually evolving. Wave's offering represents a highly complex architecture designed to solve many of the security issues currently present with e-commerce and with computer systems in general such as identity theft, fraudulent transactions, virus attacks, unauthorized access to restricted networks and other security problems that users of computer systems generally encounter. Moreover, Wave's technology involves a new approach to conducting business and exchanging information using computer systems and, as a result, intensive marketing and sales efforts have been and will continue to be necessary in order to generate demand for products using Wave's technology. From inception through December 31, 2002, we have realized only minimal operating revenues, and do not anticipate significant revenues until well into the next fiscal year. This is due to the early stage nature of market development for our products and services and the digital security industry as a whole. Wave expects to continue to incur substantial additional expenses associated with continued research and development and business development activities that will be necessary to commercialize our technology. This will likely result in significant losses for the foreseeable future. There are numerous risks that could adversely affect our efforts to achieve profitability.

For the years ended December 31 2002, 2001 and 2000 we have incurred approximately \$19.2 million, \$24.2 million, and \$26.6 million in selling, general and administrative expenses, respectively. The activities supported by these expenditures include business development, sales, marketing (including product development and product management), corporate communications and public relations, information technology and management information systems, human resources, accounting, executive management, corporate governance and general administrative functions. As we have evolved our technology and expanded upon our original product vision, the business development activities and cost of supporting those activities has grown considerably. This growth is attributable to our expansion, as we have branched out into different technologies such as developing data broadcast technology with the investment into WaveXpress, the development of our existing open programmable architecture which was accomplished in large part through our acquisition of N*ABLE Technologies, Inc. ("N*ABLE"), and our expansion into digital signature and electronic document management through our acquisition of SmartSignature and SmartSAFE. In addition, we have expanded internationally having made a significant investment in GlobalWave in an attempt to exploit overseas markets. The cost associated with supporting this expansion has been substantial and has added

significantly to our cash requirements over the past three years. Given the early stage nature of the markets for products that use our technology, we have expended and will continue to expend considerable resources, in the sales, marketing, business development and support activities referred to above that will be necessary for us to be successful in developing salable products and markets for our technology.

In June 2000, Wave increased its ownership percentage of GlobalWave, from 25% to 40%. On October 10, 2000, Wave entered into an agreement with GlobalWave and its Joint Venture partner Redwave, plc., formerly Internet Technology Group, plc. ("ITG"), to subscribe for additional shares to maintain a 40% ownership interest in the venture. As consideration for the additional shares, Wave committed to invest approximately \$5.7 million in cash and development services. Wave accounted for its investment in GlobalWave using the equity method of accounting, and accordingly recognized its share (40%) of GlobalWave's results of operations in the accompanying consolidated statement of operations, to the extent of its investment in GlobalWave of \$5.7 million. On July 24, 2002 Wave acquired the remaining 60% of Global Wave in exchange for 1,700,000 shares of its Class A Common Stock for a total purchase price of approximately \$2,244,000. The purchase of the 60% of the remaining assets of GlobalWave was accounted for as an acquisition of assets and not considered a business combination, as GlobalWave had effectively ceased operations prior to the acquisition. In exchange for the 1,700,000 shares, Wave received approximately \$1,380,000 in cash, tangible fixed assets of approximately \$9,000 and the exclusive rights under the licenses that it had previously sold to GlobalWave, which granted GlobalWave the exclusive right to commercialize the Wave Commerce System in Europe; the Middle East and Africa. Wave incurred a charge to operations representing the amount by which the purchase price exceeded the tangible assets that Wave received of approximately \$855,000. In addition, GlobalWave forgave its receivable from Wave of \$189,000. The net charge of approximately \$666,000 has been presented in the statement of operations for the quarter and year ended December 31, 2002 as an impairment charge of the acquired license. Wave assumed no liabilities as a result of this transaction.

On July 27, 1999, Wave completed the acquisition of N*ABLE, a security solutions company that produced hardware-based security solutions for the protection of sensitive user data within network client systems, including a hardware-based security co-processor that manages the secure transfer of payment or sensitive personal information to and from desktop computers. Wave paid the shareholders of N*ABLE total consideration of 2,280,821 shares of our Class A Common Stock (subject to certain post closing adjustments). The closing price per share as of the closing date was \$10.38. Founded in 1996, N*ABLE was located in Danvers, Massachusetts, with offices in Cupertino, California and Bouguenais, France. The transaction was accounted for under the pooling-of-interests method of accounting and the financial data in the Selected Financial Data table above and in the discussion below has been restated for all periods assuming the acquisition occurred on the first day of the first period presented.

In April 1999, WaveXpress, a joint venture between Wave and Sarnoff was established. For technology licensed to WaveXpress, Sarnoff and affiliates received a 40% equity stake in WaveXpress. Wave and its affiliates who purchased, for a nominal amount, founders stock in April 1999 owned the remaining 60% of the outstanding capital stock. The affiliates of Wave include Peter Sprague; Wave's former Chairman and Steven Sprague; Wave's Chief Executive Officer, of Wave, certain members of the Board of Directors of Wave and certain employees of Wave. This affiliate group owned, in the aggregate, 7% of the outstanding capital stock of WaveXpress. As of December 31, 2002, Wave owned 69% of WaveXpress while Sarnoff owned 26%. The equity interests of Wave, Sarnoff and all other shareholders including the employee stock option pool, assuming all of Wave's and Sarnoff's convertible securities are converted and warrants are exercised, would be approximately 83%, 7%, and 9 %, respectively. Under the terms of the joint venture agreement, Wave committed to provide a \$3,000,000 working capital loan to WaveXpress in the form of an unsecured convertible note, convertible into WaveXpress common stock. Wave has continued to fund WaveXpress through similar convertible notes and expects to continue to provide funding until an external round of funding can be attained. Through December 31, 2002, Wave has loaned approximately \$29.0 million in funds under these notes, of which \$9.5 million had been converted to shares of WaveXpress common stock as of December 31, 2002.

The financial statements of WaveXpress have been consolidated with those of Wave for the years ended December 31, 2002, 2001 and 2000. As the joint venture minority partners, Sarnoff and the Wave affiliates, have not contributed any cash and are not required to fund the operations of the joint venture, Wave has not recorded a minority interest in WaveXpress in the consolidated financial statements and therefore, has reflected 100% of WaveXpress' operating results in these consolidated financial statements.

The following discussion related to the consolidated financial statements of Wave should be read in conjunction with the financial statements appearing in Item 8.

Critical Accounting Policies

Wave's discussion and analysis of its financial condition and results of operations are based on the Company's consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements as well as the reported revenues and expenses during the reporting periods. On an ongoing basis, management evaluates its estimates and judgments, including those related to revenue recognition, accounts receivable reserves, marketable securities, valuation of long-lived and intangible assets accounting for joint ventures and software development. Management bases its estimates on historical experience and on various other factors that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying value of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

The following accounting policies are deemed critical to the understanding of the consolidated financial statements included under Item 8 - Financial Statements and Supplementary Data.

Method of Accounting for Joint Ventures - Wave accounts for its investments in joint ventures using the equity method of accounting when its ownership interest in the joint venture is less than fifty percent and it is determined that Wave has the ability to exercise significant influence over the joint venture's operating and financial policies. The financial statements of joint ventures in which Wave owns greater than a fifty percent interest are consolidated with Wave's financial statements pursuant to Accounting Principles Board ("APB") Opinion No. 18.

Marketable Securities - Investments, which consist solely of equity securities, are accounted for under Statement of Financial Accounting Standards (SFAS) No. 115, "Accounting for Certain Investments in Debt and Equity Securities" issued by the Financial Accounting Standards Board (FASB). Pursuant to the provisions of SFAS No. 115, investments are classified as "trading", "available-for sale" or "held to maturity". "Trading" securities are bought and held principally for the purpose of selling them in the near term and are recorded at fair value. Fair value is based upon quoted market prices. Unrealized gains and losses on trading securities are included in the determination of net earnings. "Available-for-sale" securities are being held for an unspecified period of time and may be used for liquidity or other corporate purposes and are recorded at fair value. Unrealized gains and losses on available-for-sale securities are reported as a separate component of comprehensive income (loss) in stockholders' equity. Unrealized losses that are determined to be other than temporary are recognized as charges against earnings. Factors considered when determining if an other than temporary decline has occurred include: whether a decline in market value is related to specific concerns of the issuer of the securities as opposed to general market conditions, the length of time of the decline in market price, the financial condition and near-term prospects of the issuer and other factors that may indicate that the value of the securities will not recover. "Held to maturity" securities are debt securities that are intended to be held to maturity and are recorded at amortized cost. As of December 31, 2002, all of Wave's investments have been classified as available-for-sale.

Inventories - Inventories, which are stated at the lower of cost or net realizable value, consist of inventory held for resale to customers. Cost is determined on the first-in, first-out basis and includes freight and other incidental costs incurred. Judgment is involved in evaluating backlog and in assessing the recoverability of inventory held at the balance sheet date. Wave provides inventory allowances based on the determination of excess and obsolete inventories as determined through the evaluation of future sales and changes in technology.

Research and Development and Software Development Costs - Research and development costs are expensed as incurred. Software development costs are accounted for pursuant to Statement of Financial Accounting Standards No. 86 "Accounting for the Costs of Computer Software to be Sold, Leased, or Otherwise Marketed" ("SFAS No. 86"). SFAS No. 86 specifies that costs incurred internally in creating a computer software product should be charged to expense when incurred as research and development costs until technological feasibility has been established for the product. Once technological feasibility is established and the product has achieved commercial marketability, all development costs should be capitalized until the product is available for general release to customers. We consider technological feasibility to be established upon completion of a detail program design for our SmartSignature and SmartSAFE product development. Judgment is required in determining when the technological feasibility of a product is established, if the product has achieved commercial marketability and in estimating the life of the product for which the capitalized costs will be amortized.

Impairment of Long-Lived Assets and Long-Lived Assets to Be Disposed Of - Wave reviews the valuation of long-lived assets, including property and equipment and capitalized software, under the provisions of SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" and SFAS No.86. Wave is required to assess the recoverability of long-lived assets and capitalized software costs whenever events and circumstances indicate that the carrying value may not be recoverable. Factors we consider important that could trigger an impairment review include the following:

- significant underperformance relative to expected historical or projected future operating results;
- significant changes in the manner of our use of the acquired assets or the strategy of our overall business;
- significant negative industry or economic trends; and
- significant decline in our stock price for a sustained period.

In accordance with SFAS No. 144, when we determine that the carrying value of applicable long-lived assets may not be recoverable based upon the existence of one or more of the above indicators of impairment, we evaluate whether the carrying amount of the asset exceeds the sum of the undiscounted cash flows expected to result from the use and eventual disposition of that asset. If such a circumstance exists, we would measure an impairment loss to the extent the carrying amount of the particular long-lived asset or group exceeds its fair value. We would determine the fair value based on a projected discounted cash flow method using a discount rate determined by our management to be commensurate with the risk inherent in our current business model. In accordance with SFAS No. 86, when we determine that the carrying value of certain other types of long-lived assets may not be recoverable we evaluate whether the unamortized cost exceeds the expected future net realizable value of the products. If the unamortized costs exceed the expected future net realizable value of the products, the excess amount is written off. Changes in judgments on any of these factors could impact the value of the asset being evaluated.

Wave adopted SFAS No. 144 during the first quarter of fiscal year2002 without a material impact on its financial position or results of operations.

Revenue Recognition - Wave's business model targets revenues from various sources including: licensing of our technology including EMBASSY and its supporting software infrastructure; fees from entities who use EMBASSY to secure their applets on PCs; and usage and transaction-based fees from content management, e-commerce and other services enabled by EMBASSY. In addition, we derive revenue from sales of hardware and from development contracts. To date, our sales arrangements have not included multiple-elements, nor have our arrangements required significant modification or customization of the software except for our contract with SSP Solutions for which we used the percentage of completion method of accounting that is described below.

Wave follows the provisions of statement of position "SOP" 97-2, *Software Revenue Recognition* as amended by SOP 98-9, Modification of SOP 97-2, *Software Revenue Recognition, with Respect to Certain Transactions*. Generally, Wave recognizes revenue when it is realized or realizable and earned. Wave considers revenue realized or realizable and earned when persuasive evidence of an arrangement exists, the product has been shipped or the services have been provided to the customer, the sales price is fixed or determinable and collectibility is reasonably assured. Wave reduces revenue for estimated customer returns, rotations and sales rebates when such amounts can be estimated. When these amounts cannot be estimated Wave defers revenue until the product is sold to the end-user. Revenue from software license agreements that have significant customizations and modification of the software product is deferred and recognized in a manner that approximates the percentage of completion method. In addition to the aforementioned general policy, the following are the specific revenue recognition policies for each major category of revenue.

PRODUCTS-SOFTWARE AND HARDWARE.

Revenue from delivered elements of one-time charge licensed software is recognized at the inception of the license term, provided Wave has vendor-specific objective evidence of the fair value of each undelivered element. Revenue is deferred for undelivered elements. Revenue is also deferred for the entire arrangement if vendor-specific objective evidence does not exist for each undelivered contract element. Examples of undelivered elements in which the timing of delivery is uncertain include contractual elements that give customers rights to any future upgrades at no additional charge or future maintenance that is provided within the overall price. The revenue that is deferred for any contract element is recognized when all of the revenue recognition criteria has been met for that element. However, it has not been our practice to provide periodic updates or maintenance to maintain system performance.

Revenue from the sale of hardware components is recognized when persuasive evidence of an arrangement exists, the product has been shipped to the customer, the sales price is fixed and determinable and collectivity is reasonably assured. All product is shipped with ownership passing to the buyer upon leaving our premises and payment terms are generally net 30.

SERVICES

Revenue from time and material service contracts is recognized as the services are provided. Revenue from fixed price, long-term service or development contracts is recognized over the contract term based on the percentage of services that are provided during the period compared with the total estimated services to be provided over the entire contract. Losses on fixed price contracts are recognized during the period in which the loss first becomes apparent. Payment terms vary by contract.

In October 2000, we entered into a \$10 million comprehensive development agreement with SSP Solutions to integrate Wave's EMBASSY Trusted Client technology into the SSP Secure Service Provider™ Suite to be deployed in 5 million digital set top boxes and integrated gateway products such as cable and DSL modems. In May 2001 the agreement was amended whereby under the amended terms of the agreement, the parties agreed to a \$5 million development services contract whereby Wave agreed to port its EMBASSY platform to run in a Linux environment. In addition, SSP Solutions agreed to place with Wave an open \$5,000,000 purchase order for EMBASSY products. Payment terms of the agreement provide that SSP Solutions make payments of \$277,778 per month for eighteen months. In addition, the parties agreed that in the event that SSP Solutions fails to pay any monthly installment, within 30 days of receiving written notice by Wave that it is in default, the unpaid portion of the installment shall automatically convert into a stock acquisition right allowing Wave to acquire a number of shares in SSP Solutions to be determined by dividing the unpaid amount by the fair market value of SSP Solutions common stock. As the contract was for a discrete project to integrate our technology with the SSP platform, revenue under the development services agreement has been recognized on a percentage of completion basis in accordance with SOP 97-2 as it relates to contract accounting under SOP 81-1. Percentage complete is determined based upon the actual costs incurred compared to the total estimated costs to complete, subject to cash received and milestones accomplished. Milestones include specific software development objectives that must be completed and accepted by SSP Solutions. As of December 31, 2002 Wave had received \$555,556 in cash and has not exercised any stock appreciation rights. We have recognized approximately \$198,000 and \$358,000 in revenue under the development agreement for the years ended December 31, 2002 and 2001, respectively.

Comparison of the years ended December 31, 2002 and 2001

Results of Operations

For the twelve months ended December 31, 2002 and December 31, 2001, revenues were \$446,588 and \$692,125, respectively. The decrease in revenue is attributable to decreases in hardware, services, and licensing revenues, as set forth in the following table:

	2002		2001	Increase/(Decrease)	% Change
Product	\$121,974	\$	192,506	\$ (70,532)	(37%)
Services	310,573		430,724	(120,151)	(28%)
Licensing and Other	14,041		68,895	(54,854)	(80%)
Total Net Revenues	446,588		692,125	\$ (245,537)	(35%)

The service contract revenue was derived primarily from a development contract with SSP Solutions, a shareholder of Wave. Wave also owns 19.80% of SSP Solutions. The service contract revenue derived from this development contract for the year ended December 31, 2002 was \$197,965, or 64% of the total service contract revenue versus \$357,591, or 83% of the total service contract revenue for the year ended December 31, 2001. Revenue on the contract was recognized on a percentage of completion basis limited to cash received and milestones accomplished. In February 2002, SSP formally requested that Wave suspend work on the development contract referred to above and that their remaining commitment and payments be applied toward alternative projects. Work under this contract was suspended during the first quarter of 2002, and the contract was formerly terminated pursuant to a settlement that was reached on September 30, 2002.

Cost of sales for the twelve months ended December 31, 2002, was \$202,208 compared with \$369,959 for the same period in 2001. Gross profit was \$244,380, representing a gross profit margin of 55% for the year ended December 31, 2002 versus gross profit of \$322,166 representing a gross profit margin of 47% for the year ended December 31, 2001. The \$77,786 decrease in gross profit was primarily the result of the overall decrease in sales, offset in part with a higher gross profit margin for the year ended December 31, 2002.

Revenue and gross margins during the year ended December 31, 2002 versus the same period in 2001 is indicative of a downward trend, with neither period showing significant revenues. The amount of revenues in both years has not reached a level that would contribute significantly to Wave's operations and has been sporadic. Wave does not foresee that it will achieve significant revenues at least until the latter part of 2003. Our sales forecast for the year ended December 31, 2003 approximates \$5 million in gross margin contribution. However, this forecast is not supported by a backlog of orders at this time, but rather the anticipation that various deals that we are currently pursuing will close. Wave continues to work towards solidifying strategic alliances with the major personal computer manufacturers to forge collaborative efforts to distribute its products to consumers, while also endeavoring to find markets for its products in the government and enterprise sectors by targeting large systems integrators. We are also actively pursuing agreements with manufacturers of non-EMBASSY TCPA compliant TPM's to provide services to run on these platforms. In order for Wave to achieve significant revenues it will have to be successful in these efforts, and while significant progress has been made, we are not in a position of a significant backlog of orders at this time, hence we expect to continue to experience this trend at least over the next two to three fiscal quarters. (See further discussion under "Liquidity and Capital Resources")

Research and development expenses for the twelve months ended December 31, 2002 were \$12,009,713, as compared to \$17,691,051 for the comparable period of 2001. This 32% decrease in research and development expenses was primarily attributable to lower consultant costs, which decreased by \$1,696,000 and salary and fringe cost reductions of approximately \$1,569,000 associated with headcount reductions, due to less design and development activities in 2002. In addition, Wave reduced product development expenses by \$1,302,000 and depreciation expense was reduced by \$512,000, due to assets becoming fully depreciated. WaveXpress' research and development expenses were \$2,331,080 for the year ended December 31, 2002 versus \$3,916,845 for the year ended December 31, 2001. The amounts set forth for WaveXpress are included in the consolidated amounts referred to herein. Also, the reasons for the reduction in expenditures set forth above pertain to both Wave as a whole and WaveXpress.

Selling, general and administrative expenses for the twelve months ended December 31, 2002 were \$19,188,046 as compared to \$24,184,317 for the comparable period of 2001. The 21% decrease in selling, general and administrative expenses was attributable to several factors. Wave reduced employee compensation and fringe expenses by approximately \$3,500,000 by reducing its selling, general and administrative headcount by an average of thirty-three positions. Bonuses of approximately \$936,000 and \$1,570,000 were paid to employees for the years ended December 31, 2002 and 2001, respectively, accounting for \$634,000 of the overall reduction in compensation costs. Wave also reduced professional fees expense by approximately \$358,000 by eliminating three consultant positions. The headcount reductions of both employees and consultants were made primarily in the areas of product marketing and operations for positions that supported products and/or lines of business that Wave has de-emphasized or abandoned. These included our internet related businesses: MyPublish.com; a service that allows individual publishers to offer digital content for sale via the MyPublish.com website, CharityWave.com; an online charitable donation service, Wave Direct; a website offering digital content that could be consumed using a Wave hardware device and iShopHere.com; an internet shopping portal. These products and services never reached full-scale production because the demand never reached a level that would warrant a full-scale production launch. The consultant positions that were eliminated as a result of the de-emphasis of these products were primarily involved in content preparation for these services (that is, the process of encrypting digital content to be consumed using the Commerce System). Wave also reduced headcount in administrative and support areas within the company where it was possible to consolidate and restructure certain functions. Additionally, during 2002 Wave undertook an aggressive cost cutting program that resulted in reductions in travel and entertainment expenses of \$478,000 and reductions to telecommunications expenses totaling \$163,000. In addition, Wave reduced office rent expense by approximately \$296,000 as a result of the termination of its WaveXpress lease, and its move into smaller, less costly office space. WaveXpress incurred selling, general and administrative expenses of \$2,506,768 in 2002, compared to \$4,800,927 for 2001, for a decrease of 48%. The reasons set forth above encompass WaveXpress as well as Wave as a whole.

During the year ended December 31, 2002, Wave completed a restructuring and cost reduction program to prioritize its initiatives, reduce expenses and improve efficiency. This program included a

workforce reduction, the relocation of its WaveXpress office and restructuring of certain business functions. As a result of this program, Wave recorded restructuring costs and other charges of \$726,280 consisting of \$229,000 in severance benefits associated with the workforce reduction, \$426,000 for lease termination fees and brokerage fees and \$71,000 for moving expenses related to the WaveXpress office relocation. All of these costs were incurred or paid by March 31, 2002. In connection with this program, Wave reduced its workforce by a total of thirty-six employees, nineteen of which were in research and development and seventeen that were in selling, general and administrative departments. All employees were notified of the work force reduction during the three months ended March 31, 2002. In addition, Wave recorded an impairment charge of \$905,390 for abandoned leasehold improvements and other tangible fixed assets that were disposed of or removed from operations. In the third quarter of 2002, Wave recorded an additional impairment charge which was associated with a license that was acquired in connection with its purchase of 60% of GlobalWave Group plc of \$665,641. As a result of these two impairment events, total asset impairment charges for the twelve months ended December 31, 2002 were \$1,571,031. For the year ended December 31, 2001, Wave took a charge of \$1,562,500 to write-off a technology license that it had purchased in connection with the development of the WaveXpress data broadcast system, and wrote off \$199,417 for hardware, also part of the WaveXpress terrestrial data casting system. These write-offs totaling \$1,761,917 were the result of modifications to WaveXpress' business model; consequently, the value of these assets became impaired because they were no longer needed in the business and had no alternative uses.

Goodwill amortization associated with the acquisition of the assets of Indigo Networks, LLC, for the year ended December 31, 2002 was \$0 versus \$1,720,632 in the year ended December 31, 2001. Due to the decline in Internet related business conditions, Wave wrote off the remainder of the unamortized goodwill and purchased intangible assets totaling \$2,284,570 associated with this acquisition in the fourth quarter of 2001. Accordingly, no intangible assets were subject to amortization expense for the year ended December 31, 2002.

Other Income and Expenses

Interest income for the year ended December 31, 2002 was \$477,902 versus \$2,688,105 for the year ended December 31, 2001, for a decrease of 82%. This decrease resulted from a decrease in interest bearing assets during 2002 and lower rates earned on those interest-bearing assets.

Equity in losses of GlobalWave were \$0 and \$2,332,159 for the year ended December 31, 2002 and 2001, respectively. Wave recognized its share in GlobalWave's losses to the extent of its committed investment in GlobalWave of \$5.7 million. Because Wave recognized losses equal to its committed investment as of December 31, 2001, no further losses were recognized in 2002 in connection with GlobalWave's operations.

For the year ended December 31, 2002, Wave took a charge for an "other than temporary decline" in the value of its investment in SSP of \$11,513,099. This charge was taken because it was determined that an other than temporary decline in SSP's share price had occurred due to concerns about SSP's financial condition and near-term prospects. The amount was calculated as the difference between the previously adjusted cost basis of Wave's 4,883,083 shares of SSP, 3,083,083 of which were acquired in February 2001 and 1,800,000 were acquired as settlement for termination of a development agreement (discussed below), versus the fair value of the shares based on the closing price of SSP as of December 31, 2002 on the Nasdaq national exchange, or \$0.59 per share. As a result of this charge and a similar charge that was taken in the fourth quarter of 2001 for \$1,736,682, the cost basis of the investment as of December 31, 2002 has been adjusted to \$2,881,019 from its original cost basis of \$16,130,800. The investment is presented on the December 31, 2001 balance sheet at \$11,160,758, which represents the closing value of the shares on the Nasdaq national exchange on that date. The difference between the value and the adjusted cost basis is presented as an unrealized loss in stockholders' equity. Additionally, while this block of SSP shares are registered, the number of shares we hold, including those received in the termination agreement (discussed below), exceed the average daily trading volume of SSP shares and therefore our ability to sell the shares in the open market is somewhat limited. Therefore, the value of these shares may be subject to further declines in value prior to our ability to sell the shares.

On September 30, 2002 Wave and SSP executed the Termination Agreement and Mutual Release in connection with a development agreement previously entered into between the parties whereby Wave was issued an additional 1,600,000 shares of SSP Class A Common Stock and a non-negotiable, non-interest bearing, subordinated convertible promissory note due December 31, 2005 in the principal amount of \$270,000 (the

“Note”). The Note was convertible into SSP Class A common stock at the conversion rate of \$1.35, subject to adjustments for anti-dilution stock splits, stock dividends, reclassifications, reorganizations and the like. In exchange, Wave was released from its obligation to provide any further services under the development contract as amended. The shares that Wave received were recorded on its balance sheet at estimated fair value based on the average closing price of the shares on the Nasdaq national exchange for the period from the two trading days before to the two trading days after the date of issuance of the shares, or \$1.05 per share, for an aggregate value of \$1,680,000. On December 31, 2002, SSP exercised its right to convert the Note and issue to Wave 200,000 shares of SSP common stock at the conversion rate of \$1.35. The shares that Wave received from the Note conversion were recorded at a value per share of \$0.69, for an aggregate value of \$138,000. In connection with the Termination Agreement and the Note conversion, a gain of \$1,818,000 was recognized in Wave’s statement of earnings for the year ended December 31, 2002. SSP is required to register the shares issued to Wave from this transaction by April 1, 2003. The shares are currently not registered and our ability to sell the shares is restricted. Therefore, these shares may be subject to declines in value prior to our ability to sell the shares.

In the quarter ended December 31, 2002, Wave has recorded a reserve for uncollectibility of \$999,518 in respect of certain notes receivable from Peter J. Sprague, Wave’s former Chairman. One of the loans with a balance of approximately \$799,000 was due on February 27, 2003. The Company has determined that Mr. Sprague is unable to repay the loan promptly. Mr. Sprague resigned as Chairman of Wave as of March 31, 2003. Wave intends to engage Mr. Sprague as Chairman and Chief Executive Officer of WaveXpress. Wave intends to diligently pursue collection of Mr. Sprague’s loan. Consistent with the provisions of the Sarbanes-Oxley Act of 2002, Wave has adopted a written policy prohibiting future loans to officers and directors.

Comparison of the years ended December 31, 2001 and 2000

Results of Operations

For the twelve months ended December 31, 2001 and December 31, 2000, revenues were \$692,125 and \$332,522 respectively. Revenue growth can be primarily attributed to a significant increase in hardware sales and service contract revenues, offset by a decrease in licensing and other revenue, as set forth in the following table:

	2001	2000	Increase/(Decrease)	% Change
Product	\$ 192,506	\$ 4,400	\$ 188,106	4275%
Services	430,724	-	430,724	-
Licensing and Other	68,895	328,122	(259,227)	(79)%
Total Net Revenues	692,125	332,522	359,603	108%

The service contract revenue was derived primarily from a development contract with SSP. At December 31, 2001, Wave owned 14.95% of SSP. The service contract revenue derived from this development contract for the year ended December 31, 2001 was \$357,591, or 83% of the total service contract revenue. Revenue on the contract was recognized on a percentage of completion basis limited to cash received and milestones accomplished. Cost of sales for the twelve months ended December 31, 2001, was \$369,959 compared with \$58,864 for the same period in 2000. Cost of sales in 2001 was not comparable to costs of sales for 2000, as the sales mix differed substantially in 2001 versus 2000. Sales in the year-ended 2001 from contracts and hardware produced profit margins of 45% versus sales for the year ended 2000 that consisted largely of license revenues, producing a much higher overall profit margin of 82%.

Research and development expenses for the twelve months ended December 31, 2001 were \$17,691,051, as compared to \$20,866,055 for the comparable period of 2000. This 15% decrease in research and development expenses was primarily attributable to lower consultant costs, which decreased by \$2,669,000, associated with a lessened design and development effort with respect to our proprietary integrated circuit technology and software. Significant development initiatives undertaken during the year ended December 31, 2000 included major enhancements to Wavenet, the development of EMBASSY II, the development of the EMBASSY applet developers kit, the creation of the "Trust Assurance Network" and the development of core EMBASSY applets. Many of these projects were substantially completed near the end of the first quarter of 2001. Accordingly, as the development of these projects were substantially complete,

Wave reduced its consultant work force early in 2001 resulting in significantly less research and development costs incurred during the year. WaveXpress' research and development expenses were \$3,916,845 for the year ended December 31, 2001 versus \$5,188,098 for the year ended December 31, 2000. The amounts set forth above include the WaveXpress amounts referred to herein. Also, the reasons for the reduction in expenditures set forth above pertain to both Wave as a whole and WaveXpress.

Selling, general and administrative expenses for the twelve months ended December 31, 2001 were \$24,184,317 as compared to \$26,553,634 for the comparable period of 2000. The 9% decrease in selling, general and administrative expenses was attributable to several factors. A number of consultant positions were eliminated during 2001 and were either not replaced or were converted to in-house employees, reducing the overall cost per headcount. Consultants that supported products and/or lines of business that Wave had been developing during the year ended December 31, 2000, but later de-emphasized, or abandoned in 2001 were eliminated. These included our Internet related businesses; MyPublish.com; a service that allows individual publishers to offer digital content for sale via the MyPublish.com website, CharityWave.com; an on-line charitable donation service, Wave Direct; a website offering digital content that could be consumed using a Wave hardware device and iShopHere.com; an internet shopping portal, and products that relied upon legacy hardware technology, that became obsolete. These products and services never reached full scale production as the demand never reached a level that would have warranted a full scale production launch. Reductions of consultant and professional fees accounted for cost reductions of approximately \$895,000. The consultant services that were eliminated primarily involved the process of content preparation (that is, the process of encrypting digital content to be consumed using the Commerce System). Wave also reduced trade show costs by \$320,000 and advertising and marketing expenses by \$362,000. These savings were achieved by attending fewer trade shows and by bringing the corporate marketing function in-house and using fewer outside marketing consultants. Additionally, during 2001 Wave undertook an aggressive cost cutting program that resulted in reductions in travel and entertainment expenses of \$681,000 and reductions of office supplies expenses totaling \$357,000. Finally, substantial savings were achieved by eliminating recruiting expenses of \$1,044,000 as Wave stabilized its work force late in the year-ended 2000 and into 2001. Offsetting these reductions were increases to employee compensation and fringe expenses totaling \$898,000 and litigation settlements of \$410,000. Bonuses of approximately \$1,570,000 and \$1,616,000 were paid to employees for the years ended December 31, 2001 and 2000, respectively. WaveXpress incurred selling, general and administrative expenses of \$4,800,927 in 2001, compared to \$4,992,285 for 2000, for a decrease of 4%. The reasons set forth above encompass WaveXpress as well as Wave as a whole.

Goodwill amortization associated with the acquisition of iShopHere.com, for the year ended December 31, 2001 was \$1,720,632 versus \$573,544 in the year ended December 31, 2000. This is the result of a full year's amortization having been taken for the year-ended December 31, 2001, while only four months' expense was taken in the year ended December 31, 2000, as the acquisition took place on August 31, 2000.

In the first quarter of 2001, we took a charge of \$1,562,500 to write off a technology license that was purchased in connection with the development of the WaveXpress data broadcast system. Additionally in the fourth quarter of 2001, Wave wrote off \$199,417 for hardware; also part of the WaveXpress terrestrial data casting system. These write-offs totaling \$1,761,917 were the result of modifications to WaveXpress' business model; consequently, the value of these assets became impaired because they were no longer needed in the business and had no alternative uses.

As a result of the decline in current business conditions, and our realignment of resources to focus on what it considers high-growth markets and core opportunities, Wave recorded in the fourth quarter of 2001, a charge of \$2,284,570 related to the impairment of goodwill and purchased intangible assets associated with the purchase of Indigo Networks. This amount is equal to the carrying amount of the assets prior to the impairment charge. Accordingly, the carrying amount of the goodwill and purchased intangible assets as of December 31, 2001 was \$0.

We recorded a provision for inventory obsolescence totaling \$933,304 in 2001. This charge related to chips based on legacy technology that Wave was no longer actively marketing, and therefore became impaired.

The in-process research and development ("IPRD") expense incurred in the year-ended December 31, 2000 was related to the acquisition of Indigo and its e-commerce shopping network, iShopHere.com. The portion of the purchase price allocated to in-process research and development for this acquisition was approximately 29% of the total purchase price of \$7,445,000. The IPRD was valued using an

income approach. The cash flows were discounted to present value at an appropriate rate. The discount rate was determined by an analysis of the risks associated with each of the identified intangible assets. The resulting net cash flows to which the discount rate of 27% was applied were based on management's estimates of revenues, operating expenses and income taxes from such acquired in-process technology.

Other Income and Expenses

Interest income for the year ended December 31, 2001 was \$2,688,105 versus \$5,103,716 for the year ended December 31, 2000, for a decrease of 47%. This decrease resulted from a decrease in interest bearing assets during 2001 and lower rates earned on those interest-bearing assets. Equity in losses of GlobalWave were \$2,332,159 and \$3,406,491 for the year ended December 31, 2001 and 2000, respectively. The decrease resulted from a reduction in GlobalWave's net loss, and Wave's portion being limited to Wave's investment in GlobalWave of \$5.7 million, which was reached in the fourth quarter of 2001.

As of December 31, 2001 Wave took a charge for an "other than temporary decline" in the value of its investment in SSP Solutions of \$1,736,682. This charge was taken because a decline in SSP Solutions' share price had occurred due to concerns about SSP Solutions' financial condition and near-term prospects. As a result of this charge the cost basis of the investment as of December 31, 2001 has been adjusted to \$12,576,118.

The Gain on Sale of marketable equity securities in the year ended December 31, 2000 resulted from the acquisition of ITG. Wave recognized the gain as the amount of cash received in the transaction over the book basis of the 1,000,000 shares.

Liquidity and capital resources

We have experienced net losses and negative cash flow from operations since our inception, and, as of December 31, 2002, had a deficit accumulated during the development stage of \$233,091,528. Total stockholders' equity as of December 31, 2002 was \$14,541,839. We have financed our operations principally through the issuance of Class A and B Common Stock and various series of preferred stock, for total proceeds since inception of approximately \$204,819,000.

At December 31, 2002, we had \$10,221,124 in unrestricted cash and cash equivalents. At December 31, 2001, we had \$40,437,119 in cash and cash equivalents. We held non-current marketable equity securities with a value of \$2,881,016 as of December 31, 2002 versus \$11,171,124 (\$11,160,758 of which was classified as non-current) in marketable securities at December 31, 2001. The decrease in cash and cash equivalents resulted from \$29,096,904 used in operating activities. Investing activities used \$1,327,509 for the purchase of property and equipment totaling approximately \$1,149,000, which amount included development of capitalized software of approximately \$800,000. Also included in investing activities was approximately \$1,559,000 used to meet our final funding commitment to GlobalWave. This was offset by \$1,380,000 in cash that we received when we subsequently purchased the 60% of GlobalWave that we had previously not owned. In addition, \$208,418 was provided in financing activities that consisted of repayment of a loan granted an officer for \$164,319, and proceeds from the issuance of Common Stock from exercises of employee stock options and warrants totaling \$44,099.

Wave's significant commitments with respect to leases, inventory purchases and software development contracts are as follows:

	2003	2004	2005	2006	2007	Thereafter	Total
Leases	\$702,000	\$589,000	\$574,000	\$376,000	\$280,000	\$285,000	\$2,806,000
Software Development	300,000	-	-	-	-	-	300,000
Total Commitments	\$1,002,000	\$589,000	\$574,000	\$376,000	\$280,000	\$285,000	\$3,106,000

WaveXpress has been funded entirely by Wave through a series of convertible promissory notes (the "Notes"). Through December 31, 2002 Wave had provided approximately \$32.6 million in funds under the Notes, including accrued interest of \$3.6 million. Wave expects to continue funding WaveXpress through the Notes and similar notes at least through the first quarter of 2003. Presently, Wave has committed to funding WaveXpress up to an additional \$1.0 million under the Notes.

As of December 31, 2002, we had available net operating loss carryforwards for Federal income tax purposes of approximately \$179 million. Because of the "change in ownership" provisions of the Tax Reform Act of 1986, our net operating loss carryforwards may be subject to an annual limitation on the utilization of these carryforwards against taxable income in future periods if a cumulative change in ownership of more than 50 percent of Wave occurs within any three-year period. We have made no determination concerning whether there has been such a cumulative change in ownership. However, we believe that it is likely that such a change in ownership occurred prior to or following the completion of our initial public offering in September 1994.

Wave had outstanding loans receivable from officers totaling \$1,277,860 less a reserve for uncollectibility of \$999,518 for a net balance of \$278,342 as of December 31, 2002. Notes receivable from officers were \$1,380,050 with no reserve as of December 31, 2001. Some of the loans, as indicated below were extended beyond their original terms by one year. These loans and the extensions thereon were granted to the officers, prior to the enactment of the Sarbanes-Oxley Act of 2002, to allow them to satisfy certain personal financial obligations that would otherwise have required them to liquidate some of their holdings of Wave shares. The loans were granted and extended as a means to mitigate a potential unfavorable impact to Wave's share price as a result of the officers selling large blocks of shares. The officer loans consist of the following:

On March 26, 2001 Wave made a personal loan to Mr. Gerard T. Feeney, Senior Vice President, Chief Financial Officer and Secretary of Wave as evidenced by a demand note for \$250,000, which sum was due and payable to Wave on March 26, 2002 and bore interest at a rate per annum equal to 1% over the prime interest rate. Interest on the loan accrued monthly and was payable at maturity. The terms of the loan were substantially equivalent to market terms available at that time. The due date of the demand note was subsequently extended until March 26, 2003. As of December 31, 2002 the loan balance, including accrued interest was \$278,342. As of March 26, 2003 the loan balance, including accrued interest was \$281,399. On March 27, 2003, the Compensation Committee approved an extraordinary bonus in an amount equal to Mr. Feeney's obligations with respect to such loan and accrued interest. Proceeds of this extraordinary bonus were used to repay the loan and all interest accrued on such loan. This bonus is considered extraordinary because it was granted during the year so that Mr. Feeney could repay his loan, rather than at fiscal year end when bonuses are usually awarded. The factors used in granting this extraordinary bonus were the amount of the loan, the ability to repay the loan and the impact that non-repayment of the loan would have on Mr. Feeney's abilities to fulfill his duties for Wave. Wave no longer intends to award extraordinary bonuses to executive officers or directors because there are no outstanding loans to any current executive officers or directors and the Sarbanes-Oxley Act of 2002 prohibits any future such loans. The largest amount outstanding with respect to indebtedness of Mr. Feeney during 2002 was \$278,342. Wave intends to take this extraordinary bonus into account when considering future bonus awards to Mr. Feeney.

Also during 2001, Wave made personal loans to Mr. Peter J. Sprague, former Chairman of Wave totaling \$1,062,139. The loans were evidenced by demand notes for \$713,320 dated February 27, 2001, \$184,500 dated July 25, 2001 and \$164,319 dated September 5, 2001. These notes carry terms of one year and bear interest at a rate per annum equal to 1% over the prime rate of interest. Interest on the loans accrues monthly and is payable at maturity. The terms of the loans were substantially equivalent to market terms available at that time. Two of the demand notes in the amount of \$713,320 and \$184,500 plus accrued interest came due on February 27, 2002 and July 25, 2002, respectively and were extended for an additional year beyond their original due dates, prior to the enactment of the Sarbanes-Oxley Act of 2002. The remaining loan, which had an original face value of \$165,319, and a balance of \$174,391 including accrued interest came due in September 2002. On November 12, 2002, the Compensation Committee approved the payment of an extraordinary bonus that Mr. Sprague used to repay the \$164,319 balance of the note due in September 2002 plus accrued interest of \$10,072. Accordingly, Wave has recognized approximately \$174,391 as bonus expense in selling, general and administrative expense in its statements of operations for the year ended December 31, 2002. This bonus was considered extraordinary for the same reasons as the bonus awarded to Mr. Feeney described above. This bonus was awarded based on the same factors as the bonus awarded to Mr. Feeney. As of December 31, 2002, the balances of the two notes still outstanding were \$799,143 that came due on February 27, 2003 and \$200,374 that is due on July 26, 2003, for a total of \$999,518. As of March 26, 2003, the balances of these two notes were \$807,863 that came due on February 27, 2003 and \$202,630 that is due on July 26, 2003, for a total of \$1,010,493. Wave has recorded a reserve for uncollectibility for 100% of these loans that remain outstanding as of December 31, 2002 and March 26, 2003, because Wave has determined that Mr. Sprague is unable to repay the loans promptly. Mr. Sprague resigned as Chairman of

Wave as of March 31, 2003. Wave intends to engage Mr. Sprague as Chairman and Chief Executive Officer of WaveXpress. Wave intends to diligently pursue collection of Mr. Sprague's loan. The largest aggregate amount outstanding with respect to indebtedness of Mr. Sprague during 2002 was \$1,161,573.

Consistent with the provisions of the Sarbanes-Oxley Act of 2002, Wave has adopted a written policy prohibiting future loans to officers and directors.

At December 31, 2002, we had working capital of \$8,754,620, including the loans receivable from officers referred to above, totaling \$1,277,860 less an uncollectibility reserve of \$999,518 for a balance of \$278,342. If the loans are not repaid, we will not be able to use these loans as a source of funds for operations and the amount of capital we will need to raise will be greater.

Wave's consolidated financial statements as of December 31, 2002 have been prepared under the assumption that we will continue as a going concern. Wave's independent auditors, KPMG LLP, have issued a report dated March 31, 2003, that included an explanatory paragraph referring to our significant operating losses and substantial doubt of our ability to continue as a going concern beyond the second quarter of 2003. (See Note 2 to Wave's consolidated financial statements.)

Wave has incurred substantial operating losses since its inception, and as of December 31, 2002 has an accumulated deficit of approximately \$233 million. We also expect we will incur an operating loss for the calendar year of 2003. Considering our current cash balance and Wave's projected operating cash requirements, we anticipate that we will need \$11 million of additional cash to satisfy our current forecasted cash flow requirements for the twelve-month period ending December 31, 2003. In addition to what we are forecasting in gross margins for fiscal 2003, we estimate having to raise a minimum of approximately \$5 million in capital, in order to fund our operations through 2003. In the event we are unable to raise additional capital, we anticipate that our existing capital resources will be adequate to satisfy our cash flow requirements into the second quarter of 2003, at our current expenditure rate. In order to raise the additional cash required for Wave's operations, Wave has engaged an investment banking firm and is exploring a number of financing alternatives which include debt or equity financing (or a combination of both) or one or more commercial or strategic transactions.

As Wave has not yet attained commercial acceptance of its products and has not generated any significant operating revenue, considerable uncertainty currently exists with respect to the adequacy of current funds to support our activities beyond the second quarter of 2003. If Wave is not successful in raising sufficient capital it will not be able to continue as a going concern.

Recent Accounting Pronouncements

In April 2002, the FASB issued SFAS No. 145, *Rescission of FASB Statements No. 4, 44 and 64, Amendment of FASB Statement No. 13, and Technical Corrections*. SFAS No. 145 amends existing guidance on reporting gains and losses on the extinguishment of debt to prohibit the classification of the gain or loss as extraordinary, as the use of such extinguishments have become part of the risk management strategy of many companies. SFAS No. 145 also amends SFAS No. 13 to require sale-leaseback accounting for certain lease modifications that have economic effects similar to sale-leaseback transactions. The provisions of the Statement related to the rescission of Statement No. 4 are applied in fiscal years beginning after May 15, 2002. Earlier application of these provisions is encouraged. The provisions of the Statement related to Statement No. 13 were effective for transactions occurring after May 15, 2002, with early application encouraged. The adoption of SFAS No. 145 is not expected to have a material effect on Wave's financial statements.

In June 2002, the FASB issued SFAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*. SFAS No. 146 addresses financial accounting and reporting for costs associated with exit or disposal activities and nullifies Emerging Issues Task Force (EITF) Issue 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity*. The provisions of this Statement are effective for exit or disposal activities that are initiated after December 31, 2002, with early application encouraged. The adoption of SFAS No. 146 is not expected to have a material effect on Wave's financial statements.

In November 2002, the FASB issued Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness to Others*, an

interpretation of FASB Statements No. 5, 57 and 107 and a rescission of FASB Interpretation No. 34. This Interpretation elaborates on the disclosures to be made by a guarantor in its interim and annual financial statements about its obligations under guarantees issued. The Interpretation also clarifies that a guarantor is required to recognize, at inception of a guarantee, a liability for the fair value of the obligation undertaken. The initial recognition and measurement provisions of the Interpretation are applicable to guarantees issued or modified after December 31, 2002 and are not expected to have a material effect on Wave's financial statements. The disclosure requirements are effective for financial statements of interim or annual periods ending after December 15, 2002.

In December 2002, the FASB issued SFAS No. 148, *Accounting for Stock-Based Compensation – Transition and Disclosure, an amendment of FASB Statement No. 123.* This Statement amends FASB Statement No. 123, *Accounting for Stock-Based Compensation*, to provide alternative methods of transition for a voluntary change to the fair value method of accounting for stock-based employee compensation. In addition, this Statement amends the disclosure requirements of Statement No. 123 to require prominent disclosures in both annual and interim financial statements. Certain of the disclosure modifications are required for fiscal years ending after December 15, 2002 and are included in the notes to these consolidated financial statements.

In January 2003, the FASB issued Interpretation No. 46, *Consolidation of Variable Interest Entities*, an interpretation of ARB No. 51. This Interpretation addresses the consolidation by business enterprises of variable interest entities as defined in the Interpretation. The Interpretation applies immediately to variable interests in variable interest entities created after January 31, 2003, and to variable interests in variable interest entities obtained after January 31, 2003. The application of this Interpretation is not expected to have a material effect on Wave's financial statements.

Item 7A. Quantitative and Qualitative Disclosure about Market Risk

Wave's investment portfolio consists of minority equity investments in publicly traded companies. Most predominantly, we hold 4,883,083 shares of common stock, representing a 19.80% equity interest in SSP Solutions, Inc.. These securities are generally classified as available for sale and, consequently, are recorded on the balance sheet at fair value with unrealized gains and losses reported as a separate component of accumulated other comprehensive income (loss), net of tax. These investments are inherently risky because the markets for the technologies or products they have under development are typically in the early stages and may never materialize. We recorded charges against earnings associated with losses in value on our investment in SSP that were considered to be "other than temporary" of \$11.5 million and \$1.7 million for the years ended December 31, 2002 and 2001, respectively. Also, our ability to sell these securities is limited as 1,800,000 of these shares are not registered and the average daily trading volume of SSP's shares is so low that our ability to effectively sell shares in the market is limited. Consequently, our investment in these shares is subject to further potential significant declines in value. The following table presents the hypothetical change in fair values of Wave's investments in marketable equity securities of publicly traded entities using the high and low closing prices of the securities from January 1, 2001 through March 20, 2003:

	Fair Market Value ("FMV") at the lowest closing price from January 1, 2001 through March 20, 2003	FMV as of December 31, 2002	FMV at the highest closing price from January 1, 2001 through March 20, 2003
Corporate Equities	\$ 2,636,865	\$ 2,881,016	\$ 20,348,348
Percentage decrease from highest closing price	87%	86%	-
Percentage decrease from FMV as of December 31, 2002	8%	-	-

Assuming hypothetical future changes in the market prices of these investments based on the historical data presented above, the potential loss in future values resulting from such changes could range from between 8% and 87% of the fair market value of these investments as of December 31, 2002. The amount of such hypothetical future losses in fair market value would be equal to \$230,000, \$2,500,000 and \$2,500,000, using hypothetical losses of 8%, 86% and 87%, respectively.

The exposure to market risk associated with interest rate-sensitive instruments is not material. Wave's cash and cash equivalents consist primarily of money market funds that meet high credit quality standards and the amount of credit exposure to any one issue is limited.

Item 8. Financial Statements and Supplementary Data

The consolidated financial statements, the notes thereto, and the independent auditors' report thereon are presented beginning at page F-1 of this Form 10-K and are hereby incorporated by reference into this Item 8. The quarterly financial information required by this Item 8 is included in the Notes to Consolidated Financial Statements.

Item 9. Changes in and Disagreements with Accountant on Accounting and Financial Disclosure

Not Applicable.

PART III

Item 10. Directors and Executive Officers of the Registrant

<u>Name</u>	<u>Age</u>	<u>Business Experience and Principal Occupation or Employment During Past 5 Years; Positions held with Wave Systems Corp.; Other Directorships</u>	<u>Director Since</u>
Peter J. Sprague(1)(4)	64	Chairman of the Board since 1988; Chief Executive Officer Wave from July 1991 to March 2000; Director of WaveXpress, (a majority-owned subsidiary of Wave), uWink.com, Inc. and SemEquip, Inc.; President of KWI, Inc.; Trustee of the Strang Clinic; Member of Academy of Distinguished Entrepreneurs, Babson College. Mr. Sprague is the father of Steven Sprague, President and Chief Executive Officer of Wave. Mr. Sprague has resigned as an officer and a director of Wave, effective March 31, 2003.	1988
John E. Bagalay, Jr., Ph.D.(1)(2)(3)(4)(5)	69	Senior Advisor to the Chancellor of Boston University since January 1998; Chief Operating Officer of Eurus Technologies, Inc. from January 1999 to December 1999 and Chief Financial Officer of Eurus International, Limited (formerly known as Eurus Technologies, Inc.) since January 1999; President and CEO of Cytogen Corporation from January 1998 to January 1999 and Chief Financial Officer from October 1997 to September 1998; Managing Director, Community Technology Fund, venture capital affiliate of Boston University from September 1989 to December 1997; former General Counsel of Lower Colorado River Authority, Texas Commerce Bancshares, Inc. and Houston First Financial Group; Director of Cytogen Corporation, Decorize, Inc., and several privately held companies. Mr. Bagalay's term as director expires in 2003.	1993
Nolan Bushnell (3)	60	Chairman and Chief Executive Officer of uWink.com, Inc. since December 1999 where he is leading the development of streaming media distribution models for internet entertainment. Mr. Bushnell's term as director expires in 2003.	1999
George Gilder(4)	63	Chairman of the Executive Committee of Wave since 1996; Senior Fellow at the Discovery Institute in Seattle, Washington; author of several books, including <i>Life After Television</i> , <i>Microcosm</i> , <i>The Spirit of Enterprise</i> , <i>Wealth and Poverty</i> and most recently <i>Telecosm</i> ; contributing editor to Forbes Magazine; Chairman of Gilder Technology Group, Inc. (publisher of monthly technology reports); former chairman of the Lehrman Institute Economic Roundtable; former Program Director for the Manhattan Institute; recipient of White House award for Entrepreneurial Excellence from President Reagan. Mr. Gilder's term as director expires in 2003.	1993
John E. McConnaughy, Jr. (1)(2)(3)(4)(5)	73	Chairman and Chief Executive Officer of JEMC Corporation; Director of Varsity Brands Inc., Levcor International, Inc., Fortune Natural Resources, Inc., Overhill Farms, Inc. and Consumer Portfolio Services Inc. Mr. McConnaughy is also Chairman of the Board of Trustees of the Strang Clinic and the Chairman Emeritus of the Board of the Harlem School of the Arts. Mr McConnaughy's term as director expires in 2003.	1988
Steven Sprague	38	President and Chief Executive Officer of Wave since March 2000; President and Chief Operating Officer of Wave from May 1996 to	1997

March 2000; President of Wave Interactive Network from June 1995 to December 30, 1996; Chief Executive Officer and Chairman of the Board of Directors of WaveXpress, (a majority-owned subsidiary of Wave) and Vice President and director of Specialty Broadcast Networks, Inc. Mr. Sprague is the son of Peter J. Sprague, former Chairman of Wave. Mr. Sprague's term as director expires in 2003.

Biographical Information Regarding Executive Officer Who Is Not A Director

<u>Name</u>	<u>Age</u>	<u>Business Experience and Principal Occupation or Employment During Past 5 Years; Positions held with Wave Systems Corp.; Other Directorships</u>	<u>Officer Since</u>
Gerard T. Feeney	44	Secretary of Wave since February 1999, Senior Vice President of Finance and Administration, and Chief Financial Officer of Wave since June 1998; Vice President of Finance and Operations and Chief Financial Officer of Xionics Document Technologies, Inc. from 1991 to 1998.	1998

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- (1) Member of Nominating Committee.
 - (2) Member of Compensation Committee.
 - (3) Member of Audit Committee.
 - (4) Member of Executive Committee.
 - (5) Independent Audit Committee expert.

Involvement in Certain Legal Proceedings

Mr. McConnaughy was the Chairman of the Board of the Excellence Group, LLC, which filed a petition for Bankruptcy under Chapter 11 of the U.S. Federal bankruptcy laws in January 1999. The Excellence Group's subsidiaries produced labels for a variety of customer.

Mr. Peter J. Sprague is President of KWI, Inc., which filed a petition for Bankruptcy under Chapter 11 of the U.S. Federal bankruptcy laws in December 2001. KWI is a water treatment company.

Item 11. Executive Compensation

Summary Compensation Table

The following table sets forth information with respect to the compensation paid or awarded by Wave to the Chief Executive Officer and the other executive officers whose cash compensation exceeded \$100,000. (collectively, the "Named Executive Officers") for services rendered in all capacities during 2002, 2001 and 2000.

<u>Name and Principal Position</u>	<u>Year</u>	<u>Annual Compensation</u>		<u>Long-Term Compensation Awards</u>
		<u>Salary(\$)</u>	<u>Bonus(\$)</u>	<u>Number of Shares Underlying Options(#)</u>
Peter J. Sprague (1)..... <i>Chairman</i>	2002	\$ 185,000	\$ 200,391	200,000
	2001	185,000	105,000	200,000
	2000	185,000	150,000	100,000
Steven Sprague(2)..... <i>President and Chief Executive Officer</i>	2002	250,000	161,500	252,500
	2001	250,000	175,000	250,000
	2000	250,000	250,000	500,000
Gerard T. Feeney (3)..... <i>Senior Vice President, Chief Financial Officer and Secretary</i>	2002	185,000	102,000	150,000
	2001	185,000	105,000	150,000
	2000	185,000	150,000	100,000

(1) Mr. Peter Sprague was awarded a bonus of \$150,000 that was paid in 2000 and was fully applied to his outstanding loans with Wave. In 2002 Mr. Sprague was awarded an extraordinary bonus of approximately \$174,000 that was applied in full to his outstanding loan with Wave. Mr. Sprague has resigned as an officer and director of Wave, effective March 31, 2003.

(2) Mr. Steven Sprague was elected President and Chief Executive Officer of Wave on June 26, 2000. Previously, Mr. Sprague was President and Chief Operating Officer of Wave from May 23, 1996 until he was elected Chief Executive Officer.

(3) Mr. Gerard T. Feeney was hired as Senior Vice President, Finance and Administration and Chief Financial Officer on June 8, 1998 and was elected Secretary on February 25, 1999.

Option Grants in Last Fiscal Year

The following table sets forth certain information regarding options granted during the fiscal year ended December 31, 2002 by Wave to the Named Executive Officers.

<u>Name</u>	<u>Number of Shares Underlying Options Granted (#)</u>	<u>% of Total Options Granted to Employees in Fiscal Year</u>	<u>Exercise Price (\$/Share)</u>	<u>Expiration Date</u>	<u>Potential Realizable Value at Assumed Annual Rates of Stock Price Appreciation For Option Term (1)</u>	
					<u>5% (\$)</u>	<u>10% (\$)</u>
Peter J. Sprague	200,000	12.4%	\$ 2.01	2/1/12	\$ 252,816	\$ 640,684
Steven Sprague	252,500	15.7%	\$ 2.01	2/1/12	319,180	808,864
Gerard T. Feeney	150,000	9.3%	\$ 2.01	2/1/12	189,612	480,513

(1) The potential realizable value of the options reported above was calculated by assuming 5% and 10% compounded annual rates of appreciation of the common stock from the date of grant of the options until the expiration of the options, based upon the market price on the date of grant. These assumed annual rates of appreciation were used in compliance with the rules of the Securities and Exchange Commission and are not intended to forecast future price appreciation of the common stock.

Fiscal Year End Option Value Table

The following table sets forth information regarding the aggregate number and value of options held by the Named Executive Officers as of December 31, 2002, and the aggregate number and value of options exercised by the Named Executive Officers during 2002.

<u>Name</u>	<u>Shares Acquired on Exercise</u>	<u>Value Received</u>	<u>Number of Shares Underlying Unexercised Options at December 31, 2002(#)</u>		<u>Value of Unexercised In-The-Money Options at December 31, 2002(\$)(1)</u>	
			<u>Exercisable</u>	<u>Unexercisable</u>	<u>Exercisable</u>	<u>Unexercisable</u>
Peter J. Sprague	-0-	\$ -0-	955,833	366,667	\$ 32,693	\$ -0-
Steven Sprague	-0-	-0-	1,336,172	585,833	66,227	-0-
Gerard T. Feeney	-0-	-0-	466,667	283,333	-0-	-0-

(1) The last reported bid price for Wave's Class A Common Stock on December 31, 2002 was \$1.33 per share. Value is calculated on the basis of the difference between the respective option exercise prices and \$1.33, multiplied by the number of shares of common stock underlying the respective options.

Employment Contracts

Wave has an employment agreement with Steven Sprague that provides that Mr. Sprague shall serve as President and Chief Executive Officer of Wave for consecutive one year terms unless either party provides written notice to the other of its/his intention not to renew the contract not less than sixty (60) days prior to the expiration of the then current term. The employment agreement provides that Mr. Sprague will be paid a minimum base salary of \$185,000 per year subject to increase from time to time as determined by action of the Board of Directors. The employment agreement also provides that Mr. Sprague will be entitled to operational bonuses based on performance. In the event that Mr. Sprague's employment is terminated without cause or in certain other circumstances, Mr. Sprague will be paid a lump sum in an amount equal to three (3) year's annual base salary then in effect, and continue health insurance and other benefits for a period equal to the remaining Term of Employment then in effect. This employment agreement also contains a two year post termination covenant not to compete.

Wave also has an employment agreement with Gerard T. Feeney that provides that Mr. Feeney shall serve as Senior Vice President, Finance and Administration and Chief Financial Officer of Wave for consecutive one year terms unless either party provides written notice to the other of its/his intention not to renew the contract not less than sixty (60) days prior to the expiration of the then current term. The employment agreement provides that Mr. Feeney will be paid a minimum base salary of \$160,000 per year subject to increase from time to time as determined by action of the Board of Directors. The employment agreement also provides that Mr. Feeney will be entitled to operational bonuses based on performance. In the event that Mr. Feeney's employment is terminated without cause or in certain other circumstances, Mr. Feeney will be paid a lump sum in an amount equal to one year's annual base salary then in effect, and a guaranteed portion of bonus, benefits and similar relocation package. However in the event Mr. Feeney secures employment elsewhere during the one year period subsequent to termination, severance pay will stop once employment has begun with the new employer. In addition, Mr. Feeney's options will continue to vest for at least one year from the termination date and for the portion of time greater than one year and up to his next anniversary vesting period. This employment agreement also contains a two year post termination covenant not to compete.

Compensation Interlocks and Insider Participation

None of the members of the Compensation Committee of Wave were officers or employees of Wave, nor was any executive officer of Wave a director or member of the compensation committee of any entity, of which an executive officer or director served on the Compensation Committee of Wave.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

The following table provides information about securities authorized for issuance under Wave's equity compensation plans.

Plan Category	Number of Securities to be issued upon exercise of outstanding options warrants and rights (a)	Weighted Average exercise price of outstanding options, warrants and rights (b)	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c)
Equity compensation plans approved by security holders	10,183,243	\$ 5.94	1,928,258
Wave equity compensation plans not approved by security holders	85,000	5.50	
Total Wave plans	10,268,243	\$ 5.94	1,928,258
WaveXpress equity compensation plans not approved by security holders	1,402,841	\$ 1.21	1,069,382

Equity compensation plans not approved by security holders are comprised of the following:

In connection with a software development agreement that Wave entered into with Archon Technologies, Inc. ("Archon"), Wave issued to Archon a warrant to purchase 50,000 shares of Wave Class A Common Stock at \$3.48 per share. The warrant became exercisable November 9, 2002, and expires on November 9, 2007.

A director of WaveXpress was granted a warrant to purchase 10,000 shares of Wave Class A Common Stock at \$10.00 per share, upon acceptance of an offer to serve on WaveXpress' board. This warrant is currently exercisable and expires on August 24, 2004.

As a result of the successful placement of 350 shares of Series B Preferred Stock, a consultant from Digital Media Group, Inc. was issued warrants by Wave to purchase 15,000 Class A Common shares at a price of \$3.09 per share. These warrants are currently exercisable and expires on March 1, 2006.

In connection with a consulting agreement that Wave entered into with the William Morris Agency, Inc. ("William Morris"), Wave issued William Morris a warrant to purchase 10,000 shares of Wave Class A Common Stock at \$14.73 per share. This warrant is currently exercisable and expires on March 31, 2004.

The following table sets forth certain information concerning the beneficial ownership of Wave's Class A and Class B Common Stock as of March 20, 2003 (except as otherwise noted) by (i) each stockholder who is known by Wave to own beneficially more than five percent of the outstanding Class A or Class B Common Stock, (ii) each director of Wave, (iii) each of the executive officers of Wave named in the Summary Compensation Table below, and (iv) all directors and executive officers of Wave as a group. Holders of Class A Common Stock are entitled to one vote per share on all matters submitted to a vote of the stockholders of Wave. Holders of Class B Common Stock are entitled to one vote per share on all matters submitted to a vote of the stockholders, except that holders of Class B Common Stock will have five votes per share in cases where one or more directors are nominated for election by persons other than Wave's Board of Directors and where there is a vote on any merger, consolidation or other similar transaction which is not recommended by Wave's Board of Directors. In addition, holders of Class B Common Stock will have five votes per share on all matters submitted to a vote of the stockholders in the event that any person or group of persons acquires beneficial ownership of 20% or more of the outstanding voting securities of Wave. Shares of Class B Common Stock are convertible into shares of Class A Common Stock on a one-for-one basis at the option of the holder.

Beneficial Owner(1)	Number of Shares of Class A Common Stock Owned(2)	Percent of Class	Number of Shares of Class B Common Stock Owned	Percent of Class	Percent of All Outstanding Common Stock(3)
Peter J. Sprague (4), (12)	1,928,834	3.2	161,000	49.7	3.5
John E. Bagalay, Jr.(5)	126,000	*	0	*	*
Nolan Bushnell (6)	56,316	*	4,316	1.3	*
George Gilder (7)	206,000	*	2,000	*	*
John E. McConnaughy, Jr. (8)	66,750	*	0	*	*
Steven Sprague (9), (12)	1,898,327	3.3	42,102	13.0	3.4
Gerard T. Feeney (10)	800,000	1.4	0	*	1.4
All executive officers and directors as a group (7 persons) (11)	4,860,727	8.3	209,418	64.6	8.8

*Less than one percent.

- (1) Each individual or entity has sole voting and investment power, except as otherwise indicated.
- (2) Includes shares of Class A Common Stock issuable upon the conversion of the number of shares of Class B Common Stock indicated for the beneficial owner.
- (3) In circumstances where the Class B Common Stock has five votes per share, the percentages of total voting power would be as follows: Peter J. Sprague, 4.5%; John E. Bagalay, Jr., less than 1%; Nolan Bushnell, less than 1%; George Gilder, less than 1%; John E. McConnaughy, Jr., less than 1%; Steven Sprague, 3.6%; Gerard T. Feeney, 1.4%; and all Executive Officers and directors as a group, 10.0%.
- (4) Includes 1,122,500 shares, of Class A Common Stock that are subject to options presently exercisable or exercisable within 60 days.
- (5) Includes 122,000 shares of Class A Common Stock that are subject to options presently exercisable.
- (6) Includes 52,000 shares of Class A Common Stock that are subject to options presently exercisable.
- (7) Includes 202,000 shares of Class A Common Stock that are subject to options presently exercisable.
- (8) Includes 40,000 shares of Class A Common Stock that are subject to options presently exercisable.
- (9) Includes 1,586,173 shares of Class A Common Stock that are subject to options presently exercisable or exercisable within 60 days. Also includes 37,102 shares of Class B Common Stock held in trust for the benefit of Mr. Steven Sprague's family, and for which Mr. Steven Sprague is a trustee.
- (10) Includes 600,000 shares of Class A Common Stock that are subject to options presently exercisable or exercisable within 60 days.
- (11) Includes 3,724,673 shares of Class A Common Stock that are subject to options presently exercisable or exercisable within 60 days.
- (12) Includes 223,500 shares beneficially owned by Mr. Steven Sprague and Mr. Peter J. Sprague in which voting and investment rights are shared.

Item 13. Certain Relationships and Related Transactions

Note Receivable from Director/Officers

Wave had outstanding loans receivable from officers totaling \$1,277,860 less a reserve for uncollectibility of \$999,518 for a net balance of \$278,342 as of December 31, 2002. Notes receivable from officers were \$1,380,050 with no reserve as of December 31, 2001. Some of the loans, as indicated below were extended beyond their original terms by one year. These loans and the extensions thereon were granted to the officers, prior to the enactment of the Sarbanes-Oxley Act of 2002, to allow them to satisfy certain personal financial obligations that would otherwise have required them to liquidate some of their holdings of Wave shares. The loans were granted and extended as a means to mitigate a potential unfavorable impact to Wave's share price as a result of the officers selling large blocks of shares. The officer loans consist of the following:

On March 26, 2001 Wave made a personal loan to Mr. Gerard T. Feeney, Senior Vice President, Chief Financial Officer and Secretary of Wave as evidenced by a demand note for \$250,000, which sum was due and payable to Wave on March 26, 2002 and bore interest at a rate per annum equal to 1% over the prime interest rate. Interest on the loan accrued monthly and was payable at maturity. The terms of the loan were

substantially equivalent to market terms available at that time. The due date of the demand note was subsequently extended until March 26, 2003. As of December 31, 2002 the loan balance, including accrued interest was \$278,342. As of March 26, 2003 the loan balance, including accrued interest was \$281,399. On March 27, 2003, the Compensation Committee approved an extraordinary bonus in an amount equal to Mr. Feeney's obligations with respect to such loan and accrued interest. Proceeds of this extraordinary bonus were used to repay the loan and all interest accrued on such loan. This bonus is considered extraordinary because it was granted during the year so that Mr. Feeney could repay his loan, rather than at fiscal year end when bonuses are usually awarded. The factors used in granting this extraordinary bonus were the amount of the loan, the ability to repay the loan and the impact that non-repayment of the loan would have on Mr. Feeney's abilities to fulfill his duties for Wave. Wave no longer intends to award extraordinary bonuses to executive officers or directors because there are no outstanding loans to any current executive officers or directors and the Sarbanes-Oxley Act of 2002 prohibits any future such loans. The largest amount outstanding with respect to indebtedness of Mr. Feeney during 2002 was \$278,342. Wave intends to take this extraordinary bonus into account when considering future bonus awards to Mr. Feeney.

Also during 2001, Wave made personal loans to Mr. Peter J. Sprague, former Chairman of Wave totaling \$1,062,139. The loans were evidenced by demand notes for \$713,320 dated February 27, 2001, \$184,500 dated July 25, 2001 and \$164,319 dated September 5, 2001. These notes carry terms of one year and bear interest at a rate per annum equal to 1% over the prime rate of interest. Interest on the loans accrues monthly and is payable at maturity. The terms of the loans were substantially equivalent to market terms available at that time. Two of the demand notes in the amount of \$713,320 and \$184,500 plus accrued interest came due on February 27, 2002 and July 25, 2002, respectively and were extended for an additional year beyond their original due dates, prior to the enactment of the Sarbanes-Oxley Act of 2002. The remaining loan, which had an original face value of \$165,319, and a balance of \$174,391 including accrued interest came due in September 2002. On November 12, 2002, the Compensation Committee approved the payment of an extraordinary bonus that Mr. Sprague used to repay the \$164,319 balance of the note due in September 2002 plus accrued interest of \$10,072. Accordingly, Wave has recognized approximately \$174,391 as bonus expense in selling, general and administrative expense in its statements of operations for the year ended December 31, 2002. This bonus was considered extraordinary for the same reasons as the bonus awarded to Mr. Feeney described above. This bonus was awarded based on the same factors as the bonus awarded to Mr. Feeney. As of December 31, 2002, the balances of the two notes still outstanding were \$799,143 that came due on February 27, 2003 and \$200,374 that is due on July 26, 2003, for a total of \$999,518. As of March 26, 2003, the balances of these two notes were \$807,863 that came due on February 27, 2003 and \$202,630 that is due on July 26, 2003, for a total of \$1,010,493. Wave has recorded a reserve for uncollectibility for 100% of these loans that remain outstanding as of December 31, 2002 and March 26, 2003, because Wave has determined that Mr. Sprague is unable to repay the loans promptly. Mr. Sprague resigned as Chairman of Wave as of March 31, 2003. Wave intends to engage Mr. Sprague as Chairman and Chief Executive Officer of WaveXpress. Wave intends to diligently pursue collection of Mr. Sprague's loan. The largest aggregate amount outstanding with respect to indebtedness of Mr. Sprague during 2002 was \$1,161,573.

Consistent with the provisions of the Sarbanes-Oxley Act of 2002, Wave has adopted a written policy prohibiting future loans to officers and directors.

Specialty Broadcast Networks

In August 2001, Wave loaned \$150,000 to Specialty Broadcast Networks ("SBN") pursuant to an unsecured convertible term note. SBN's business is to create new video and Internet content networks and aggregate this content into commercially viable web sites and interactive networks. The loan was made to SBN to fund initial operations. The largest aggregate amount due Wave under the note during 2002 was \$159,879, including accrued interest of \$9,879. Wave also entered into a stockholder agreement pursuant to which Wave acquired a 50% stake in SBN, for a nominal amount. Steven Sprague is a director and Executive Officer of SBN. The note bears interest at a rate per annum equal to the prime rate and is convertible into shares of SBN common stock. Interest on the note accrues monthly. As of March 20, 2003 the loan balance, including accrued interest thereon was approximately \$161,000. The note together with accrued interest is due and payable no later than April 30, 2004. Wave's commitment to make further loans to SBN pursuant to the note expired on February 3, 2002, and Wave has made no further loans to SBN.

Compensation to Michael Sprague

During 2002, Michael Sprague, son of Mr. Peter J. Sprague, the former Chairman and former Chief Executive Officer of Wave, served as Vice President of Services Development of WaveXpress and was paid compensation of \$125,619 for serving in this capacity.

ITEM 14. Controls and Procedures

- (a) *Evaluation of disclosure controls and procedures.* Under new Securities and Exchange Commission regulations implementing portions of the Sarbanes-Oxley Act of 2002, our CEO and CFO are required to certify in this annual report their responsibility for establishing and maintaining disclosure controls and procedures designed to ensure that material information in relation to Wave is made known to them. Our CEO and CFO are also required to certify that they have evaluated the effectiveness of our disclosure controls and procedures as of a date within 90 days prior to the filing of this report, and that they have presented in this report their conclusions about the effectiveness of the disclosure controls and procedures as a result of the evaluation. Based on their evaluation, our CEO and CFO have concluded that our disclosure controls and procedures are effective, providing them with material information relating to Wave as required to be disclosed in the reports we file with the Commission on a timely basis.
- (b) *Changes in internal controls.* There were no significant changes in Wave's internal controls or in other factors that could significantly affect these disclosure controls subsequent to the date of the CEO and CFO's 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

(a) (1) Financial Statements:

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(a) (2) Financial Statement Schedules:

All schedules have been omitted since they are either not required or not applicable.

(a) (3) Exhibits:

<u>Exhibit No.</u>	<u>Description of Exhibit</u>
3.1*	— Restated Certificate of Incorporation of Wave (incorporated by reference to Exhibit 3.1 of Wave's Registration Statement on Form S-1, File No. 33-75286)
3.2*	— Bylaws of Wave (incorporated by reference to Exhibit 3.2 of Wave's Registration Statement on Form S-1, File No. 33-75286)
4.1*	— Form of Stock Certificate of Class A Common Stock (incorporated by reference to Exhibit 4.1 of Wave's Registration Statement on Form S-1, File No. 33-75286)
4.2*	— Form of Representative's Warrant Agreement, including the form of Representative's Warrant (incorporated by reference to Exhibit 4.2 of Wave's Registration Statement on Form S-1, File No. 33-75286).
4.3*	— Certificate of Designation of Series B Preferred Stock of Wave as filed with the Delaware Secretary of State on May 24, 1996 (incorporated by reference to Exhibit 3.1 of Wave's Current Report on Form 8-K, filed on June 6, 1996, File No. 0-24752)
4.4*	— Certificate of Designation of Series C Convertible Preferred Stock as filed with the Delaware Secretary of State on December 27, 1996 (incorporated by reference to Exhibit 3.1 of Wave's Current Report on Form 8-K, filed on January 8, 1997, File No. 0-24752)
4.5*	— Certificate of Designation of Series D Convertible Preferred Stock as filed with the Delaware Secretary of State on December 27, 1996 (incorporated by reference to Exhibit 3.1 of Wave's Current Report on Form 8-K, filed on June 3, 1997, File No. 0-24752)

Exhibit No.	Description of Exhibit
4.6*	— Certificate of Designation of Series F Convertible Preferred Stock of Wave as filed with the Delaware Secretary of State on October 9, 1997 (incorporated by reference to Exhibit 3.1 of Wave's Current Report on Form 8-K, filed on October 15, 1997, File No. 0-24752)
4.7*	— Certificate of Designation of Series G Convertible Preferred Stock of Wave as filed with the Delaware Secretary of State on March 5, 1998 (incorporated by reference to Exhibit 3.1 of Wave's Current Report on Form 8-K, filed on March 19, 1998, File No. 0-24752)
+10.1*	— Joint Technology Development Agreement, dated as of May 1, 1992, between The Titan Corporation and Cryptologics International, Inc. (incorporated by reference to Exhibit 10.2 of Wave's Registration Statement on Form S-1, File No. 33-75286)
+10.2*	— License and Cross-License Agreement, dated as of May 1, 1992, between The Titan Corporation and Cryptologics International, Inc. (incorporated by reference to Exhibit 10.3 of Wave's Registration Statement on Form S-1, File No. 33-75286)
10.3*	— Amendment to License and Cross-License Agreement, dated as of August 27, 1993, between The Titan Corporation and Wave (incorporated by reference to Exhibit 10.4 of Wave's Registration Statement on Form S-1, File No. 33-75286)
10.4*	— Amended and Restated License Agreement, dated February 14, 1994, by and among Wave, Peter J. Sprague and John R. Michener (incorporated by reference to Exhibit 10.5 of Wave's Registration Statement on Form S-1, File No. 33-75286)
†10.5*	— Wave 1994 Stock Option Plan (incorporated by reference to Exhibit 10.6 of Wave's Registration Statement on Form S-1, File No. 33-75286)
†10.6*	— Wave Non-Employee Directors Stock Option Plan (incorporated by reference to Exhibit 10.7 of Wave's Registration Statement on Form S-1, File No. 33-75286)
†10.7*	— Wave 1996 Performance Stock Option Plan (incorporated by reference to Exhibit 10.12 of Wave's Annual Report on Form 10-K, filed on April 1, 2002, File #0-24752)
10.8*	— Addendum to License and Cross-License Agreement, dated February 28, 1997, between The Titan Corporation and Wave (incorporated by reference to Exhibit 10.10 of Wave's Annual Report on Form 10-K, filed on March 24, 1997, File No. 0-24752).
†10.9*	— Employment Contract, dated June 8, 1998, between Gerard T. Feeney and Wave (incorporated by reference to Exhibit 10.18 of Wave's Annual Report on Form 10-K, filed on April 1, 1999, File No. 0-24752).
†10.10*	— Employment Contract, dated November 10, 1998, between Steven Sprague and Wave (incorporated by reference to Exhibit 10.19 of Wave's Annual Report on Form 10-K, filed on April 1, 1999, File No. 0-24752).
10.11*	— Asset Purchase Agreement dated August 13, 2000, by and among Wave and Indigo Networks, LLC (incorporated by reference to Exhibit 99.1 of Wave's Current Report on Form 8-K, filed on September 15, 2000, File #0-24752)
10.12*	— Consulting Services Agreement dated September 14, 2001, by and between Wave and Archon Technologies, Inc. (incorporated by reference to Exhibit 10.14 of Wave's Annual Report on Form 10-K, filed on April 1, 2002, File #0-24752)

Exhibit No.	Description of Exhibit
10.13*	— Office Building Lease dated October 20, 2002 between Stevens Creek Investors, LLC and Wave (incorporated by reference to Exhibit 10.13 of Wave's Annual Report on Form 10-K, filed on March 31, 2003, File #0-24752)
10.14*	— Form of Asset Purchase Agreement dated October 4, 2001, by and between Wave and SignOnLine (incorporated by reference to Exhibit 10.15 of Wave's Annual Report on Form 10-K, filed on April 1, 2002, File #0-24752)
10.15*	— First Amendment to Asset Purchase Agreement dated October 4, 2001, by and between Wave and SignOnLine (incorporated by reference to Exhibit 10.16 of Wave's Annual Report on Form 10-K, filed on April 1, 2002, File #0-24752)
10.16*	— Termination Agreement and Mutual Release between Wave Systems Corp. and SSP Solutions, Inc. date September 30, 2002 (Incorporated herein by referenced to Exhibit 10.1 of Wave's Quarterly Report on Form 10-Q for the quarter ended September 30, 2002, filed on November 14, 2002, File #0-24752)
10.17*	— Subordinated Convertible Promissory Note between Wave Systems Corp. and SSP Solutions, Inc. dated September 30, 2002 (Incorporated herein by referenced to Exhibit 10.2 of Wave's Quarterly Report on Form 10-Q for the quarter ended September 30, 2002, filed on November 14, 2002, File #0-24752)
10.18*	— Share Purchase Agreement between Redwave plc, GlobalWave Group plc and Wave Systems Corp. dated June 19, 2002 (Incorporated herein by referenced to Exhibit 10.3 of Wave's Quarterly Report on Form 10-Q/A for the quarter ended September 30, 2002, filed on March 19, 2003, File #0-24752)
10.19*	— GlobalWave Group plc Notice of Extraordinary General Meeting dated June 20, 2002 (Incorporated herein by referenced to Exhibit 10.4 of Wave's Quarterly Report on Form 10-Q/A for the quarter ended September 30, 2002, filed on March 19, 2003, File #0-24752)
10.20	— Joint Venture Agreement dated October 15, 1999 between Wave, WaveXpress and Sarnoff
10.21	— Stockholder Agreement dated October 15, 1999 between Wave, WaveXpress and Sarnoff
21.1*	— Subsidiaries of Registrant (incorporated by reference to Exhibit 10.12 of Wave's Annual Report on Form 10-K, filed on April 1, 2002, File #0-24752)
23.1	— Consent of Independent Auditors – KPMG LLP
99.1*	— Demand Note, dated March 26, 2001 between Gerard T. Feeney and Wave (incorporated by reference to Exhibit 99.1 of Wave's Annual Report on Form 10-K, filed on April 1, 2002, File #0-24752)
99.2*	— Demand Note, dated February 27, 2001 between Peter J. Sprague and Wave (incorporated by reference to Exhibit 99.2 of Wave's Annual Report on Form 10-K, filed on April 1, 2002, File #0-24752)
99.3*	— Demand Note, dated July 25, 2001 between Peter J. Sprague and Wave (incorporated by reference to Exhibit 99.3 of Wave's Annual Report on Form 10-K, filed on April 1, 2002, File #0-24752)
99.4*	— Demand Note, dated September 5, 2001 between Peter J. Sprague and Wave (incorporated by reference to Exhibit 99.4 of Wave's Annual Report on Form 10-K, filed on April 1, 2002, File #0-24752)
99.5	— Section 906 Certification
99.6	— Allonge to Demand Promissory Note, dated March 26, 2002 between Gerard

- T. Feeney and Wave
- 99.7 — Allonge to Demand Promissory Note, dated February 27, 2002 between Peter J. Sprague and Wave
- 99.8 — Allonge to Demand Promissory Note, dated July 25, 2002 between Peter J. Sprague and Wave

* Incorporated herein by reference

+ Confidential treatment has been granted as to portions of this exhibit.

† Management contract or compensatory plan.

(b) Reports on Form 8-K

There have been no reports on Form 8-K filed during the quarter-ended December 31, 2002.

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.

Dated: June 27, 2003

WAVE SYSTEMS CORP.

By: /s/ Steven K Sprague

Name: Steven K. Sprague

Title: President and 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.

<u>Signature</u>	<u>Title</u>	<u>Date</u>
<u>/s/ Steven Sprague</u> Steven Sprague	President, Chief Executive Officer and Director	June 27, 2003
<u>/s/ John E. Bagalay, Jr.</u> John E. Bagalay, Jr.	Acting Chairman	June 27, 2003
<u>/s/ George Gilder</u> George Gilder	Director	June 27, 2003
<u>/s/ John E. McConnaughy, Jr.</u> John E. McConnaughy, Jr.	Director	June 27, 2003
<u>/s/ Nolan Bushnell</u> Nolan Bushnell	Director	June 27, 2003
<u>/s/ Gerard T. Feeney</u> Gerard T. Feeney	Senior Vice President, Finance and Administration, Chief Financial Officer and Secretary (Principal Financial Officer and Duly Authorized Officer of the Registrant)	June 27, 2003

CERTIFICATIONS

I, Steven K. Sprague, certify that:

1. I have reviewed this annual report on Form 10-K of Wave Systems Corp.

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

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

4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and 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 registrant's board of directors (or persons performing the equivalent function):

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

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.

Date: June 27, 2003

/s/ Steven K. Sprague

Steven K. Sprague, President
and Chief Executive Officer

I, Gerard T. Feeney, certify that:

1. I have reviewed this annual report on Form 10-K of Wave Systems Corp.
2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this annual report;
3. Based on my knowledge, the financial statements, and other financial information included in this annual report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this annual report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and 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 registrant's board of directors (or persons performing the equivalent function):
 - a) All significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
 - 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.

Date: June 27, 2003

/s/ Gerard T. Feeney
Gerard T. Feeney, Chief Financial Officer

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INDEPENDENT AUDITORS' REPORT

The Board of Directors and Stockholders
Wave Systems Corp.:

We have audited the consolidated financial statements of Wave Systems Corp. and subsidiaries (a development stage corporation) as listed in the accompanying index. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Wave Systems Corp. and subsidiaries as of December 31, 2002 and 2001, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2002 and for the period from February 12, 1988 (date of inception) to December 31, 2002 in conformity with accounting principles generally accepted in the United States of America.

The accompanying consolidated financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note 2 to the consolidated financial statements, the Company has suffered recurring losses from operations and has an accumulated deficit that raises substantial doubt about its ability to continue as a going concern. Management's plans in regard to these matters are also described in Note 2. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

KPMG LLP

Boston, Massachusetts
March 31, 2003

WAVE SYSTEMS CORP. AND SUBSIDIARIES
(a development stage corporation)

Consolidated Balance Sheets
December 31, 2002 and 2001

Assets

	2002	2001
Current assets:		
Cash and cash equivalents	\$ 10,221,124	\$ 40,437,119
Cash Collected on Behalf of Charities	235,553	358,531
Marketable securities	-	10,366
Notes Receivable from Officers	278,342	1,380,050
Inventories	1,112,818	581,912
Prepaid expenses and other receivables	574,316	624,535
Total current assets	12,422,153	43,392,513
Marketable Equity Securities	2,881,016	11,160,758
Property and equipment, net	2,542,765	4,291,228
Other assets	363,438	1,389,803
Total Assets	18,209,372	60,234,302

Liabilities and Stockholders' equity

Current liabilities:

Accounts payable and accrued expenses	3,404,377	5,807,878
Due to Charities	263,156	423,053
Deferred Revenue	-	197,965
Total current liabilities	3,667,533	6,428,896

Stockholders' Equity:

Common Stock, \$.01 par value. Authorized 75,000,000 shares as Class A; 51,771,918 shares issued and outstanding in 2002 and 49,996,506 in 2001	517,720	499,965
Common Stock, \$.01 par value. Authorized 13,000,000 shares as Class B; 324,225 shares issued and outstanding in 2002 and 357,083 in 2001	3,242	3,571
Capital in excess of par value	247,112,405	244,330,985
Deficit accumulated during the development stage	(233,091,528)	(189,624,123)
Accumulated Other Comprehensive Income – unrealized gain (loss) on marketable securities	-	(1,404,992)
Total stockholders' equity	14,541,839	53,805,406
Total Liabilities and Stockholders' Equity	\$ 18,209,372	\$60,234,302

See accompanying notes to consolidated financial statements.

WAVE SYSTEMS CORP. AND SUBSIDIARIES

(a development stage corporation)

Consolidated Statements of Operations

Years ended December 31, 2002, 2001, 2000, and
 period from February 12, 1988 (date of inception)
 through December 31, 2002

	2002	2001	2000	Period from February 12, 1988 (date of inception) through December 31, 2002
Net Revenues:				
Product	\$ 121,974	\$ 192,506	\$ 4,400	\$ 486,114
Services	310,573	430,724	–	741,297
Licensing and Other	14,041	68,895	328,122	505,899
Total Net Revenues	<u>446,588</u>	<u>692,125</u>	<u>332,522</u>	<u>1,733,310</u>
Cost of sales:				
Product	64,769	135,134	3,520	281,055
Services	132,582	227,124	–	359,706
Licensing and Other	4,857	7,701	55,344	135,637
Total Cost of Sales	<u>202,208</u>	<u>369,959</u>	<u>58,864</u>	<u>776,398</u>
Gross margin	244,380	322,166	273,658	956,912
Operating expenses:				
Selling, general and administrative	19,188,046	24,184,317	26,553,634	127,659,959
Research and development	12,009,713	17,691,051	20,866,055	83,962,689
Amortization of Goodwill	–	1,720,632	573,544	2,294,176
Write-off of Intangibles and other Impaired Assets	1,571,031	1,761,917	–	3,332,948
Restructuring Costs and other special charges	726,280	–	–	726,280
Write-off of Goodwill	–	2,284,570	–	3,054,456
In Process research and development expense	–	–	2,176,000	2,176,000
Acquisition Costs	–	–	–	1,494,000
Aladdin license expense	–	–	–	3,889,000
	<u>33,495,070</u>	<u>47,642,487</u>	<u>50,169,233</u>	<u>228,589,508</u>
Other income (expense):				
Interest income	477,902	2,688,105	5,103,716	10,191,301
Interest expense	–	–	–	(1,695,461)
Equity in net losses of GlobalWave	–	(2,332,159)	(3,406,491)	(5,738,650)
Loss on Other than Temporary Decline in Marketable Equity Securities	(11,513,099)	(1,736,682)	–	(13,249,781)
Gain on Sale of Marketable Securities	–	–	542,457	542,457
Gain on termination of development contract	1,818,000	–	–	1,818,000
Provision for loss on officer note receivable	(999,518)	–	–	(999,518)
License fee	–	–	–	5,000,000
License warrant cost	–	–	–	(1,100,000)
Other (expense)	–	–	–	(227,280)
	<u>(10,216,715)</u>	<u>(1,380,736)</u>	<u>2,239,682</u>	<u>(5,458,932)</u>
Net loss	(43,467,405)	(48,701,057)	(47,655,893)	(233,091,528)
Accrued dividends on preferred Stock	–	–	–	4,350,597
Net loss to common stockholders	<u>\$ (43,467,405)</u>	<u>\$ (48,701,057)</u>	<u>\$ (47,655,893)</u>	<u>\$ (237,442,125)</u>
Loss per common share – basic and diluted	<u>\$ (0.85)</u>	<u>\$ (0.97)</u>	<u>\$ (1.03)</u>	<u>\$ (11.54)</u>
Weighted average number of common shares outstanding during the period	<u>51,135,548</u>	<u>49,949,875</u>	<u>46,149,587</u>	<u>20,578,073</u>

See accompanying notes to consolidated financial statements.

WAVE SYSTEMS CORP. AND SUBSIDIARIES
(a development stage corporation)

Consolidated Statements of Stockholders' Equity (Deficiency) And Comprehensive Income (Loss)

	Class A Common Stock		Class B Common Stock		Capital in excess of par value	Deficit accumulated during the development stage	Deferred compensation	Note receivable from stockholder	Total
	Shares	Amount	Shares	Amount					
Shares issued to founders at \$.003 per share	-	\$ -	4,680,000	\$ 46,800	\$(31,200)	\$ -	\$ -	\$ -	\$ 15,600
Shares issued at \$1.25 per share, net of expenses of \$36,574 from September through November 1988	-	-	300,000	3,000	335,426	-	-	-	338,426
Net loss for period ended December 31, 1988	-	-	-	-	-	(326,832)	-	-	(326,832)
Balance at December 31, 1988	-	-	4,980,000	49,800	304,226	(326,832)	-	-	27,194
Shares issued at \$1.25 per share, net of expenses of \$68,750, from January through December 1989	-	-	270,000	2,700	266,050	-	-	-	268,750
Shares issued at \$1.25 per share in July 1989 as compensation for services rendered	-	-	1,920	19	2,381	-	-	-	2,400
Shares issued by principal stockholders at \$1.25 per share in December 1989 as compensation for services rendered	-	-	-	-	374,000	-	-	-	374,000
Net loss for year ended December 31, 1989	-	-	-	-	-	(982,186)	-	-	(982,186)
Balance at December 31, 1989	-	-	5,251,920	52,519	946,657	(1,309,018)	-	-	(309,842)
Shares issued by principal stockholder at \$1.25 per share in March 1990 as compensation for services rendered	-	-	-	-	56,250	-	-	-	56,250
Shares issued by principal stockholder at \$.50 per share in March 1990 as compensation for services rendered	-	-	-	-	60,000	-	-	-	60,000
Shares issued at \$1.67 per share in May 1990 as compensation for services rendered	-	-	6,000	60	9,940	-	-	-	10,000
Shares issued at \$1.67 per share, net of expenses of \$5,000 in March, April, November and December 1990	-	-	390,000	3,900	641,100	-	-	-	645,000
Net loss for year ended December 31, 1990	-	-	-	-	-	(1,178,129)	-	-	(1,178,129)
Balance at December 31, 1990	-	-	5,647,920	56,479	1,713,947	(2,487,147)	-	-	(716,721)
Shares issued at \$1.67 per share from March through November 1991	-	-	315,000	3,150	521,850	-	-	-	525,000
Shares issued at \$1.67 per share in November 1991 as compensation for services rendered	-	-	19,800	198	32,802	-	-	-	33,000
Net loss for year ended December 31, 1991	-	-	-	-	-	(1,009,368)	-	-	(1,009,368)
Balance at December 31, 1991 (carried forward)	-	-	5,982,720	59,827	2,268,599	(3,496,515)	-	-	(1,168,089)

See accompanying notes to consolidated financial statements.

WAVE SYSTEMS CORP. AND SUBSIDIARIES
(a development stage corporation)

Consolidated Statements of Stockholders' Equity (Deficiency) And Comprehensive Income (Loss)- (Continued)

	Class A Common Stock		Class B Common Stock		Capital in excess of par value	Deficit accumulated during the development stage	Deferred compensation	Note receivable from stockholder	Total
	Shares	Amount	Shares	Amount					
Balance at December 31, 1991 (brought forward)	-	-	5,982,720	59,827	2,268,599	(3,496,515)	-	-	(1,168,089)
Shares issued at \$1.67 per share from January through October 1992	-	-	708,000	7,080	1,172,920	-	-	-	1,180,000
Shares issued at \$1.67 per share in May 1992 in connection with License and Cross-License Agreement	-	-	674,976	6,750	1,118,210	-	-	-	1,124,960
Shares issued at \$1.67 per share in May 1992 as compensation for services rendered	-	-	18,000	180	29,820	-	-	-	30,000
Shares issued at \$2.50 per share in May and November 1992 as compensation for services rendered	-	-	771,000	7,710	1,919,790	-	-	-	1,927,500
Shares issued at \$2.50 per share, net of expenses of \$7,500, in November and December 1992	-	-	323,001	3,230	796,773	-	-	-	800,003
Shares issued by principal stockholder in December 1992 at \$2.50 per share as compensation for services rendered	-	-	-	-	75,000	-	-	-	75,000
Shares canceled in October and December 1992	-	-	(75,000)	(750)	750	-	-	-	-
Issuance of stock options at \$.003 exercise price per share in June 1992	-	-	-	-	798,400	-	(398,660)	-	399,740
Amortization of deferred compensation	-	-	-	-	-	-	155,455	-	155,455
Accrued dividends on preferred stock	-	-	-	-	(6,383)	-	-	-	(6,383)
Note receivable and accrued interest from stockholder	-	-	-	-	-	-	-	(152,974)	(152,974)
Net loss for the year ended December 31, 1992	-	-	-	-	-	(4,182,638)	-	-	(4,182,638)
Balance at December 31, 1992	-	-	8,402,697	84,027	8,173,879	(7,679,153)	(243,205)	(152,974)	182,574
Shares issued at \$1.67 per share in February 1993	-	-	30,000	300	49,800	-	-	-	50,100
Shares issued at \$3.50 per share, net of expenses of \$82,427, from April through December 1993	-	-	550,359	5,504	1,838,294	-	-	-	1,843,798
Shares issued at \$3.50 per share from May to December 1993 as compensation for services rendered, for the acquisition of property and equipment and as additional interest on borrowings	-	-	73,319	733	255,884	-	-	-	256,617
Issuance of warrants to purchase Class B Common Stock from September to December 1993 in conjunction with the issuance of convertible debt	-	-	-	-	72,893	-	-	-	72,893
Amortization of deferred compensation	-	-	-	-	-	-	243,205	-	243,205
Accrued dividends on preferred stock	-	-	-	-	(38,467)	-	-	-	(38,467)
Note receivable and accrued interest from stockholder	-	-	-	-	-	-	-	(39,783)	(39,783)
Net loss for year ended December 31, 1993	-	-	-	-	-	(3,959,334)	-	-	(3,959,334)
Balance at December 31, 1993	-	-	9,056,375	90,564	10,352,283	(11,638,487)	-	(192,757)	(1,388,397)

See accompanying notes to consolidated financial statements.

WAVE SYSTEMS CORP. AND SUBSIDIARIES
(a development stage corporation)

Consolidated Statements of Stockholders' Equity (Deficiency) And Comprehensive Income (Loss)- (Continued)

	Class A Common stock		Class B Common stock		Capital in excess of par value	Deficit accumulated during the development stage	Deferred compensation	Note receivable from stockholder	Total
	Shares	Amount	Shares	Amount					
Balance at December 31, 1993	-	-	9,056,375	90,564	10,352,283	(11,638,487)	-	(192,757)	(1,388,397)
Shares issued at \$3.50 per share in January and February 1994	-	-	95,715	957	334,046	-	-	-	335,003
Shares issued at \$3.50 per share in February 1994 as additional interest on borrowings	-	-	5,700	57	19,893	-	-	-	19,950
Issuance of warrants to purchase Class B Common Stock in January and February 1994 in conjunction with the issuance of convertible debt	-	-	-	-	115,234	-	-	-	115,234
Accrued dividends on preferred stock	-	-	-	-	(39,484)	-	-	-	(39,484)
Accrual of interest on note receivable from stockholder	-	-	-	-	-	-	-	(17,315)	(17,315)
Sale of warrants to underwriter in September 1994	-	-	-	-	4	-	-	-	4
Conversion of notes payable	-	-	599,507	5,995	2,079,131	-	-	-	2,085,126
Shares issued at \$5.00 per share in initial public offering in September 1994, net of expenses of \$2,929,835	3,728,200	37,282	-	-	15,673,883	-	-	-	15,711,165
Net loss for year ended December 31, 1994	-	-	-	-	-	(4,271,501)	-	-	(4,271,501)
Balance at December 31, 1994	3,728,200	37,282	9,757,297	97,573	28,534,990	(15,909,988)	-	(210,072)	12,549,785
Shares issued at prices ranging from \$1.00 per share to \$3.13 per share as compensation for services rendered	31,559	315	-	-	57,184	-	-	-	57,499
Exercise of options to purchase Class B Common Stock	-	-	681,700	6,817	429,413	-	-	-	436,230
Accrued dividends on preferred stock	-	-	-	-	(40,600)	-	-	-	(40,600)
Accrual of interest on note receivable from stockholder	-	-	-	-	-	-	-	(17,318)	(17,318)
Exchange of Class B Common Stock for Class A Common Stock	2,855,859	28,559	(2,855,859)	(28,559)	-	-	-	-	-
Net loss for the year ended December 31, 1995	-	-	-	-	-	(6,832,866)	-	-	(6,832,866)
Balance at December 31, 1995	6,615,618	66,156	7,583,138	75,831	28,980,987	(22,742,854)	-	(227,390)	6,152,730
Exercise of options to purchase Class A Common Stock	214,091	2,141	-	-	420,366	-	-	-	422,507
Shares issued at prices ranging from \$2.06 per share to \$3.44 per share as compensation for services rendered	42,077	421	-	-	123,029	-	-	-	123,450
Issuance of unregistered Class B Common Stock to acquire Wave Interactive Network valued at approximately \$.98 per share	-	-	375,000	3,750	364,688	-	-	-	368,438
Issuance of warrants to purchase unregistered shares of Class A Common Stock in conjunction with the issuance of convertible debt and preferred stock	-	-	-	-	283,455	-	-	-	283,455
Conversion of Class B Preferred Stock	2,960,303	29,603	-	-	3,078,921	-	-	-	3,108,524
Accrual of interest on note receivable	-	-	-	-	-	-	-	(17,315)	(17,315)
Accrued dividends on preferred stock	-	-	-	-	(199,014)	-	-	-	(199,014)
Exchange of Class B Common Stock for Class A Common Stock	1,749,997	17,500	(1,749,997)	(17,500)	-	-	-	-	-
N*ABLE APIC in connection with the issuance of Class A Common Stock due to merger	873,317	8,733	-	-	1,296,241	-	-	-	1,304,974
Net loss for the year ended December 31, 1996	-	-	-	-	-	(10,126,546)	-	-	(10,126,546)
Balance at December 31, 1996	12,455,403	124,554	6,208,141	62,081	34,348,673	(32,869,400)	-	(244,705)	1,421,203

See accompanying notes to consolidated financial statements.

WAVE SYSTEMS CORP. AND SUBSIDIARIES
(a development stage corporation)

Consolidated Statements of Stockholders' Equity (Deficiency) And Comprehensive Income (Loss)- (Continued)

	Class A Common stock		Class B Common stock		Capital in excess of par value	Deficit Accumulated during the development stage	Series G Convertible Preferred Stock	Note receivable from stockholder	Total
	Shares	Amount	Shares	Amount					
Balance at December 31, 1996	<u>12,455,403</u>	<u>124,554</u>	<u>6,208,141</u>	<u>62,081</u>	<u>34,348,673</u>	<u>(32,869,400)</u>	<u>-</u>	<u>(244,705)</u>	<u>1,421,203</u>
Exercise of options to purchase Class A and B Common Stock	70,326	703	10,330	104	139,081	-	-	-	139,888
Shares issued at prices ranging from \$1.00 per share to \$3.00 per share as compensation for services rendered	126,885	1,269	-	-	304,227	-	-	-	305,496
Conversion of preferred stock into Common Stock	7,998,860	79,989	-	-	6,703,028	-	-	-	6,783,017
Issuance of Class A Common Stock and warrants to purchase Class A Common Stock to Aladdin	500,000	5,000	-	-	3,834,000	-	-	-	3,839,000
Issuance of Class A Common Stock and warrants to purchase Class A Common Stock	799,964	8,000	-	-	792,000	-	-	-	800,000
Reduction in note receivable	-	-	-	-	-	-	-	50,000	50,000
Accrual of interest on note receivable	-	-	-	-	-	-	-	(17,319)	(17,319)
Issuance of warrants to purchase Class A Common Stock in conjunction with the issuance of preferred stock	-	-	-	-	386,462	-	-	-	386,462
Accrued dividend on preferred stock including accretion of assured incremental yield	-	-	-	-	(1,372,984)	-	-	-	(1,372,984)
Assured incremental yield on issuance of Series F convertible preferred stock and debt	-	-	-	-	682,000	-	-	-	682,000
N*ABLE APIC in connection with the issuance of Class A Common Stock due to merger	1,404,723	14,047	-	-	10,133,497	-	-	-	10,147,544
Net loss	-	-	-	-	-	(18,012,635)	-	-	(18,012,635)
Exchange of Class B Common Stock for Class A Common Stock	<u>1,796,518</u>	<u>17,965</u>	<u>(1,796,518)</u>	<u>(17,965)</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>
Balance at December 31, 1997	25,152,679	\$251,527	4,421,953	\$44,220	\$55,949,984	\$(50,882,035)	\$ -	\$(212,024)	\$5,151,672
Exercise of options to purchase Class A Common Stock	77,558	775	-	-	151,180	-	-	-	151,955
Options issued to employees below fair market-value	-	-	-	-	234,723	-	-	-	234,723
Exercise of warrants to purchase Class A Common Stock	1,652,770	16,528	-	-	3,945,740	-	-	-	3,962,268
Warrants to purchase Class A Common Stock to be issued as part of technology licensing agreement and issued to consultants for services	-	-	-	-	1,546,824	-	-	-	1,546,824
Shares issued at prices ranging from \$1.00 per share to \$5.00 per share as compensation for services rendered	121,400	1,214	-	-	647,274	-	-	-	648,488
Reduction in note receivable	-	-	-	-	-	-	-	75,000	75,000
Issuance of Series G Convertible Preferred stock and Common Stock warrants, net of issuance costs of \$222,500	-	-	-	-	218,250	-	1,809,250	-	2,027,500
Assured incremental yield on issuance of Series G convertible preferred stock and debt	-	-	-	-	750,000	-	-	-	750,000
Accrual of interest on note receivable	-	-	-	-	-	-	-	(12,318)	(12,318)
Accrued dividend on preferred stock including accretion of assured incremental yield	-	-	-	-	(858,863)	-	837,263	-	(21,600)
Conversion of Series G Preferred Stock	2,394,494	23,945	-	-	2,274,756	-	(2,298,701)	-	-
N*ABLE's APIC in connection with the issuance of Class A Common Stock due to the merger	2,781	28	-	-	59,182	-	-	-	59,210
Net loss	-	-	-	-	-	(16,586,027)	-	-	(16,586,027)
Adjustment for net loss of N*ABLE for the six months ended June 30, 1998	-	-	-	-	-	2,253,461	-	-	2,253,461
Exchange of Class B Common Stock for Class A Common Stock	<u>1,281,288</u>	<u>12,813</u>	<u>(1,281,288)</u>	<u>(12,813)</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>
Balance at December 31, 1998	<u>30,682,970</u>	<u>\$306,830</u>	<u>3,140,665</u>	<u>\$31,407</u>	<u>\$64,919,050</u>	<u>\$(65,214,601)</u>	<u>\$ 347,812</u>	<u>\$(149,342)</u>	<u>\$ 241,156</u>

See accompanying notes to consolidated financial statements.

WAVE SYSTEMS CORP. AND SUBSIDIARIES
(a development stage corporation)

Consolidated Statements of Stockholders' Equity (Deficiency) And Comprehensive Income (Loss) - (Continued)

	Class A Common Stock		Class B Common Stock		Capital in excess of par value	Deficit accumulated during the development stage	Series G Convertible Preferred Stock	Accumulated Other Comprehensive Income	Note receivable from stockholder	Total
	Shares	Amount	Shares	Amount						
Balance at December 31, 1998	30,682,970	\$306,830	3,140,665	\$31,407	\$64,919,050	\$(65,214,601)	\$ 347,812	-	\$(149,342)	\$241,156
Net loss	-	-	-	-	-	(28,052,572)	-	-	-	(28,052,572)
Unrealized gain on Marketable Securities	-	-	-	-	-	-	-	2,860,500	-	2,860,500
Comprehensive loss	-	-	-	-	-	-	-	-	-	(25,192,072)
Exercise of options to purchase Class A Common Stock	964,000	9,640	-	-	1,622,431	-	-	-	-	1,632,071
Warrants exercised to purchase Class A Common Stock	3,370,238	33,702	-	-	6,708,057	-	-	-	-	6,741,759
Shares Issued at \$11.00 per share, net of issuance costs	2,090,405	20,904	-	-	21,481,665	-	-	-	-	21,502,569
Conversion of Bridge to Loan to purchase Class A Common Stock	787,349	7,874	-	-	2,567,380	-	-	-	-	2,575,254
Warrants to Purchase Class A Common Stock	-	-	-	-	-	-	-	-	-	-
For services rendered	-	-	-	-	1,075,240	-	-	-	-	1,075,240
Shares issued as compensation for services rendered	83,461	834	-	-	1,149,486	-	-	-	-	1,150,320
Accrual of interest on note receivable	-	-	-	-	-	-	-	-	(4,818)	(4,818)
Conversion of Series G Preferred Stock	377,102	3,771	-	-	344,041	-	(347,812)	-	-	-
Accrued dividend on preferred stock	-	-	-	-	(13,239)	-	-	-	-	(13,239)
Exchange of Class B Common Stock for Class A stock	<u>1,090,158</u>	<u>10,902</u>	<u>(1,090,158)</u>	<u>(10,902)</u>	-	-	-	-	-	-
Balance at December 31, 1999	39,445,683	\$394,457	2,050,507	\$20,505	\$99,854,111	\$(93,267,173)	\$ 0	\$2,860,500	\$(154,160)	\$9,708,240
Net loss	-	-	-	-	-	(47,655,893)	-	-	-	(47,655,893)
Unrealized gain (loss) on marketable securities	-	-	-	-	-	-	-	(937,196)	-	(937,196)
Comprehensive loss	-	-	-	-	-	-	-	-	-	(48,593,089)
Shares issued at \$34.00 per share, net of issuance costs	3,600,800	36,008	-	-	114,941,407	-	-	-	-	114,977,415
Shares issued in exchange for substantially all of the assets of Indigo Networks, LLC at \$19.30 per share	374,889	3749	-	-	7,231,609	-	-	-	-	7,235,358
Shares issued as compensation for services at \$13.75 per share	7,879	79	-	-	108,254	-	-	-	-	108,333
Exercise of warrants to purchase Class A Common Stock	319,692	3,197	-	-	1,331,048	-	-	-	-	1,334,245
Exercise of Options to purchase Class A Common Stock	2,030,958	20,309	-	-	4,950,872	-	-	-	-	4,971,181
Compensation on Employee Options issued	-	-	-	-	318,609	-	-	-	-	318,609
Exchange of Class B Common Stock for Class A Common Stock	1,271,296	12,713	(1,271,296)	(12,713)	-	-	-	-	-	-
Repayment of note receivable from stockholder	-	-	-	-	-	-	-	-	154,160	154,160
Balance at December 31, 2000	47,051,197	\$ 470,512	779,211	\$ 7,792	\$228,735,910	\$(140,923,066)	\$ 0	\$ 1,923,304	\$ 0	\$90,214,452
Net loss	-	-	-	-	-	(48,701,057)	-	-	-	(48,701,057)
Investment Loss on Marketable Securities	-	-	-	-	-	-	-	(3,328,296)	-	(3,328,296)
Comprehensive loss	-	-	-	-	-	-	-	-	-	(52,029,353)
Shares issued in exchange for 3,600,000 shares of BIZ Interactive Zone, Inc. at \$7.16 per share	2,000,000	20,000	-	-	14,292,800	-	-	-	-	14,312,800
Exercise of Options	523,181	5,232	-	-	749,721	-	-	-	-	754,953
Compensation on Employee Options Issued	-	-	-	-	552,554	-	-	-	-	552,554
Exchange of Class B Common Stock for Class A Common Stock	<u>422,128</u>	<u>4,221</u>	<u>(422,128)</u>	<u>(4,221)</u>	-	-	-	-	-	-
Balance at December 31, 2001	<u>49,996,506</u>	<u>\$499,965</u>	<u>357,083</u>	<u>\$3,571</u>	<u>\$244,330,985</u>	<u>\$(189,624,123)</u>	<u>\$ 0</u>	<u>\$(1,404,992)</u>	<u>\$ 0</u>	<u>\$ 53,805,406</u>

See accompanying notes to consolidated financial statements.

WAVE SYSTEMS CORP. AND SUBSIDIARIES
(a development stage corporation)

Consolidated Statements of Stockholders' Equity (Deficiency) And Comprehensive Income (Loss) - (Continued)

	Class A Common Stock		Class B Common Stock		Capital in excess of par value	Deficit accumulated during the development stage	Series G Convertible Preferred Stock	Accumulated Other Comprehensive Income	Note receivable from stockholder	Total
	Shares	Amount	Shares	Amount						
Balance at December 31, 2001	49,996,506	\$ 499,965	357,083	\$ 3,571	\$244,330,985	\$(189,624,123)	\$ 0	\$ (1,404,992)	\$ 0	\$53,805,406
Net loss	-	-	-	-	-	(43,467,405)	-	-	-	(43,467,405)
Investment Loss on Marketable Securities	-	-	-	-	-	-	-	1,404,992	-	1,404,992
Comprehensive loss	-	-	-	-	-	-	-	-	-	(42,062,413)
Issuance of Class A Common Stock to acquire 60% of the Remaining assets of GlobalWave, Ltd	1,700,000	17,000	-	-	2,227,000	-	-	-	-	2,244,000
Exercise of Options	42,554	426	-	-	43,673	-	-	-	-	44,099
Issuance of warrants to purchase Class A Common Stock	-	-	-	-	143,500	-	-	-	-	143,500
Compensation on Expense Employee Options Issued	-	-	-	-	367,247	-	-	-	-	367,247
Exchange of Class B Common Stock for Class A Common Stock	<u>32,858</u>	<u>329</u>	<u>(32,858)</u>	<u>(329)</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>
Balance at December 31, 2002	<u>51,771,918</u>	<u>\$517,720</u>	<u>324,225</u>	<u>\$3,242</u>	<u>\$247,112,405</u>	<u>\$(233,091,528)</u>	<u>\$ 0</u>	<u>\$ 0</u>	<u>\$ 0</u>	<u>\$14,541,839</u>

See accompanying notes to consolidated financial statements.

WAVE SYSTEMS CORP. AND SUBSIDIARIES
(a development stage corporation)

Consolidated Statements of Cash Flows

Years ended December 31, 2002, 2001, 2000, and the Period
From February 12, 1988 (Date of Inception) through December 31, 2002

	2002	2001	2000	Period from February 12, 1988 (date of inception) through December 31, 2002
	<u>2002</u>	<u>2001</u>	<u>2000</u>	<u>2002</u>
Cash flows from operating activities:				
Net loss	\$(43,467,405)	\$(48,701,057)	\$(47,655,893)	\$ (233,091,528)
Adjustments to reconcile net loss to net cash used in operating activities:				
Write-off of goodwill	-	2,284,570	-	3,054,456
Goodwill Amortization	-	1,720,632	573,544	2,294,176
Depreciation and amortization	2,000,705	2,531,324	2,593,594	9,632,131
Reserve for note from affiliate	-	-	-	1,672,934
Provision for loss on officer note receivable	999,518	-	-	999,518
Non-cash expenses:				
Accretion of assured incremental yield on convertible debt	-	-	-	119,000
Common stock issued in connection with License Agreement	-	-	-	1,124,960
Realized gain on marketable securities	-	-	(542,457)	(542,457)
Net losses realized on GlobalWave investment	-	2,332,159	3,406,491	5,738,650
Common stock issued for services rendered and additional interest on borrowings	-	-	108,333	3,600,199
Warrants issued as compensation for services	143,500	-	-	2,895,095
Issuance of warrants to Aladdin	-	-	-	2,939,000
Accrued interest on note payable	-	-	-	121,219
In Process research and development	-	-	2,176,000	2,176,000
Write-off of Impaired Assets	1,571,031	1,761,917	-	3,332,948
Loss on Other than Temporary Decline in Marketable Equity Securities	11,513,099	1,736,682	-	13,249,781
Gain on termination of development contract with SSP	(1,818,000)	-	-	(1,818,000)
Preferred stock issued for services rendered	-	-	-	265,600
Compensation associated with issuance of Stock Options	367,247	552,554	318,609	1,872,873
Amortization of deferred compensation	-	-	-	398,660
Amortization of discount on notes payable	-	-	-	166,253
Common stock issued by principal stockholder for services	-	-	-	565,250
Changes in assets and liabilities:				
Increase (decrease) in deferred revenue	(197,965)	197,965	-	-
Increase in accrued interest on note receivable	(62,129)	(80,410)	105,985	(142,540)
(Increase) Decrease in inventories	(530,906)	43,236	(193,462)	(1,112,818)
(Increase) decrease in prepaid expenses and other receivables	50,219	92,478	(194,834)	(543,995)
(Increase) decrease in other assets	1,026,365	(112,278)	(870,604)	(378,353)
Increase (decrease) in accounts payable and accrued expenses	(655,264)	(2,638,780)	26,365	3,793,475
Increase in amounts due to charities	(159,897)	423,053	-	263,156
Increase in cash restricted on behalf of Charities	122,978	(358,531)	-	(235,553)
Net cash used in operating activities	<u>(29,096,904)</u>	<u>(38,214,486)</u>	<u>(40,148,329)</u>	<u>(177,589,910)</u>

(Continued)

WAVE SYSTEMS CORP. AND SUBSIDIARIES
(a development stage corporation)

Consolidated Statements of Cash Flows (Continued)

Years ended December 31, 2002, 2001, 2000 and the Period
From February 12, 1988 (Date of Inception) through December 31, 2002

	2002	2001	2000	Period from February 12, 1988 (date of inception) through December 31, 2002
Cash flows from investing activities:				
Acquisition of property and equipment	(1,148,723)	(1,507,598)	(3,829,300)	(11,443,477)
Investment in GlobalWave joint venture	(1,559,250)	-	(4,142,000)	(5,701,250)
Cash received in GlobalWave acquisition	1,380,464			1,380,464
Purchase of intangible assets	-	-	(750,000)	(2,500,000)
Short-term loans to affiliate	-	-	-	(1,672,934)
Organizational costs	-	-	-	(14,966)
Proceeds from sale of marketable securities	-	-	2,162,457	2,162,457
Exercise of warrant to acquire marketable securities-available for sale	-	-	-	(1,620,000)
Net cash used in investing activities	(1,327,509)	(1,507,598)	(6,558,843)	(19,409,706)
Cash flows from financing activities:				
Net proceeds from issuance of common stock	44,099	754,953	121,072,842	192,536,220
Net proceeds from issuance of preferred stock and warrants	-	-	-	12,283,027
Payment on (issuance of) note receivable from stockholder	164,319	(1,299,640)	48,175	(1,135,321)
Proceeds from notes payable and warrants to Stockholders	-	-	-	4,083,972
Repayments of notes payable to stockholders	-	-	-	(1,069,972)
Proceeds from notes payable and warrants	-	-	-	1,284,254
Repayments of note payable	-	-	-	(255,000)
Redemption of Preferred Stock	-	-	-	(506,440)
Net cash provided by (used in) financing activities	208,418	(544,687)	121,121,017	207,220,740
Net increase (decrease) in cash and cash equivalents	(30,215,995)	(40,266,771)	74,413,845	10,221,124
Cash and cash equivalents at beginning of period	40,437,119	80,703,890	6,290,045	-
Cash and cash equivalents at end of period	<u>\$10,221,124</u>	<u>\$40,437,119</u>	<u>\$ 80,703,890</u>	<u>\$10,221,124</u>

Supplemental information about noncash investing and financing activities:

On July 24, 2002, 1,700,000 shares of our common stock were issued to acquire 60% of GlobalWave, Ltd., see Note 15.

On February 2, 2001, 2,000,000 shares of our common stock were issued to acquire 3,600,000 shares of BIZ Interactive Zone, Inc. for \$14,312,800. See Note 13.

On August 31, 2000, 374,889 shares of our common stock were issued to acquire substantially all of the assets of Indigo Networks, LLC for \$7,445,358, including acquisition costs of \$210,000. See Note 4.

See accompanying notes to consolidated financial statements.

(1) Business of the Company

Wave is a leading developer of the next generation of computer security solutions. Wave provides a complete end-to-end suite of products and services that support hardware-based security products and create a Trusted Computing environment when implemented exclusively or in conjunction with traditional security solutions. Wave's products allow authentication, authorization and other security processes to be implemented in hardware at the PC or other platform level, creating a much more secure computing environment. The financial statements of Wave have been presented in the development stage format as prescribed by Statement of Financial Accounting Standards No. 7. Management has determined that Wave meets the criteria of a development stage enterprise as prescribed in Statement of Financial Accounting Standard No. 7 because it has devoted substantially all of its efforts since inception toward research and development activities and establishing a new business; and although planned principal operations have commenced, there has been no significant revenue from those operations.

(2) Liquidity

The accompanying consolidated financial statements have been prepared assuming that Wave will continue as a going concern. Wave has incurred substantial operating losses since its inception, and as of December 31, 2002 has an accumulated deficit of approximately \$233 million. We also expect we will incur an operating loss for the calendar year of 2003. Although we currently have working capital of approximately \$8.8 million, we expect our operating and research and development expenditures over the next two fiscal quarters will exceed this amount. We do not anticipate sufficient revenue over this same period to fund our operations. As a result, we will need to raise additional capital in order to continue operating beyond this period. Considering our current cash balance and Wave's projected operating cash requirements, we anticipate that we will need \$11 million of additional cash to satisfy our current forecasted cash flow requirements for the twelve-month period ending December 31, 2003. In addition to what we are forecasting in gross margins for fiscal 2003, we estimate having to raise a minimum of approximately \$5 million in capital, in order to fund our operations through 2003. In order to raise the additional cash required for Wave's operations, Wave has engaged an investment banking firm and is exploring a number of financing alternatives which include debt or equity financing (or a combination of both) or one or more commercial or strategic transactions. In addition to raising additional capital, our operating plan for the calendar year of 2003 includes the realization of a particular level of sales revenue, and an operating expense budget that must be met in order to achieve our plan. Should sales be less than forecast, expenses higher than forecast or if the availability of financing is less than the amount in our operating plan, Wave will not have adequate resources to fund our operations.

These factors raise substantial doubt about Wave's ability to continue as a going concern. If Wave is not successful in raising additional capital or is not successful executing its business plan, it could be forced to cease operations or merge with another company. No assurance can be provided that any of these initiatives will be successful.

(3) Significant Accounting Policies

(a) Basis of Consolidation

The consolidated financial statements include the financial statements of Wave, Wave Systems Holdings, Inc., a wholly owned subsidiary and WaveXpress, Inc. a majority-owned joint venture. All significant intercompany accounts and transactions have been eliminated in consolidation.

(b) Use of Estimates

The preparation of financial statements and related disclosures in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect amounts reported in the Consolidated Financial Statements and accompanying notes. Estimates are used for, but not limited to, depreciation and amortization, charges for other than temporary declines in value of marketable equity securities and other special charges, inventory allowances and contingencies. Actual results could differ from those estimates.

(c) Method of Accounting for Joint Ventures

Wave accounts for its investments in joint ventures using the equity method of accounting when its ownership interest in the joint venture is less than fifty percent and it is determined that Wave has the ability to exercise significant influence over the joint venture's operating and financial policies. The financial statements of joint

ventures in which Wave owns greater than a fifty percent interest are consolidated with Wave's financial statements pursuant to APB Opinion No. 18. (see note 15)

(d) Cash and Cash Equivalents

Wave considers all highly liquid instruments with an original or remaining maturity of three months or less to be cash equivalents. Substantially all cash and cash equivalents are custodial with two major financial institutions.

(e) Marketable Securities

Investments, which consist solely of equity securities, are accounted for under Statement of Financial Accounting Standards (SFAS) No. 115, "Accounting for Certain Investments in Debt and Equity Securities" issued by the Financial Accounting Standards Board (FASB). Pursuant to the provisions of SFAS No. 115, investments are classified as "trading", "available-for sale" or "held to maturity". "Trading" securities are bought and held principally for the purpose of selling them in the near term and are recorded at fair value. Fair value is based upon quoted market prices. Unrealized gains and losses on trading securities are included in the determination of net earnings. "Available-for-sale" securities are being held for an unspecified period of time and may be used for liquidity or other corporate purposes and are recorded at fair value. Unrealized gains and losses on available-for-sale securities are reported as a separate component of comprehensive income (loss) in stockholders' equity. Unrealized losses that are determined to be other than temporary are recognized as charges against earnings. Factors considered when determining if an other than temporary decline has occurred include: whether a decline in market value is related to specific concerns of the issuer of the securities as opposed to general market conditions, the length of time of the decline in market price, the financial condition and near-term prospects of the issuer and other factors that may indicate that the value of the securities will not recover. "Held to maturity" securities are debt securities that are intended to be held to maturity and are recorded at amortized cost. As of December 31, 2002, all of Wave's investments have been classified as available-for-sale.

(f) Inventories

Inventories, which are stated at the lower of cost or net realizable value, consist of inventory held for resale to customers. Cost is determined on the first-in, first-out basis and includes freight and other incidental costs incurred. Wave provides inventory allowances based on excess and obsolete inventories

(g) Property and Equipment

Property and equipment, including purchased computer software, are stated at cost less accumulated depreciation. Depreciation and amortization are computed using the straight-line method over the estimated useful lives of the assets which range from between three to five years. Amortization of leasehold improvements is computed using the remaining lease terms.

(h) Goodwill and Purchased Intangible Assets

In July 2001, FASB issued SFAS No. 142, *Goodwill and Other Intangible Assets* ("SFAS 142") which is effective for all fiscal years beginning after December 15, 2001. SFAS No. 142 replaces the requirement to amortize intangible assets with indefinite lives and goodwill with a requirement for an impairment test. SFAS No. 142 also requires an evaluation of intangible assets and their useful lives and a transitional impairment test for goodwill and certain intangible assets. After transition, the impairment tests must be performed annually. Because Wave does not have any goodwill and/or other intangible assets which qualify for the prescribed treatment under SFAS No. 142, there is no impact from the adoption of SFAS No. 142 to Wave's financial position or results of operations as of December 31, 2002.

For the years ended 2001 and 2000, goodwill was amortized using the straight-line method, generally over a period of 2 to 3 years.

(i) *Income Taxes*

Wave accounts for income taxes under the asset and liability method. As such, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

(j) *Stock Option Plan*

Statement of Financial Accounting Standards (“SFAS”) No. 123, “*Accounting for Stock-based Compensation*,” as amended by SFAS No. 148 “*Accounting for Stock-Based Compensation Transition and Disclosure- an amendment to FASB Statement No. 123*,” allows companies to recognize expense for the fair value of stock-based awards or to continue to apply the provisions of Accounting Principles Board (“APB”) Opinion No. 25 “*Accounting for Stock Issued to Employees*,” and disclose the effects of SFAS No. 123 as if the fair-value-based method defined in SFAS No. 123 had been applied. Under APB Opinion No. 25, compensation expense is recognized only if on the measurement date the fair value of the underlying stock exceeds the exercise price. Wave has elected to apply the provisions of APB Opinion No. 35 and provide the pro forma disclosure provisions of SFAS No. 123 and No. 148.

The following table shows Wave’s pro forma net loss and loss per share if the company had accounted for stock options under SFAS No. 123 for the years ended December 31:

	<u>2002</u>	<u>2001</u>	<u>2000</u>
Net loss to Common stockholders - as reported	\$(43,467,405)	\$(48,701,057)	\$(47,655,893)
Net loss to Common shareholders - pro forma	(50,876,578)	(69,720,636)	(64,029,399)
Loss per Common share - as reported	(0.85)	(0.97)	(1.03)
Loss per Common share - pro forma	\$ (0.99)	\$ (1.40)	\$ (1.39)

(k) *Research and Development and Software Development Costs*

Research and development costs are expensed as incurred. Software development costs are accounted for pursuant to Statement of Financial Accounting Standards No. 86 “*Accounting for the Costs of Computer Software to be Sold, Leased, or Otherwise Marketed*” which requires software development costs for products that have achieved commercial marketability to be capitalized subsequent to the establishment of a product’s technological feasibility and prior to general release of the product. Wave capitalized software development costs of \$610,413 and \$770,469 during the years ended December 31, 2002 and 2001, respectively. There were no software development costs capitalized during 2000.

(l) *Loss Per Share*

Basic net loss per common share has been calculated based upon the weighted average number of shares of common stock outstanding during the period. Diluted net loss per share is also computed using the weighted average number of common shares and excludes dilutive potential common shares outstanding, as their effect is anti-dilutive. Dilutive potential common shares consist primarily of employee stock options. Diluted net loss per share is equal to basic net loss per share and is therefore not presented separately in the financial statements.

(m) *Impairment of Long-Lived Assets and Long-Lived Assets to Be Disposed Of*

Wave reviews the valuation of long-lived assets, including property and equipment and capitalized software, under the provisions of SFAS No. 144, "*Accounting for the Impairment or Disposal of Long-Lived Assets*" and SFAS No.86, "*Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed*". Wave is required to assess the recoverability of long-lived assets and capitalized software development costs basis whenever events and circumstances indicate that the carrying value may not be recoverable. Factors we consider important that could trigger an impairment review include the following:

- significant underperformance relative to expected historical or projected future operating results;
- significant changes in the manner of our use of the acquired assets or the strategy of our overall business;
- significant negative industry or economic trends; and
- significant decline in our stock price for a sustained period.

In accordance with SFAS No. 144, when we determine that the carrying value of applicable long-lived assets may not be recoverable based upon the existence of one or more of the above indicators of impairment, we evaluate whether the carrying amount of the asset exceeds the sum of the undiscounted cash flows expected to result from the use and eventual disposition of that asset. If such a circumstance exists, we would measure an impairment loss to the extent the carrying amount of the particular long-lived asset or group exceeds its fair value. We would determine the fair value based on a projected discounted cash flow method using a discount rate determined by our management to be commensurate with the risk inherent in our current business model. In accordance with SFAS No. 86, when we determine that the carrying value of capitalized software development costs may not be recoverable we evaluate whether the unamortized cost exceeds the expected future net realizable value of the products. If the unamortized costs exceed the expected future net realizable value of the products, the excess amount is written off. Changes in judgments on any of these factors could impact the value of the asset being evaluated.

Wave adopted SFAS No. 144 during the first quarter of fiscal year 2002 without a material impact on its financial position or results of operations.

(n) *Revenue Recognition*

Wave's business model targets revenues from various sources including: licensing of our technology including EMBASSY and its supporting software infrastructure; fees from entities who use EMBASSY to secure their applets on PCs; and usage and transaction-based fees from content management, e-commerce and other services enabled by EMBASSY. In addition, we derive revenue from sales of hardware and from development contracts. To date, our sales arrangements have not included multiple-elements, nor have our arrangements required significant modification or customization of the software except for our contract with SSP Solutions for which we used the percentage of completion method of accounting that is described below.

Wave follows the provisions of statement of position "SOP" 97-2, *Software Revenue Recognition* as amended by SOP 98-9, *Modification of SOP 97-2, Software Revenue Recognition, with Respect to Certain Transactions*. Generally, Wave recognizes revenue when it is realized or realizable and earned. Wave considers revenue realized or realizable and earned when persuasive evidence of an arrangement exists, the product has been shipped or the services have been provided to the customer, the sales price is fixed or determinable and collectability is reasonably assured. Wave reduces revenue for estimated customer returns, rotations and sales rebates when such amounts can be estimated. When these amounts cannot be estimated Wave defers revenue until the product is sold to the end-user. Revenue from software license agreements that have significant customizations and modification of the software product is deferred and recognized in a

manner that approximates the percentage of completion method. In addition to the aforementioned general policy, the following are the specific revenue recognition policies for each major category of revenue.

PRODUCTS-SOFTWARE AND HARDWARE.

Revenue from delivered elements of one-time charge licensed software is recognized at the inception of the license term, provided Wave has vendor-specific objective evidence of the fair value of each undelivered element. Revenue is deferred for undelivered elements. Revenue is also deferred for the entire arrangement if vendor-specific objective evidence does not exist for each undelivered contract element. Examples of undelivered elements in which the timing of delivery is uncertain include contractual elements that give customers rights to any future upgrades at no additional charge or future maintenance that is provided within the overall price. The revenue that is deferred for any contract element is recognized when all of the revenue recognition criteria has been met for that element. However, it has not been our practice to provide period updates or maintenance to maintain system performance.

Revenue from the sale of hardware components is recognized when persuasive evidence of an arrangement exists, the product has been shipped to the customer, the sales price is fixed and determinable and collectivity is reasonably assured. All product is shipped with ownership passing to the buyer upon leaving our premises and payment terms are generally net 30.

SERVICES

Revenue from time and material service contracts is recognized as the services are provided. Revenue from fixed price, long-term service or development contracts is recognized over the contract term based on the percentage of services that are provided during the period compared with the total estimated services to be provided over the entire contract. Losses on fixed price contracts are recognized during the period in which the loss first becomes apparent. Payment terms vary by contract. Payment terms vary by contract.

In October 2000, we entered into a \$10 million comprehensive development agreement with SSP Solutions, Inc. (formerly BIZ Interactive Zone, Inc.) to integrate Wave's EMBASSY Trusted Client technology into the SSP Secure Service Provider™ Suite to be deployed in 5 million digital set top boxes and integrated gateway products such as cable and DSL modems. In May 2002 the agreement was amended whereby under the amended terms of the agreement, the parties agreed to a \$5 million development services contract whereby Wave agreed to port its EMBASSY platform to run in a Linux environment. In addition, SSP Solutions agreed to place with Wave an open \$5,000,000 purchase order for EMBASSY products. Payment terms of the agreement provide that SSP Solutions make payments of \$277,778 per month for eighteen months. In addition, the parties agreed that in the event that SSP Solutions fails to pay any monthly installment, within 30 days of receiving written notice by Wave that it is in default, the unpaid portion of the installment shall automatically convert into a stock acquisition right allowing Wave to acquire a number of shares in SSP Solutions to be determined by dividing the unpaid amount by the fair market value of SSP Solutions common stock. As the contract was for a discrete project to integrate our technology with the SSP platform, revenue under the development services agreement has been recognized on a percentage of completion basis in accordance with SOP 97-2 as it relates to contract accounting under SOP 81-1. Percentage complete is determined based upon the actual costs incurred compared to the total estimated costs to complete, subject to cash received and milestones accomplished. Milestones include specific software development objectives that must be completed and accepted by SSP Solutions. As of December 31, 2002 Wave has received \$555,556 in cash and has not exercised any stock appreciation rights. We have recognized approximately \$197,556 and \$358,000 in revenue under the development agreement for the years ended December 31, 2002 and 2001, respectively.

(o) *Recent Accounting Pronouncements*

In April 2002, the FASB issued SFAS No. 145, *Rescission of FASB Statements No. 4, 44 and 64, Amendment of FASB Statement No. 13, and Technical Corrections*. SFAS No. 145 amends existing guidance on reporting gains and losses on the extinguishment of debt to prohibit the classification of the gain or loss as extraordinary, as the use of such extinguishments have become part of the risk management strategy of many companies. SFAS No. 145 also amends SFAS No. 13 to require sale-leaseback accounting for certain lease modifications that have economic effects similar to sale-leaseback transactions. The provisions of the Statement related to the rescission of Statement No. 4 are applied in fiscal years beginning after May 15, 2002. Earlier application of these provisions is encouraged. The provisions of the Statement related to Statement No. 13 were effective for transactions occurring after May 15, 2002, with early application encouraged. The adoption of SFAS No. 145 is not expected to have a material effect on Wave's financial statements.

In June 2002, the FASB issued SFAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*. SFAS No. 146 addresses financial accounting and reporting for costs associated with exit or disposal activities and nullifies Emerging Issues Task Force (EITF) Issue 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity*. The provisions of this Statement are effective for exit or disposal activities that are initiated after December 31, 2002, with early application encouraged. The adoption of SFAS No. 146 is not expected to have a material effect on Wave's financial statements.

In November 2002, the FASB issued Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness to Others, an interpretation of FASB Statements No. 5, 57 and 107 and a rescission of FASB Interpretation No. 34*. This Interpretation elaborates on the disclosures to be made by a guarantor in its interim and annual financial statements about its obligations under guarantees issued. The Interpretation also clarifies that a guarantor is required to recognize, at inception of a guarantee, a liability for the fair value of the obligation undertaken. The initial recognition and measurement provisions of the Interpretation are applicable to guarantees issued or modified after December 31, 2002 and are not expected to have a material effect on Wave's financial statements. The disclosure requirements are effective for financial statements of interim or annual periods ending after December 15, 2002 and are included in the notes to the financial statements. At December 31, 2002, the Company does not have any financial guarantees as defined by this pronouncement.

In December 2002, the FASB issued SFAS No. 148, *Accounting for Stock-Based Compensation – Transition and Disclosure, an amendment of FASB Statement No. 123*. This Statement amends FASB Statement No. 123, *Accounting for Stock-Based Compensation*, to provide alternative methods of transition for a voluntary change to the fair value method of accounting for stock-based employee compensation. In addition, this Statement amends the disclosure requirements of Statement No. 123 to require prominent disclosures in both annual and interim financial statements. Certain of the disclosure modifications are required for fiscal years ending after December 15, 2002 and are included in the notes to these consolidated financial statements.

In January 2003, the FASB issued Interpretation No. 46, *Consolidation of Variable Interest Entities, an interpretation of ARB No. 51*. This Interpretation addresses the consolidation by business enterprises of variable interest entities as defined in the Interpretation. The Interpretation applies immediately to variable interests in variable interest entities created after January 31, 2003, and to variable interests in variable interest entities obtained after January 31, 2003. The application of this Interpretation is not expected to have a material effect on Wave's financial statements as the Company does not have any variable interest entities.

(4) Business Combinations

(a) *Pooling of Interests*

On July 27, 1999, Wave acquired N*ABLE. The transaction was accounted for as a pooling of interests and the historical financial information for all periods presented prior to the date of acquisition were restated. Wave exchanged 2,280,821 shares of its Class A Common Stock for all the outstanding shares of N*ABLE for a fair value of approximately \$23.7 million.

(b) *Purchase Acquisition*

On August 31, 2000, Wave purchased substantially all of the assets of Indigo and its e-commerce shopping network, iShopHere.com. The aggregate purchase price totaled \$7,445,000, which consisted of 374,889 shares of Class A Common Stock priced at \$19.30 per share, for a total value of \$7,235,000 plus transaction costs of \$210,000. The purchase price was based on the average closing price of Wave's Class A Common Stock for the ten trading days immediately preceding the date of the purchase, in accordance with the purchase agreement. The following is a summary of the allocation of the purchase price:

Fair market value of tangible assets	\$ 690,000
In-Process R&D	2,176,000
Goodwill and purchased intangible assets	<u>4,579,000</u>
Total consideration	<u>\$7,445,000</u>

The amount allocated to in-process research and development totaling \$2,176,000 was determined using established valuation techniques and was expensed upon acquisition as technological and/or commercial feasibility had not been established. The amount allocated to goodwill and purchased intangible assets amounted to \$4,578,746 and is being amortized on a straight-line basis over periods not exceeding three years. The following table sets forth the goodwill and purchased intangible asset values as of December 31, 2001:

	<u>2001</u>
Developed Technology	\$ 779,000
Assembled Workforce	310,000
Contracts	77,300
Goodwill and purchased intangible assets	<u>3,412,446</u>
Total Goodwill and purchased intangible assets	\$ 4,578,746
Accumulated Amortization	<u>(2,294,176)</u>
Net Book Value before impairment charge	2,284,570
Impairment Charge	<u>(2,284,570)</u>
Net Book Value	\$ -0-

Amortization expense associated with goodwill and purchased intangibles was \$0, \$1,720,632, and \$573,544 for the years ended December 31, 2002, 2001 and 2000, respectively.

The consolidated financial statements include the operating results of iShopHere.com from the date of acquisition, which consisted of a net loss of approximately \$0 in 2002, \$1,561,000 in 2001 and \$846,000 in 2000. The selected unaudited pro forma condensed consolidated financial information presented below has been derived from the audited and unaudited historical financial statements of Wave and Indigo, and reflects management's estimate of pro forma adjustments. This pro forma presentation does not purport to represent what our results of operations would actually have been if such transactions and events had in fact occurred on those dates or to project our results of operations for any future period. The unaudited pro forma consolidated statements of operations give effect to the acquisition of Indigo as if it had occurred on January 1, 1999. (Pro-forma information for 2002 and 2001 are not presented as there are no pro-forma adjustments applicable to 2002 or 2001.)

<i>Dollars in thousands except per share data</i>	2000
Net revenues	\$ 372
Net loss	(50,363)
Net loss per share	\$ (1.08)

Due to the decline in current business conditions, Wave had realigned resources to focus on what it considered high-growth markets and core opportunities. As a result, Wave recorded a charge of \$2,284,570 related to the impairment of goodwill and purchased intangible assets associated with the Indigo asset purchase in 2001. This amount is equal to the carrying amount of the assets prior to the impairment charge.

(5) Related Party Transactions

(a) Notes Receivable from Officers

Wave had outstanding loans receivable from officers totaling \$1,277,860 less a reserve for uncollectibility of \$999,518 for a net balance of \$278,342 as of December 31, 2002. Notes receivable from officers were \$1,380,050 with no reserve as of December 31, 2001. Some of the loans, as indicated below were extended beyond their original terms by one year. These loans and the extensions thereon were granted to the officers, prior to the enactment of the Sarbanes-Oxley Act of 2002, to allow them to satisfy certain personal financial obligations that would otherwise have required them to liquidate some of their holdings of Wave shares. The loans were granted and extended as a means to mitigate a potential unfavorable impact to Wave's share price as a result of the officers selling large blocks of shares. The officer loans consist of the following:

On March 26, 2001 Wave made a personal loan to Mr. Gerard T. Feeney, Senior Vice President, Chief Financial Officer and Secretary of Wave as evidenced by a demand note for \$250,000, which sum was due and payable to Wave on March 26, 2002 and bore interest at a rate per annum equal to 1% over the prime interest rate. Interest on the loan accrued monthly and was payable at maturity. The terms of the loan were substantially equivalent to market terms available at that time. The due date of the demand note was subsequently extended until March 26, 2003. As of December 31, 2002 the loan balance, including accrued interest was \$278,342. As of March 26, 2003 the loan balance, including accrued interest was \$281,399. On March 27, 2003, the Compensation Committee approved an extraordinary bonus in an amount equal to Mr. Feeney's obligations with respect to such loan and accrued interest. Proceeds of this extraordinary bonus were used to repay the loan and all interest accrued on such loan. This bonus is considered extraordinary because it was granted during the year so that Mr. Feeney could repay his loan, rather than at fiscal year end when bonuses are usually awarded. The factors used in granting this extraordinary bonus were the amount of the loan, the ability to repay the loan and the impact that non-repayment of the loan would have on Mr. Feeney's abilities to fulfill his duties for Wave. Wave no longer intends to award extraordinary bonuses to executive officers or directors because there are no outstanding loans to any current executive officers or directors and the Sarbanes-Oxley Act of 2002 prohibits any future such loans. The largest amount outstanding with respect to indebtedness of Mr. Feeney during 2002 was \$278,342. Wave intends to take this extraordinary bonus into account when considering future bonus awards to Mr. Feeney.

Also during 2001, Wave made personal loans to Mr. Peter J. Sprague, former Chairman of Wave totaling \$1,062,139. The loans were evidenced by demand notes for \$713,320 dated February 27, 2001, \$184,500 dated July 25, 2001 and \$164,319 dated September 5, 2001. These notes carry terms of one year and bear interest at a rate per annum equal to 1% over the prime rate of interest. Interest on the loans accrues monthly and is payable at maturity. The terms of the loans were substantially equivalent to market terms available at that time. Two of the demand notes in the amount of \$713,320 and \$184,500 plus accrued interest

came due on February 27, 2002 and July 25, 2002, respectively and were extended for an additional year beyond their original due dates, prior to the enactment of the Sarbanes-Oxley Act of 2002. The remaining loan, which had an original face value of \$165,319, and a balance of \$174,391 including accrued interest came due in September 2002. On November 12, 2002, the Compensation Committee approved the payment of an extraordinary bonus that Mr. Sprague used to repay the \$164,319 balance of the note due in September 2002 plus accrued interest of \$10,072. Accordingly, Wave has recognized approximately \$174,391 as bonus expense in selling, general and administrative expense in its statements of operations for the year ended December 31, 2002. This bonus was considered extraordinary for the same reasons as the bonus awarded to Mr. Feeney described above. This bonus was awarded based on the same factors as the bonus awarded to Mr. Feeney. As of December 31, 2002, the balances of the two notes still outstanding were \$799,143 that came due on February 27, 2003 and \$200,374 that is due on July 26, 2003, for a total of \$999,518. As of March 26, 2003, the balances of these two notes were \$807,863 that came due on February 27, 2003 and \$202,630 that is due on July 26, 2003, for a total of \$1,010,493. Wave has recorded a reserve for uncollectibility for 100% of these loans that remain outstanding as of December 31, 2002 and March 26, 2003, because Wave has determined that Mr. Sprague is unable to repay the loans promptly. Mr. Sprague resigned as Chairman of Wave as of March 31, 2003. Wave intends to engage Mr. Sprague as Chairman and Chief Executive Officer of WaveXpress. Wave intends to diligently pursue collection of Mr. Sprague's loan. The largest aggregate amount outstanding with respect to indebtedness of Mr. Sprague during 2002 was \$1,161,573.

Consistent with the provisions of the Sarbanes-Oxley Act of 2002, Wave has adopted a written policy prohibiting future loans to officers and directors.

(b) Payments to Related Party

In 1997, Wave paid \$182,209 to Enterprise Engineering Associates ("EEA"), during which time Mr. Michael Sprague was an employee of EEA. On August 1, 1997, Michael Sprague became an employee of Wave, at an annual salary of \$110,000. On November 1, 1999 he became an employee of WaveXpress at an annual salary of \$120,000 and was paid \$125,319 for the year ended December 31, 2002 and \$120,000 for each of the years ended December 31, 2001 and 2000. Michael Sprague is the son of the Chairman and former Chief Executive Officer of Wave

(c) Acquisition and Dispositions

In November 1995, Wave entered into a transaction with certain individuals whereby shares in its newly formed subsidiary, Wave Interactive Network, Inc. ("WIN"), were transferred in exchange for a demand note. The amount of the demand note was based on the level of funding provided to WIN by Wave during 1995. The demand note from WIN accrued interest at a rate of Prime plus 1% and, subject to certain limitations associated with WIN's ability to raise additional capital, was convertible into an undiluted 20% of the common shares of WIN at the option of Wave. Wave retained a 1% ownership in WIN and transferred the remaining ownership to certain individuals, including former employees. Approximately 65% of the ownership was transferred to Steven Sprague, President and CEO of WIN, and three other children of Mr. Peter J. Sprague, former Chairman and former CEO of Wave. The note was fully reserved as its collectibility was dependent upon WIN's ability to raise additional capital. In addition, Wave entered into a separate commercial agreement that, among other things, granted certain distribution rights to WIN in exchange for royalties and other consideration.

During 1996, Wave continued to finance the operations of WIN through additional demand notes with terms similar to the original demand note. The additional notes amounting to \$1,004,000 were also fully reserved. On December 30, 1996, effective as of October 18, 1996, Wave entered into a merger agreement with WIN whereby Wave exchanged, for all of the outstanding WIN common stock that it did not own, 375,000 shares of Class B Common Stock. These Class B shares are restricted securities within the meaning of Rule 144 of the Securities Act of 1933, as amended (the "Act"). Additionally, based on the attainment of a specified milestone, the shareholders of WIN were entitled to receive an additional 325,000 shares of Wave's Class B Common Stock. During 1999, the time to attain the milestone had expired as did the entitlement to additional shares and no additional shares were issued. Wave also issued a 10% convertible note and a warrant to refinance a convertible note obligation of WIN amounting to approximately \$456,000, which included accrued interest to October 18, 1996, and an outstanding warrant. Included in the results of operations are WIN's operations from October 18, 1996. The acquisition was accounted for by the purchase method.

The purchase price of \$952,438 was determined based on the estimated fair value of the consideration given to the WIN shareholders and note holders and was allocated to goodwill as WIN had no net tangible assets. Subsequently, in 1997, Wave determined it was uncertain whether the current and expected future results of operations of WIN would be adequate to support the goodwill capitalization, and wrote-off the goodwill as impaired.

(d) *Sarnoff Corporation*

For the years-ended December 31, 2002, 2001 and 2000, Wave incurred expenses for consulting and travel, payable to Sarnoff of approximately \$0, \$57,000 and \$924,000, respectively. Sarnoff is Wave's joint venture partner in WaveXpress and owns approximately 26% of WaveXpress, (7% on a fully diluted basis). Payments made to Sarnoff for the years-ended December 31, 2002, 2001 and 2000 were \$0, \$396,000 and \$986,000, respectively. As of December 31, 2002 and 2001, Wave had accounts payable to Sarnoff of \$0 and \$6,000, respectively.

(6) Property and Equipment

Property and equipment as of December 31 consisted of the following:

	<u>2002</u>	<u>2001</u>
Equipment	\$ 5,457,015	\$ 5,797,900
Furniture, fixtures and improvements	882,492	1,914,405
Computer software	<u>4,230,605</u>	<u>3,192,288</u>
	10,570,112	10,904,593
Less: Accumulated depreciation	<u>8,027,347</u>	<u>6,613,365</u>
Total	<u>\$ 2,542,765</u>	<u>\$ 4,291,228</u>

Computer software includes \$1,380,882 capitalized pursuant to SFAS 86. This asset has not yet been placed in service, therefore no amortization has been taken on these capitalized costs. It is expected that these costs will be amortized over a three-year life, once the product is ready to bring to market.

Depreciation expense on property and equipment amounted to approximately \$2,001,000, \$2,219,000, \$1,969,000 and \$8,695,000 for the years ended December 31, 2002, 2001, 2000 and for the period from inception through December 31, 2002, respectively.

(7) Accounts Payable and Accrued Expenses

Accounts payable and accrued expenses as of December 31 consisted of the following:

	<u>2002</u>	<u>2001</u>
Accrual of costs related to the ITG agreement	\$ -	\$ 188,986
Accounts payable	1,189,889	1,631,430
Accrued consulting and professional fees	360,728	405,346
Accrued payroll and related costs	1,108,160	1,281,012
Accrued Rent	142,595	87,836
Annual Report and Shareholders Meeting	95,631	141,299
Accrual of committed investment in GlobalWave	-	1,407,664
Accrued loss contingency	-	200,000
Franchise Tax Payable	39,133	-
Software Licenses	384,167	-
Other accrued liabilities	<u>84,074</u>	<u>464,305</u>
Total	<u>\$ 3,404,377</u>	<u>\$ 5,807,878</u>

(8) Capital Stock

(a) Redeemable Preferred Stock

Wave has authorized 2,000,000 shares of preferred stock having a par value of \$.01 per share. On October 19, 1992, the Board of Directors designated and issued 360 shares of this preferred stock of Wave as "Series A Cumulative Redeemable Preferred Stock" ("Series A Preferred Stock").

The Series A Preferred Stock was issued in settlement of compensation owed to a former officer of Wave for services provided to Wave. The holder of the Series A Preferred Stock was entitled to receive a dividend at the rate of \$60 per share per annum, when and as declared by the Board of Directors of Wave. Dividends were cumulative from the date of original issue, and payable upon redemption. On August 11, 1999, Wave redeemed these shares for a total payment of \$506,440, including accrued and unpaid dividends.

In May of 1996, Wave raised \$3,214,026, net of issuance costs of \$285,974, through the placement of 350 shares of Series B Preferred Stock ("Series B Preferred Stock") pursuant to Regulation S of the Securities Act of 1933 ("the Act"). The Series B Preferred Stock had a stated value of \$10,000 per share, accrued dividends for liquidation and conversion purposes at 6% per annum and ranked senior to Wave's Common Stock and Series C Convertible Preferred Stock ("Series C Preferred Stock") and junior to the Series A Preferred Stock. Series B Preferred Stock was convertible by the holder, in increments, into Wave's Class A Common Stock. The Series B Preferred Stock was convertible at the lesser of 110% of the average closing bid price for the five days immediately preceding the issue date or 85% of the average closing bid price for the five days immediately preceding the conversion date.

During 1996, 330 shares of Wave's Series B Preferred Stock were converted into 2,960,303 shares of Wave's Class A Common Stock and the remaining 20 shares of Series B Preferred Stock were converted in 1997 into 117,240 shares of Wave's Class A Common Stock.

In December of 1996, Wave raised \$2,634,037 net of issuance costs of \$365,963 (\$101,964 of which related to the value ascribed to warrants issued) through the placement of 150,000 shares of Series C Preferred Stock pursuant to Regulation D of the Act. The Series C Preferred Stock had a stated value of \$20 per share, which accrued dividends payable quarterly in cash at 6% per annum.

The Series C Preferred Stock ranked senior to Wave's Common Stock and junior to the Series A and B Preferred Stock. Series C Preferred Stock was convertible by the holder, in increments, into Wave's Class A Common Stock based on the market price of Wave's Class A Common Stock at the time of conversion. The Series C Preferred Stock was convertible at the lesser of \$2.31 per share or 80%, as adjusted, of the average of the fair value of the Class A Common Stock for the five days prior to the conversion date. During 1997 all of the Series C Preferred Stock was converted into 2,850,439 shares of Wave's Class A Common Stock.

In May of 1997 Wave raised approximately \$1,316,000, net of issuance costs of \$272,000 (\$162,000 of which related to the value ascribed to warrants issued), through the placement of 80,000 shares of newly created Series D Convertible Preferred Stock. The Series D Preferred Stock had a stated value of \$20 per share, which accrued dividends payable quarterly in cash at 6%.

The Series D Convertible Preferred Stock was convertible into the Class A Common Stock of Wave at an effective conversion price of the lower of (i) \$1.35, or (ii) 80% of the average closing bid price on the NASDAQ National Market System of Wave's Class A Common Stock for the five (5) trading days immediately preceding the date of conversion. During 1997 all of the Series D Convertible Preferred Stock was converted into 2,070,095 shares of Wave's Class A Common Stock.

(b) Convertible Preferred Stock

In October 1997 Wave raised approximately \$1,850,000, net of issuance costs of \$397,000 (\$224,000 of which related to the value ascribed to warrants issued), through the private placement of 112,500 shares of newly created Series F Convertible Preferred Stock. The Series F Convertible Preferred Stock had a stated value of \$20 per share, which accrued dividends payable quarterly in cash at 6%. The Series F Convertible Preferred Stock was convertible into the Class A Common Stock at an effective conversion price of the lower of (a) \$1.05 and (b) 80% of the average of the five (5) lowest trading prices of Class A Common Stock. During 1997 all of the Series F Convertible Preferred Stock was converted into 2,961,086 shares of Wave's Class A Common Stock.

During March of 1998, Wave issued 150,000 shares of newly created Series G Convertible Preferred Stock for an aggregate purchase price of \$3,000,000. The Series G Convertible Preferred Stock was senior to Wave's classes of Common Stock, and was junior to Wave's Series A Preferred Stock in liquidation rights. The Series G Convertible Preferred Stock accrued dividends at the rate of 6% per annum. The Series G Convertible Preferred Stock was convertible into Wave's unregistered Class A Common Stock at the lower of \$1.12 or 80% of the average of the five lowest closing bids for the 25 calendar days prior to conversion. In addition, Wave issued warrants to the purchaser and placement agent for 225,000 shares of Wave's Class A Common Stock at an exercise price of \$1.38. The Series G Convertible Preferred Stock was converted into 2,394,494 and 377,102 shares of Wave's Class A Common Stock during 1998 and 1999, respectively.

(c) *Common Stock*

In December 1989, March through October 1990, and November 1991, substantially all stockholders as of December 29, 1989 were offered the right to acquire a number of shares equivalent to their pre-offering holdings at a price of \$.003 per share. Substantially all stockholders that received the offer accepted this offer. This was accounted for essentially as a stock split effected in the form of a rights offering, and all shares issued in conjunction with this offering were reflected in the accompanying consolidated financial statements retroactively.

Two principal stockholders did not acquire the full amount of shares to which they were entitled. Most of the additional proportionate shares that these stockholders would have been credited with were offered instead to certain officers, employees and stockholders for \$.003 per share. To the extent that these rights were offered to the individuals in compensation for services rendered to Wave, compensation expense equal to the difference between the estimated fair value as of the date of issuance and the purchase price of the stock was recorded. The estimated fair value of the Common Stock was determined based on sales to third parties near the date of issuance. Compensation expense associated with the issuance of these shares of \$430,250 is included in the accompanying consolidated statement of operations for the period from inception to December 31, 2001.

In May and November, 1992, Wave issued 770,000 shares of Class B restricted Common Stock to certain employees, officers and stockholders of Wave for a purchase price of \$.003 per share, payable in the form of services to Wave. As these shares were issued for services rendered, compensation expense of \$1,927,500 was recorded representing the estimated fair value of \$2.50 per share at the date of issuance, the price at which Common Stock was sold to third parties near the time of issuance.

In February 1995, Wave agreed to grant 36,000 shares of Class A Common Stock, 12,000 of which were issued in 1995 with the remainder issued in 1996, to two consultants and six non-employee directors as compensation for services rendered. Expenses of \$112,500 were recorded in 1995 representing the stock's fair value of \$3.13 per share at the time of the agreement to grant.

In July 1995, Wave issued 19,559 shares to two vendors in payment for services rendered. Costs of \$20,000 were recorded representing the stock's fair value of approximately \$1.00 per share at the time the services were rendered.

In July and August 1996, Wave issued 15,000 and 3,077 shares of Class A Common Stock to two consultants as compensation for services rendered. Expenses of \$40,938 have been recorded representing the stock's fair value of \$2.06 and \$3.44 per share, respectively, at their dates of issuance.

During 1997 Wave issued 126,885 shares of Wave's Class A Common Stock to vendors or for the settlement of liabilities. Expenses of \$305,496 have been recorded representing the stocks' fair value at the date of issuance.

During 1997 Wave sold approximately 800,000 shares of Wave's Class A Common Stock and warrants to purchase 160,000 shares of Wave's Class A Common Stock, exercisable at an exercise price of \$1.00, for an aggregate purchase price of \$800,000. The warrants were exercised or expired during 1999.

During 1997 Wave issued 500,000 shares of Wave's Class A Common Stock in connection with a license agreement with Aladdin Knowledge Systems, Ltd. for its proprietary persistent encryption technology. The shares were issued at their fair value on the date of issuance.

On March 23, 1999, Wave sold 2,090,954 shares of its Class A Common Stock at a price of \$11.00 per share, for an aggregate purchase price of \$23,000,494. These shares were sold to a group of accredited investors pursuant to Regulation D promulgated under the securities act of 1933, as amended. Pacific Growth Equities,

Inc. acted as sole placement agent for the private placement, receiving a commission of 6% or approximately \$1.2 million for their services.

In January 2000, the Company issued 275,000 shares of its class A Common Stock to one (1) accredited investor, for an aggregate purchase price of \$1,100,000. These shares were issued upon the exercise of a warrant granted on January 26, 1999. The warrant to purchase 275,000 shares of the Company's Class A Common Stock at an exercise price of \$4.00 per share, was exercisable until January 26, 2004. The Warrants were issued as consideration for a \$2,000,000 promissory note, bearing no interest, due January 26, 2002.

On March 7, 2000 Wave sold 3,600,800 shares of its Class A Common Stock at a price of \$34.00 per share, for an aggregate purchase price of \$122,427,200. The shares were sold to a group of accredited investors pursuant to Regulation D promulgated under the Securities Act of 1933, as amended. Pacific Growth Equities, Inc. acted as sole placement agent for the private placement, receiving a commission of 6% or approximately \$7.3 million for their services.

On August 31, 2000 the Company sold 374,889 shares of its Class A Common Stock, at a price of \$19.30 per share in exchange for substantially all of the assets of Indigo Networks, LLC and its e-commerce shopping network, iShopHere.com. Additional costs to complete the transaction were \$210,000. These Securities were registered on September 21, 2000.

On February 2, 2001 Wave issued 2,000,000 shares of its Class A Common Stock, at a price of \$7.16 per share, for an aggregate purchase price of \$14,312,800 to acquire 3,600,000 shares of the Series B Preferred Stock of BIZ, then a privately held company, in a private placement exempt from registration under code section 4(2) of the Securities Act of 1933, as amended. Wave's investment in BIZ represented approximately 17.8% of the outstanding capital stock of BIZ. On August 24, 2001 Litronic, Inc. ("Litronic"), a provider of authentication and encryption security technology, completed a merger with BIZ to form SSP Solutions. SSP Solutions trades on the NASDAQ National Stock Market as SSPX. As a result of the merger, Wave's 3,600,000 shares of BIZ were converted into 3,083,083 shares of common stock of SSP.

On July 24, 2002 Wave issued 1,700,000 shares of its Class A Common Stock to Redwave plc in exchange for 60% of the remaining assets of GlobalWave Limited for a total purchase price of approximately \$2,244,000. Prior to this transaction, Wave owned 40% of GobaWave Limited (See Note 15 Joint Ventures).

(d) Recapitalization

In January 1994, the Board of Directors authorized Wave to amend and restate Wave's Certificate of Incorporation to reflect the authorization of 25,000,000 shares of a newly created Class A Common Stock, which stock has voting rights of one vote per share, and the reclassification of the then current outstanding shares of Common Stock into Class B Common Stock. In June 1994, the Board of Directors authorized that the Class B Common stock will have one vote per share, except that Class B Common Stock will have five votes per share in cases where one or more directors are nominated for election by persons other than Wave's Board of Directors and where there is a vote on any merger, consolidation or other similar transaction, which is not recommended by Wave's Board of Directors. In addition, the Class B Common Stock will have five votes per share on all matters submitted to a vote of the stockholders in the event that any person or group of persons acquires beneficial ownership of 20% or more of the outstanding voting securities of Wave. The Class B Common Stock is convertible into shares of Class A Common Stock at any time. The classes of Common Stock are alike in all other respects.

(9) Options and Warrants

1991 Plan

In September 1991, the Board of Directors authorized the establishment of a stock option plan (the "1991 Plan"). The total number of shares of Class B Common Stock subject to the Plan was 2,700,000. Options terminate upon the earlier of the date of the expiration of the option or upon termination of the employment relationship between Wave or a subsidiary and the optionee for any reason other than death, disability or retirement.

Under the 1991 Plan, employees are entitled to exercise their options on dates determined by the Compensation Committee of the Board of Directors. Vesting provisions for options granted generally range from immediate vesting to pro rata vesting over a three-year period. Options granted under the 1991 Plan, at the discretion of the Compensation Committee, included the right to acquire a reload option. A reload option

provides for the automatic grant of a new option at the then-current market price in exchange for each previously owned share tendered by an employee in a Stock-for-Stock exercise.

The 1991 Plan terminated on September 26, 2001 in accordance with its termination provision. Accordingly, no further options may be granted under the 1991 Plan. All options outstanding under the 1991 Plan continue in full force and effect subject to their original terms. As of December 31, 2002, there remained 203,532 options outstanding under the 1991 Plan at an exercise price of \$1.15 per share.

1994 Plans

In January 1994, the Board of Directors authorized the establishment of the 1994 Employee Stock Option Plan (the "1994 Plan"). The initial number of shares of Class A Common Stock subject to the 1994 Plan was 1,000,000. The terms of the 1994 Plan are similar to those of the 1991 Plan. Options are granted with exercise prices that approximate fair market value at the date of grant. In May 1996, July 1997, November 1998 and June 2000 Wave's shareholders approved amendments to Wave's 1994 Plan to increase the number of shares of Class A Common Stock reserved for issuance there under by 1,000,000, 1,000,000, 5,000,000 and 5,000,000, respectively. Therefore, the total number of shares of Class A Common Stock reserved for issuance under the 1994 Plan is 13,000,000 shares. As of December 31, 2002, there were approximately 1,332,000 shares available for grant under the 1994 Plan.

In January 1994, the Board of Directors authorized the establishment of the Non-Employee Directors Stock Option Plan (the "Directors' Plan"). The total number of shares of Class A Common Stock subject to the Directors' Plan was initially 200,000. Pursuant to the Directors' Plan, each director who was not an employee of Wave received an initial grant of options to purchase 12,000 shares of Class A Common Stock. Options are granted with exercise prices that approximate fair market value at the date of grant.

Any person subsequently elected as a director who was not an employee of Wave received an initial grant of options to purchase 12,000 shares of Class A Common Stock on the day he or she was elected a director. In addition, on the day immediately following each of the dates on which an incumbent director was reelected, he or she received an additional grant of options to purchase 2,000 shares of Class A Common Stock.

The Stockholders of Wave have since, authorized certain changes to the Directors' Plan. In February 1995, the annual option grant for directors was increased from a total of 2,000 shares of Class A Common Stock to 10,000 shares of Class A Common Stock. In July 1995, the Board authorized an increase to the total number of shares subject to the Directors' Plan from 200,000 shares to 500,000 shares. In November 1998, the stockholders of Wave authorized an increase to the total number of shares subject to the Directors' Plan from 500,000 shares to 1,000,000 shares. The stockholders also amended the Directors' Plan to provide that options issued to non-employee directors under such plan vest on the day following the grant. (Initial option grants under the Directors' Plan vested one-third upon grant, and one-third on each of the first and second anniversaries. Annual option grants vested 25% after each three-month period following grant.)

Options under the Directors' Plan are exercisable for a period of ten years from the date of grant. Options may not be exercised after the option holder ceases to be a director of Wave, except that in the event of death or disability of the option holder, the option may be exercised for a period of one year after the date of death or disability, and, in the event of retirement of the option holder, the option may be exercised for a period of three months after the date of retirement. As of December 31, 2002, there were approximately 405,000 shares available for grant under the Director's Plan.

In September 1996, the Board of Directors authorized the establishment of the 1996 Performance Stock Option Plan (the "1996 Plan"). The initial number of shares of Class A Common Stock subject to the 1996 Plan was 800,000. The terms of the 1996 Plan are similar to those of the 1994 and 1991 Plans. Options are granted with exercise prices that approximate fair market value at the date of grant. As of December 31, 2002, there were approximately 125,000 shares available for grant under the 1996 Plan.

The per share weighted-average fair value of stock options under all plans granted during 2002, 2001 and 2000 was \$1.62, \$2.89 and \$12.18 on the dates of grant using the Black Scholes option-pricing model with the following weighted-average assumptions:

	<u>2002</u>	<u>2001</u>	<u>2000</u>
Expected Life (Years)	5	5	5
Interest Rate	3.0%	4.0%	6.0%
Volatility	113%	119%	123%

Dividend Yield

0%

0%

0%

Wave applies APB Opinion No. 25 in accounting for its Plans. Compensation expense has been recognized in the financial statements for Stock options granted to employees at exercise prices below the market value of \$333,137 in 2002, \$552,554 in 2001 and \$318,609 in 2000. Deferred compensation for stock options granted to employees at exercise prices below market value was approximately \$372,000 and \$1,000,000 as of December 31, 2002 and 2001, respectively; and is being recognized over a period of three years from the date of grant.

Summary of Option Activity

A summary of option activity through December 31, 2002 follows:

	Class A and B shares <u>subject to option</u>	Weighted average <u>exercise price</u>
Balance at January 1, 1991	-	\$ -
Options granted	<u>30,000</u>	1.67
Balance at December 31, 1991	30,000	1.67
Options granted	<u>816,750</u>	1.18
Balance at December 31, 1992	846,750	1.20
Options granted	<u>949,186</u>	3.10
Balance at December 31, 1993	1,795,936	2.20
Options granted	310,200	3.05
Options canceled	<u>(108,500)</u>	3.38
Balance at December 31, 1994	1,997,636	2.27
Options granted	777,850	2.22
Options canceled	(349,205)	2.11
Options exercised	<u>(681,700)</u>	.64
Balance at December 31, 1995	1,744,581	2.92
Options granted	1,342,075	2.65
Options canceled	(503,879)	3.20
Options exercised	<u>(214,091)</u>	1.97
Balance at December 31, 1996	2,368,686	2.79
Options granted	707,914	1.02
Options canceled	(676,741)	1.57
Options exercised	<u>(70,326)</u>	1.90

	Class A and B shares <u>subject to option</u>	Weighted average <u>exercise price</u>
Balance at December 31, 1997	2,329,533	2.38
Options granted	5,756,893	2.47
Options canceled	(707,384)	2.48
Options exercised	<u>(78,653)</u>	1.94
Balance at December 31, 1998	7,300,389	2.40
Options granted	1,925,447	10.15
Options canceled	(450,378)	3.51
Options exercised	<u>(964,000)</u>	1.69
Balance at December 31, 1999	7,811,458	4.33
Options granted	3,444,037	13.58
Options canceled	(905,145)	12.33
Options exercised	<u>(2,030,958)</u>	2.51
Balance at December 31, 2000	8,319,392	\$7.90
Options Granted	2,934,272	3.46
Options Canceled	(1,128,327)	8.16
Options Exercised	<u>(473,511)</u>	<u>1.42</u>
Balance at December 31, 2001	9,651,826	6.85
Options Granted	1,607,959	1.94
Options Canceled	(1,033,989)	8.44
Options Exercised	<u>(42,553)</u>	<u>1.04</u>
Balance at December 31, 2002	10,183,243	\$5.94

At December 31, 2002, there were approximately 6,349,221 options exercisable at prices ranging from \$.49 to \$37.50.

The following table summarizes information about stock options outstanding at December 31, 2002:

<u>Range of exercise prices</u>	<u>Number outstanding</u>	<u>Number exercisable</u>	<u>Weighted average exercise price</u>	<u>Weighted average remaining contractual life</u>
\$.49 – 0.74	2,032	2,032	\$.49	4.5 years
0.75 - 1.12	242,264	242,264	1.10	5.2 years
1.13 – 1.69	1,344,008	843,256	1.33	7.1 years
1.70 – 2.55	1,659,596	166,429	1.96	8.9 years
2.56 – 3.84	1,841,486	1,808,153	3.64	5.5 years
3.85 – 5.78	2,192,572	1,152,200	4.09	7.5 years
5.79 – 8.68	246,928	169,928	6.64	6.7 years
8.69 - 13.04	1,218,985	903,867	11.82	6.9 years
13.05 – 19.58	1,178,642	889,939	15.00	6.9 years
19.59 – 29.38	206,730	137,819	19.69	7.6 years
29.39 – 37.50	50,000	33,334	33.75	7.2 years

1999 WaveXpress Stock Incentive Plan

In April 2000, the board of directors of WaveXpress authorized the establishment of a stock option plan. The total number of shares of WaveXpress' Class A Common Stock subject to the Plan is 2,500,000. Options terminate upon the earlier of the date of expiration of the option or upon termination of the employment relationship between WaveXpress and the optionee for any reason other than death, disability or retirement.

Employees are entitled to exercise their options on dates determined by WaveXpress' Compensation Committee of the Board of Directors. Vesting provisions for options granted generally range from immediate vesting to pro rata vesting over a three-year period.

Stock option activity during 2002 and 2001 is as follows:

	2002		2001		2000	
	Number of Shares	Weighted Average Exercise Price	Number of Shares	Weighted Average Exercise Price	Number of Shares	Weighted Average Exercise Price
Balance at Beginning of year	1,029,975	\$ 1.22	634,964	\$ 1.23	-	\$ -
Granted	1,011,799	1.20	756,840	1.20	690,520	1.23
Exercised	-	-	(27,777)	1.20	-	-
Canceled	(638,933)	1.20	(334,052)	1.20	(55,556)	1.20
Balance at end of year	<u>1,402,841</u>	1.21	<u>1,029,975</u>	1.22	<u>634,964</u>	1.23
Exercisable at end of year	<u>658,156</u>	1.23	<u>176,682</u>	1.30	<u>97,089</u>	1.23
Additional shares available for grant at end of year	<u>1,069,382</u>		<u>1,442,248</u>		<u>1,865,036</u>	

The per share weighted-average fair value of stock options granted during 2002, 2001 and 2000 was \$0.85, \$0.89 and \$0.99, respectively, on the date of grant using a Black-Scholes option-pricing model with the following weighted-average assumptions:

	2002	2001	2000
Expected dividend yield	0%	0%	0%
Risk-free interest rate	3%	4%	6%
Expected Volatility	119%	127%	149%
Expected life	3 years	3 years	3 years

The following table summarizes information about WaveXpress' fixed stock options outstanding at December 31, 2002:

Exercise Price	Options Outstanding			Options Exercisable	
	Number Outstanding	Weighted Average Remaining Contractual Life (in years)	Weighted Average Exercise Price	Number Outstanding	Weighted Average Exercise Price
\$1.20	1,394,644	9.0	\$1.20	649,959	\$1.20
\$3.00 – 4.50	8,197	7.6	\$3.37	8,197	\$3.37
\$1.20 – 4.50	<u>1,402,841</u>	8.9	\$1.21	<u>658,156</u>	\$1.23

Warrants

In 1993 and 1994, Wave issued warrants to acquire a total of 151,600 shares of Class B Common Stock at \$3.50 per share in conjunction with sales of Class B Common Stock to individuals and institutions. All warrants were exercisable for a period of five years from the date of issuance and were subsequently canceled or exercised in 1998 and 1999.

In 1993 and 1994, Wave issued warrants to acquire a total of 376,253 shares of Class B Common Stock at \$3.50 per share in conjunction with the issuance of its 10% Convertible Notes which have since been repaid and in 1994, Wave issued warrants to acquire a total of 46,799 shares of Class B Common Stock at \$6.00 per share in conjunction with the issuance of its 15% Notes, also which have since been repaid. All warrants were exercisable for a period of five years from their dates of issuance. These warrants were exercised or canceled in 1998 and 1999.

Under the terms of Wave's initial public offering, the underwriter acquired warrants to purchase 360,000 Class A Common Stock at a price of \$6.50 per share for nominal consideration. These warrants were exercisable for four years commencing in September 1995. These warrants were exercised during 1999.

As a result of the successful placement of 350 shares of Series B Preferred Stock, a consultant from Digital Media Group, Inc. was issued warrants by Wave to purchase 15,000 Class A Common shares at a price of \$3.09 per share. These warrants are exercisable for ten years commencing in March 1996, and are still outstanding.

Due to the successful placement of 150,000 shares of Wave's Series C Convertible Stock, Wharton Capital Partners Ltd. and The Shemano Group, Inc., two financial consulting firms, were issued warrants by Wave to purchase 37,500 Class A Common Stock each at a price of \$2.54 per share. These warrants were exercised in 1999.

In connection with the acquisition of WIN, Wave issued a warrant that allowed the holder the ability to purchase unregistered shares of Wave's Class A Common Stock at a price of \$1.25 per share at the earlier of the conversion of a note or April 18, 1998 for a period of five years. The number of shares able to be purchased under this warrant is based on a formula of \$170,000 divided by 80% of the fair market value of the Class A Common Stock at the time of conversion. This warrant was subsequently extended one year by issuing 100,000 additional warrants to be exercised at prices ranging from \$1.49 to \$3.43. These warrants were exercised during July 1999.

As a result of the successful placement of 80,000 shares of Wave's Series D Preferred Stock, JNC Opportunity Fund, the acquirer of the placement, received 80,000 warrants to purchase Wave's unregistered Class A Common Stock, and financial consultants, primarily Wharton Capital Partners, received a total of 40,000 warrants. The warrants were exercised in 1999 at an exercise price of \$1.62.

As a result of the successful placement of 112,500 shares of Wave's Series F Preferred Stock, Combination Inc., the acquirer of the placement, received 112,500 warrants to Wave's unregistered Class A Common Stock, and Wharton Capital Partners received 56,250 warrants. The warrants had an exercise price of \$1.26, and expire on October 9, 2002. The warrants were exercised in 1998.

In connection with the private placement of approximately 800,000 shares of Wave's Class A Common Stock, Wave issued 160,000 warrants to purchase shares of Wave's unregistered Class A Common Stock at an exercise price of \$1.00. The warrants were exercised or expired during 1999.

In connection with a technology license agreement with Aladdin, Wave issued two warrants on July 18, 1997 to purchase Wave's Class A Common Stock. The first warrant was exercisable in 100,000 share lots, and provided the holder with the right to acquire 1,216,136 shares of Wave's unregistered Class A Common Stock at an exercise price of \$1.70 per share. The first warrant had a life of two years. The second warrant provided the holder with the right to acquire 7% of Wave's Class A Common Stock on a fully diluted basis for the average closing price for the 15 trading days prior to exercise and had a three year life. During June of 1998, Aladdin exercised a portion of the second warrant to purchase 1,000,000 shares of Common Stock. On March 31, 1999 Aladdin exercised their entire first warrant for 1,216,136 Class A Common Stock. Associated with the second warrant, Aladdin had the right to acquire shares approximating 3.45% of Wave's Class A Common Stock. The remaining shares under the second warrant were not exercised, and expired July 17, 2001.

In connection with a \$2,000,000 convertible promissory note, warrants to acquire 275,000 shares of Class A Common Stock were issued. Wave incurred a non-cash charge to interest expense for approximately \$666,000. These warrants were subsequently exercised in January 2000.

In connection with a software development agreement that Wave entered into with Archon Technologies, Inc. ("Archon"), Wave issued to Archon a warrant to purchase 50,000 shares of Wave Class A Common Stock at \$3.48 per share. The warrant is exercisable November 9, 2002, and expires on November 9, 2007.

In 2001, 50,320 warrants were exercised at \$1.83 per share. In 2000, 44,692 warrants were exercised at prices ranging from between \$1.10 and \$5.50 per share

A summary of warrants outstanding at December 31, 2002, follows:

<u>Class A and B shares subject to warrants</u>	<u>Range of exercise prices</u>	<u>Weighted Average Remaining Contractual Life</u>
65,000	\$3.09 – \$3.48	1.5 years
20,000	\$10.00 - \$14.73	4.5 years

At December 31, 2002, warrants to acquire approximately 85,000 shares of Class A Common Stock were exercisable.

(10) Licensing Agreements

(a) Licensed Patents

In February 1994, Wave entered into an Amended and Restated License Agreement (the "Agreement") with Mr. Peter J. Sprague, the former Chairman and former Chief Executive Officer of Wave, and Mr. John Michener, then a shareholder and officer of Wave, whereby Wave was granted an exclusive license to make, have made, use, lease, sell or otherwise perform services covered by certain licensed patents which are a fundamental part of some of Wave's products. The Agreement amends and restates certain license agreements entered into by Wave prior to February 1994.

The Agreement provides for royalty payments to be made to the licensors in the aggregate amount of two percent of the total gross revenues derived by Wave and any sublicensee of Wave from the exploitation of these licensed patents, less amounts paid, if any, to (i) information and database providers for information distributed to or through Wave or its sublicensees, and to (ii) Wave's sublicensees for manufacturing the product or performing the services covered by these patents. Royalty payments are payable quarterly and are to be apportioned 75% to Mr. Sprague and 25% to Mr. Michener.

Payment of royalties is secured by a security interest in and to these licensed patents. Mr. Sprague assigned all of his right, title, and interest in the licensed patents to Wave.

Wave believes that the agreements as a whole provide it with exclusive rights under the patents. There can be no assurance that Wave will enjoy exclusive rights to the licensed patents under these agreements. No payments have been made to date.

(b) Aladdin License Agreement

During the third quarter of 1997 Wave entered into a license agreement with Aladdin, an Israeli company, for technology and in-process research and development related to Aladdin's proprietary persistent encryption system. Under the terms of the Aladdin license agreement, Wave is prohibited from using any other encryption technology for the first five years. This technology will be incorporated into the Wave System to facilitate pay-per-view content distribution.

Wave acquired the license for this technology in exchange for \$950,000 plus two warrants to purchase Wave's Class A Common Stock valued at approximately \$2.9 million (see note 9). The cost of this license was expensed as research and development costs. Aladdin also is provided a royalty payment of 5% to 9% of Wave's net content revenues.

In connection with this agreement, Aladdin acquired an equity position in Wave by purchasing 500,000 shares of Wave's Class A Common Stock for \$900,000, which approximated the fair market value of the shares on the date of purchase (see note 8).

(11) License and Cross-License Agreements

On May 1, 1992, Wave entered into a Joint Technology Development Agreement and License and Cross-License Agreement ("License and Cross-License Agreement") with The Titan Corporation ("Titan") whereby Titan granted to Wave license rights to the use of certain patents which are co-owned or licensed by Titan.

Wave granted to Titan the exclusive right to make for, sell in, and lease in a "Retained Market," as defined in the agreement, the subject matter described in any Company patent. The Retained Market is defined generally as the market for "Government Information," as defined in the agreement, used solely by a government entity, and the market for products used to access such information. Wave issued to Titan 674,976 shares of Class B Common Stock in return for the license to Titan's patents. These shares were valued at \$1.67 per share (total \$1,124,960), the estimated fair value of the shares at the time of issuance (based on the price at which shares were sold to third parties near the time of issuance), and were included in research and development expense in the accompanying consolidated statement of operations for the period from February 12, 1988 through December 31, 2002.

The License and Cross-License Agreement provides for royalties to be paid by Wave to Titan based upon Wave's "Net Revenues," as defined in the agreement. Net Revenues are defined generally as gross product revenues less amounts paid to information providers and data base providers for information provided to Wave for use in its products and services. Royalties are payable on a quarterly basis.

The License and Cross-License Agreement also provides for royalties to be paid to Wave by Titan based upon Titan's "Allocable Net Revenues," as defined in the agreement. Allocable Net Revenues are generally defined as that portion that a Company patent or information adds to Titan's gross amounts invoiced to purchasers for all products or information services making use of a Company patent or know-how and information. Royalties are payable on a quarterly basis.

The License and Cross-License Agreement specifies certain events of termination, some of which have already occurred but which have been waived or extended by Titan.

A director of Wave, who resigned from the Board at the end of 1997, is also the President, Chief Executive Officer, and a director of Titan. Pursuant to the terms of a related stockholders agreement, Titan has the right to designate a member of Wave's Board of Directors for as long as Titan continues to own at least 50% of the shares originally issued to Titan. As of December 31, 2002, no royalties have been earned by Titan. On February 28, 1997, Wave and Titan executed an addendum to the License Agreement whereby Wave received a sole license to Titan's patent to develop and distribute products to the in-home consumer microcomputers market segment. Under this addendum, Titan waived all defaults previously incurred by Wave as well as extended the license agreement to expire at the time the patents expire.

(12) Revenue Sharing Agreements With Partners

Wave has, and intends to continue to, enter into revenue sharing arrangements with information providers, software developers, and hardware and systems manufacturers. Such revenue sharing arrangements are expected to be negotiated between each of the partners and Wave. It is anticipated that revenue sharing arrangements will vary according to the market in which the Wave system is adopted and from which revenues are derived. Generally, a significant portion of the revenue collected by Wave will be paid directly to the information provider or software developer. Once these payments are made, the remainder of revenues will be shared between Wave and other partners. There can be no assurance that Wave will be successful in entering into definitive agreements with these parties, or that the terms of such agreements will be favorable to Wave.

(13) Development Contract with SSP Solutions, Inc.

In October 2000, Wave entered into a \$10 million comprehensive development agreement with BIZ Interactive Zone, Inc. to integrate Wave's EMBASSY Trusted Client technology into BIZ's suite of products for deployment into 5 million digital set top boxes and integrated gateway products such as cable and DSL modems. The development agreement outlined the broad objectives of the project but it required that the parties complete a more detailed plan with related milestones in order to guide the overall project.

In February 2001, Wave entered into an unrelated stock purchase agreement with BIZ pursuant to which Wave purchased 3,600,000 shares of BIZ Series B preferred stock in exchange for 2,000,000 shares of its Class A Common Stock. Subsequently, Litronic, Inc., a provider of authentication and encryption security technology, completed a merger with BIZ to form SSP Solutions, Inc. (See Note 14). The intention of the cross investment was to add an additional incentive to both parties under the agreement and it was intended to be a swap of shares of equal value.

In May of 2001, the development agreement with BIZ discussed above, was amended whereby the parties agreed to a \$5 million development services contract whereby Wave agreed to port its EMBASSY platform to run in a

Linux environment. In addition, SSP agreed to place with Wave an open \$5 million purchase order for EMBASSY products. Payment terms of the agreement provided that SSP make payments of \$277,778 per month for eighteen months. In addition, the parties agreed that in the event that SSP failed to pay any monthly instalment within 30 days of receiving written notice by Wave that it is in default, the unpaid portion of the instalment would automatically convert into a stock acquisition right allowing Wave to acquire a number of shares in SSP to be determined by dividing the unpaid amount by the fair market value of SSP common stock. As the contract was for a discrete project to integrate our technology with the SSP platform, revenue under the development services agreement had been recognized on a percentage of completion basis in accordance with SOP 97-2 as it relates to contract accounting under SOP 81-1. Percentage complete is determined based upon the actual costs incurred compared to the total estimated costs to complete, limited to cash received and milestones accomplished. Milestones included specific software development objectives that must be accepted by SSP.

As of December 31, 2001, Wave received \$555,556 in cash and had not exercised any stock appreciation rights. Wave recognized approximately \$358,000 in revenue under the development agreement at December 31, 2001 under the percentage of completion method of accounting.

Effective January 29, 2002, due to a refocus of SSP's development efforts, SSP formally requested Wave to suspend work on the Linux project. SSP further requested Wave to (i) agree to amend the existing contract, (ii) agree to identify any balance of development budget left from the Linux project commitment and (iii) agree to formally estimate the costs to complete two other projects that SSP would like Wave to focus upon. At that time, Wave had ceased all work relating to SSP and recognized the remaining non-refundable cash received, \$198,000 in during the quarter ended March 31, 2002. Revenue was recognized under the percentage of completion method of accounting.

On September 30, 2002 Wave and SSP executed a Termination Agreement and Mutual Release whereby Wave was issued an additional 1,600,000 shares of SSP Class A Common Stock and a non-negotiable, non-interest bearing, subordinated convertible promissory note due December 31, 2005 in the principal amount of \$270,000 (the "Note") as a fee for the termination by SSP of the contract. The Note is convertible into SSP Class A common stock at the rate of \$1.35 which is subject to adjustments for anti-dilution stock splits, stock dividends, reclassifications, reorganizations and the like. In exchange, Wave was released from its obligation to provide any further services under the development contract as amended. The shares that Wave received were recorded on the its balance sheet at estimated fair value based on the average closing price of the shares on the Nasdaq national exchange for the period from the two trading days before to the two trading days after the date of issuance of the shares, or \$1.05 per share, for an aggregate value of \$1,680,000. A termination fee of \$1,680,000 was recognized in Wave's statement of operations in connection with this transaction. On December 13, 2002 SSP exercised its right to convert the Note into 200,000 shares of SSP common stock. The 200,000 shares that Wave received from the Note conversion were initially recorded on the balance sheet at \$0.69 per share, for an aggregate value of \$138,000.

(14) Investments

On February 2, 2001 Wave issued 2,000,000 shares of its Class A Common Stock, at a price of \$7.16 per share, for an aggregate purchase price of \$14,312,800 to acquire 3,600,000 shares of the Series B Preferred Stock of BIZ, then a privately held company, in a private placement exempt from registration under code section 4(2) of the Securities Act of 1933, as amended. Wave's investment in BIZ represented approximately 17.8% of the outstanding capital stock of BIZ. Accordingly, the investment had been accounted for under the cost method of accounting, because the investment was less than 20% of the outstanding capital stock of BIZ and because Wave could not exercise significant influence over BIZ. On August 24, 2001, SSP was formed through a merger with Litronic. As a result of the merger, Wave was issued 3,083,083 shares (14.95%) of the common stock of SSP in exchange for the BIZ shares it held, as noted above.

During 2002, SSP issued Wave an additional 1,800,000 shares of common stock in connection with the cancellation of a development agreement between the two parties and the conversion of the Note. Wave has accounted for its investment in SSP as non-current marketable equity securities available for sale. Unrealized holding gains and losses on these securities are recorded in other comprehensive income in stockholders' equity, unless the unrealized loss in the investment is deemed to be other than temporary, whereby the decline in value is recognized as a realized loss in Wave's statement of operations. As of December 31, 2002 and 2001, Wave's investment in SSP was valued at \$2,881,016 and \$11,160,758. As detailed in the table below:

As of December 31, 2001

As of December 31, 2002

Acquisition Date	Shares	Original Cost	Other than Temporary Decline	Adjusted basis	Unrealized Gain/ (Loss)	Carrying Value	Other than Temporary Decline	Carrying Value
February 2, 2001	3,083,083	\$ 14,312,800	\$(1,736,685)	\$12,576,115	\$(1,415,357)	\$11,160,758	\$(10,757,099)	\$ 1,819,016
September 30, 2002	1,600,000	1,680,000	-	-	-	-	(736,000)	944,000
December 13, 2002	200,000	138,000	-	-	-	-	(20,000)	118,000
	<u>4,883,083</u>	<u>\$ 16,130,800</u>	<u>\$(1,736,685)</u>	<u>\$12,576,115</u>	<u>\$(1,415,357)</u>	<u>\$11,160,758</u>	<u>\$(11,513,099)</u>	<u>\$ 2,881,016</u>

In addition, Wave holds 107,975 common shares of XO Communications Corporation (“XO”). As of December 31, 2002 and 2001 the stock had a market value of \$0 and \$10,366, respectively

(15) Joint Ventures

(a) *GlobalWave, Ltd*

In July of 1997, Wave entered into a joint venture with ITG, a United Kingdom Internet service provider. The joint venture was initially owned 25% by Wave and 75% by ITG. Wave contributed its technical expertise and ITG contributed initial working capital and the commitment to fund all future working capital requirements of the joint venture. The objective of the joint venture company, GlobalWave is to promote and commercialize Wave’s technology in certain European, African and Middle Eastern markets. Pursuant to the joint venture agreement, Wave received a license fee of \$5 million in exchange for the joint venture's right to market Wave’s technology in European, African and Middle Eastern markets. The license fee was paid by ITG as part of its commitment to fund the joint venture. During the third quarter of 1997, Wave received \$1.0 million from the joint venture representing partial payment of the license fee, with the remaining payments to be made upon Wave's attaining certain milestones related to the number of Wave Meters distributed. The amount received was recorded as deferred license fee income in the third quarter of 1997 as it was uncertain whether Wave had met the contractual requirements required in order to have earned the first payment. During the fourth quarter of 1997, Wave met these requirements and began recognizing the license fee ratably over the contractual period, and recorded the \$1 million as a license fee income. Also Wave accrued \$490,000 in the fourth quarter of 1997 for expenses related to Wave's obligation to assist the joint venture in setting up the Wave system in the designated markets. In January 1998, the joint venture agreement was modified to extend the milestone dates and provide for the payment of an additional \$750,000 of the \$5 million license fee to Wave. The payment of \$750,000 was received in January 1998. Wave also received the final payment of \$3.25 million in June 1998. This payment and the \$750,000 received in January 1998 totaled \$4 million received in 1998. As part of the agreement, after the final license fee was paid, the companies issued a warrant to each other to purchase approximately one million shares of each other's Common Stock. The exercise price of the Wave warrants was \$1.75 per share. The exercise price of the ITG warrant was approximately .995 British pound per share. On June 5, 1998, the final milestone for the last payment on the license fee was attained and Wave became obligated to issue its warrant to ITG pending approval by the shareholders of ITG for it to issue its reciprocal warrant. On this date the net fair market value of the exchange of warrants represented a net cost to Wave of approximately \$1.1 million. Wave recorded this cost as ITG net warrant cost in the Consolidated Statement of Operations.

On November 5, 1999, Wave exercised its warrant for 1,000,000 shares in ITG at a total cost of \$1,620,000. Also during 1999, ITG exercised its 1,000,000 warrants in Wave yielding total proceeds of \$1,750,000.

In February, 2000, ITG was acquired by Concentric Network Corporation. As a result of this transaction, Wave received \$2,162,457 in cash and 83,910 shares of Concentric Common Stock. Subsequently, Concentric was acquired by XO, whereby Wave’s 83,910 shares in Concentric were converted into 107,975 shares of XO. (See Note 13 - Investments). In addition, certain assets of ITG, namely the 1,000,000 shares of Wave Common Stock and ITG's interest in GlobalWave, were distributed to Redwave.

In June, 2000, Wave increased its ownership percentage of GlobalWave from 25% to 40%. As part of the new joint venture agreement, Wave's partner in the venture, Redwave, agreed to contribute \$7.5 million and 500,000 shares of Wave Common Stock held by Redwave, in exchange for 600,000 shares of GlobalWave class A Common Stock. Wave received 400,000 shares of GlobalWave class B Common Stock in exchange for a technology license granted by Wave to GlobalWave. Prior to September 30, 2000, no value had been assigned to these shares, as Wave had not provided any funding to GlobalWave.

On October 10, 2000, Wave entered into an agreement with GlobalWave and Redwave to subscribe for additional Class B shares of GlobalWave. Under the terms of the agreement, Wave subscribed for 40,000

additional "B" shares of GlobalWave at £100 per share (approximately \$142.80), the consideration for which consisted of £1.5 million (approximately \$2.14 million) in development costs incurred by Wave on behalf of GlobalWave, £1.4 million in cash (\$2.0 million), and £1.1 million (approximately \$1.6 million) in cash and/or future development services, for total consideration of £4.0 million (approximately \$5.7 million). In addition, Redwave has agreed to subscribe for an additional 60,000 GlobalWave "A" shares, the consideration for which will consist of the conversion of debt and cash totaling £6.0 million (£5,966,615 in debt and £33,385 in cash; approximately \$8.6 million). The resulting ownership interest in the venture will remain 60% for Redwave and 40% for Wave.

Also, in October 2000, Wave and Redwave formed a joint venture holding company, Wave European Technologies plc, ("WET") for their European interests, including their respective 40% and 60% stakes in GlobalWave. Subsequent to the formation of WET, WET's name changed to GlobalWave Group, plc.

As of December 31, 2002, Wave has contributed its entire committed investment of approximately \$5.7 million in the form of development costs incurred and cash. Pursuant to the equity method of accounting, Wave had recognized its equity share (40%) of GlobalWave's net losses in its operating results for the years-ended December 31, 2002, 2001 and 2000 of \$0, \$2.3 million and \$3.4 million, respectively.

On July 24, 2002 Wave issued 1,700,000 shares of its Class A Common Stock in exchange for 60% of the remaining assets of GlobalWave for a total purchase price of approximately \$2,244,000. The purchase of the 60% of the remaining assets of GlobalWave was accounted for as an acquisition of assets and not considered a business combination, as GlobalWave had effectively ceased operations prior to the acquisition. In exchange for the 1,700,000 shares, Wave received approximately \$1,380,000 in cash, tangible fixed assets of approximately \$9,000 and the exclusive rights under the licenses that it had previously sold to GlobalWave, which granted GlobalWave the exclusive right to commercialize the Wave Commerce System in Europe; the Middle East and Africa. Wave incurred a charge to operations representing the amount by which the purchase price exceeded the tangible assets that Wave received of approximately \$855,000. In addition, GlobalWave forgave its receivable from Wave of \$189,000. The net charge of approximately \$666,000 has been presented in the statement of operations for the year ended December 31, 2002 as an impairment charge of the acquired license. Wave assumed no liabilities as a result of this transaction.

(b) WaveXpress

In April 1999, Wave joined with Sarnoff Corporation to form a new joint venture, WaveXpress. WaveXpress develops secure data broadcast architecture, infrastructure and content services. This technology and these services will allow content providers to send digital content to properly equipped PC's by utilizing unused bandwidth in the Digital Television Spectrum or broadcast over cable television lines. Consumers will be able to purchase this content directly through a secure network connection, thus enabling a significant new revenue stream for broadcasters or cable television operators. On October 15, 1999, Wave and Sarnoff signed a joint venture agreement that formally established WaveXpress. Under this agreement, Sarnoff and its affiliates received a 40% equity stake in WaveXpress. Wave received a 53% equity interest; and its affiliates, who purchased founders stock in April 1999 for a nominal amount, owned the remaining 7% of the outstanding capital stock. The affiliates of Wave include Peter Sprague; former Chairman of Wave and Steven Sprague; Chief Executive Officer of Wave, certain members of the Board of Directors of Wave and certain Wave employees.

Wave has funded WaveXpress through a series of convertible notes, some with attached warrants. The notes bear interest at rates of 2% to 3% above the prime rate of Chase Manhattan Bank. Generally, the notes are convertible into shares of Common Stock of WaveXpress at varying prices per share. In addition, some of the notes carry attached warrants that allow Wave to purchase additional shares of WaveXpress, generally at the conversion price of the notes. As of September 30, 2002, Wave owned 69% of WaveXpress while Sarnoff owned 26%. The equity interests of Wave, Sarnoff and Wave's affiliates referred to above, assuming all of Wave's and Sarnoff's convertible securities are converted and warrants are exercised, would be approximately 83%, 8%, and 9%, respectively. Through December 31, 2002, Wave has provided approximately \$32.6 million in funds, including approximately \$3.6 million in accrued interest. During 2001, some of the notes, totaling \$9.5 million matured and were converted into 1,826,570 shares of WaveXpress common stock. These amounts are eliminated in consolidation.

Neither Sarnoff nor any of the other minority shareholders have provided or are obligated to provide funding to WaveXpress. Accordingly, the financial statements of WaveXpress have been included in the consolidated financial statements of Wave as of December 31, 2002 and for the period then ended. In addition, Wave has not recorded a minority interest in WaveXpress in the consolidated financial statements and therefore has reflected 100% of WaveXpress' balance sheet and operating results in its consolidated financial statements.

WaveXpress has incurred net losses of \$6.3 million, \$10.2 million, and \$11.2 million for the years ended December 31, 2002, 2001 and 2000, respectively.

(16) Cash Collected on Behalf of Charities

As of December 31, 2002, Wave held cash received on behalf of charities of \$235,553 in connection with Charitywave.com, Wave's on-line charitable donation service. These donations were received primarily on behalf of donors to the New York Times Neediest Cases Fund. In addition, Wave had a receivable from its credit card processor of \$27,603 as of December 31, 2002, associated with these donations. The total of \$263,156 is reflected as due to charities in the December 31, 2002 financial statements, and was paid to the applicable charities within 30 days, in accordance with the standard Charitywave.com contracts with its member charities.

As of December 31, 2001, Wave held cash received on behalf of charities of \$358,531 in connection with Charitywave.com, Wave's on-line charitable donation service. These donations were received primarily on behalf of donors to the New York Times 9/11 Disaster Relief Fund. In addition, Wave had a receivable from its credit card processor of \$64,522 as of December 31, 2001, associated with these donations. The total of \$423,053 is reflected as due to charities in the December 31, 2001 financial statements, and was paid to the applicable charities within 30 days, in accordance with the standard Charitywave.com contracts with its member charities.

(17) Commitments and Contingencies

Litigation

Wave is a party to legal proceedings generally incidental to its business. Management believes that the outcome of such litigation will not have a material adverse effect on the consolidated financial position of the Company.

Leases

Summarized below is a listing of properties leased by Wave pursuant to non-cancelable operating leases. Our principal research and development activities are conducted at the Princeton and Cupertino facilities.

<u>Location</u>	<u>Annual Lease Cost</u>	<u>Lease Expiration Date</u>
Lee, MA	\$ 147,095	Aug. 2004
New York, NY	90,000	Monthly
Princeton, NJ	264,000	Jun. 2003
Cupertino, CA	168,228	Feb. 2008
Nashville, TN	47,233	Sep. 2003
Orvault, France	92,172	Sep. 2010
New York, NY ⁽¹⁾	<u>304,317</u>	Apr. 2006
Total	<u>\$1,113,045</u>	

⁽¹⁾ *WaveXpress facility*

Future minimum lease payments under non-cancelable operating leases (with initial or remaining lease terms in excess of one year) as of December 31, 2002 are as follows:

2003	\$ 701,948
2004	589,105
2005	573,782
2006	375,724
2007	280,098
Thereafter	284,961
Total minimum lease payments	<u>\$ 2,805,617</u>

Rent expense for the years ended December 31, 2002, 2001, 2000 and for the period from inception through December 31, 2002 amounted to approximately \$1,804,000, \$2,101,000, \$1,960,000 and \$8,984,000, respectively.

There were no capital lease obligations as of December 31, 2002.

(18) Income Taxes

The Company did not provide for any income tax expense or (benefit) for the years ending December 31, 2002, 2001 and 2000.

The following table summarizes the significant differences between the United States federal statutory tax rate and the Company's effective tax rate for financial statement reporting purposes:

	<u>2002</u>	<u>2001</u>	<u>2000</u>
Statutory tax rate	34%	34%	34%
Equity in loss from subsidiaries	(1)	(2)	(10)
Change in valuation allowance	<u>(33)</u>	<u>(32)</u>	<u>(24)</u>
Total	<u>--%</u>	<u>--%</u>	<u>--%</u>

The tax effects of temporary differences that give rise to the deferred tax asset at December 31, 2002 and 2001 are as follows:

	<u>2002</u>	<u>2001</u>
Deferred tax assets:		
Net operating loss carryforwards	\$76,174,000	\$ 61,604,000
Accrued expenses	383,000	831,000
Intangibles	2,015,000	4,609,000
Reserves	974,000	549,000
Depreciation	845,000	786,000
Other	<u>5,631,000</u>	<u>-</u>
Total gross deferred tax assets	86,022,000	68,421,000
Less valuation allowance	(86,022,000)	(68,421,000)
Net deferred tax asset	<u>\$ -</u>	<u>\$ -</u>

The valuation allowance increased by approximately \$17.6 million and \$23.9 million, during the years ended December 31, 2002 and 2001, respectively.

Management has concluded that it is more likely than not that Wave will not have sufficient taxable income of an appropriate character within the carryback and carryforward period permitted by current law to allow for the utilization of certain of the deductible amounts generating the deferred tax assets and, therefore, a valuation allowance of \$86,022,000 and \$68,421,000 has been established to reduce the deferred tax assets at December 31, 2002 and 2001 respectively.

Wave has net operating loss carryforwards for tax return purposes of approximately \$179 million, which expire beginning in 2003 through 2022. Pursuant to the Section 382 of the Internal Revenue Code, the annual utilization of Wave's net operating loss carryforwards may be limited if a cumulative change in ownership of more than 50% occurs within a three year period. Wave has not determined whether there has been such a cumulative change in ownership or the impact on the utilization of the loss carryforwards if such change has occurred.

(19) Defined Contribution Plan

Wave adopted the Wave Systems Corp. 401(k) Savings and Investment Plan, a defined contribution plan, to which substantially all employees can contribute, on January 1, 1995. Employees of Wave become eligible immediately on employment. Wave has the option to make discretionary matching contributions; no contributions were made in 2002, 2001 or 1999.

(20) Disclosures about the Fair Value of Financial Instruments

Cash and Cash Equivalents, Marketable Securities, Prepaid Expenses and Other Receivable, Accounts Payable and Accrued Expenses, and Note Payable

The carrying amounts of these instruments, other than marketable securities and the note payable, approximate fair value because of their short maturities. Marketable securities are valued based on the value of the securities as traded on the Nasdaq Stock Exchange.

Fair value estimates are made at a specific point in time, based on relevant market information and information about the financial instrument. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

(21) Restructuring Costs and Other Charges

During the quarter ended March 31, 2002, Wave completed a restructuring and cost reduction program to prioritize its initiatives, reduce expenses and improve efficiency. This program included a workforce reduction, the relocation of its WaveXpress office and restructuring of certain business functions.

As a result of this program, Wave recorded restructuring costs and other related charges of \$726,280 consisting of \$229,000 in severance benefits associated with the workforce reduction, \$426,000 for lease termination fees and brokerage fees and \$71,000 for moving expenses related to the WaveXpress office relocation. All costs were incurred and paid during the quarter ended March 31, 2002. Overall, Wave reduced its force by a total of thirty-six employees, nineteen of which were in research and development and seventeen that were in selling, general and administrative departments. All employees were notified of the workforce reduction during the quarter ended March 31, 2002. In addition, Wave recorded an impairment charge of \$905,390 for leasehold improvements in the abandoned office and other tangible fixed assets that were disposed of or removed from operations in connection with this transaction.

Wave also recorded a charge of approximately \$488,000 in the quarter ended March 31, 2002, relating to a payment made to a former supplier as a settlement for a demand for arbitration filed against Wave. The arbitration arose out of a claim that Wave had breached a contract with the supplier to purchase computer components to be incorporated into an Internet security device produced by Wave. The total settlement payment made by Wave was for \$688,000, of which \$200,000 was accrued for as of December 31, 2001. This charge is included in "selling, general and administrative expense".

(22) Segment Reporting

Effective December 31, 2000, Wave adopted SFAS No. 131 "Disclosures about Segments of an Enterprise and Related Information." SFAS 131 supercedes previously issued segment reporting disclosure rules and requires reporting of segment information that is consistent with the way in which management operates Wave. Prior to December 31, 2000, SFAS 131 was not applicable because Wave only operated as one segment.

Wave's products include the Wave EMBASSY® Trusted Client Platform and Services and WaveXpress Data Broadcasting Products and Services. These products and services constitute Wave's reportable segments. Net Losses for reportable segments exclude interest income, interest expense, equity in losses of equity method investees and realized gains on marketable securities. These items are not reported by segment since they are excluded from the measurement of segment performance reviewed by Wave's management.

The following sets forth reportable segment data:

	For the years ended December 31,		
	2002	2001	2000
Operating Revenues:			
EMBASSY® Trusted Client Platform and Services	\$ 446,588	\$ 672,325	\$ 332,522
WaveXpress Data Broadcasting	-	19,800	-
Total Operating Revenues	<u>446,588</u>	<u>692,125</u>	<u>332,522</u>
(Net Loss):			
EMBASSY® Trusted Client Platform and Services (1)	(26,914,035)	(37,068,320)	(39,712,441)
WaveXpress Data Broadcasting	<u>(6,336,655)</u>	<u>(10,252,001)</u>	<u>(10,183,134)</u>
Total Segments Net Loss	<u>(33,250,690)</u>	<u>(47,320,321)</u>	<u>(49,895,575)</u>
Interest Income	477,902	2,688,105	5,103,716
Interest Expense	-	-	-
Equity in net losses of equity method investees	-	(2,332,159)	(3,406,491)
Gain on termination of development contract	1,818,000	-	-
Provision for loss on officer note receivable	(999,518)	-	-
Loss for Other than Temporary Decline in Marketable Equity Securities	(11,513,099)	(1,736,682)	-
Gain on sale of marketable securities	-	-	542,457
Net Loss	<u>\$ (43,467,405)</u>	<u>\$ (48,701,057)</u>	<u>\$ (47,655,893)</u>
Depreciation and Amortization Expense:			
EMBASSY® Trusted Client Platform and Services (2)	1,563,987	3,281,547	2,228,078
WaveXpress Data Broadcasting	436,718	970,408	939,060
Total Depreciation Expense	<u>\$ 2,000,705</u>	<u>\$ 4,251,955</u>	<u>\$ 3,167,138</u>
Capital Expenditures:			
EMBASSY® Trusted Client Platform and Services	1,083,877	1,307,271	1,323,485
WaveXpress Data Broadcasting	73,755	200,327	4,275,815
Total Capital Expenditures	<u>\$ 1,157,632</u>	<u>\$ 1,507,598</u>	<u>\$ 5,599,300</u>
Assets:			
EMBASSY® Trusted Client Platform and Services	17,560,523	58,562,392	92,164,096
WaveXpress Data Broadcasting	<u>648,849</u>	<u>1,671,910</u>	<u>5,920,365</u>
Total Assets	<u>\$ 18,209,372</u>	<u>\$ 60,234,302</u>	<u>\$ 98,084,461</u>

(1) Includes \$0, \$0 and \$2,176,000 in in-process research and development for the years-ended December 31, 2002, 2001 and 2000 respectively (See Note 4).

(2) Includes \$0, \$1,720,632, and \$573,544 in goodwill amortization for the year-ended December 31, 2002, 2001 and 2000 respectively (See note 4)

(23) Selected Quarterly Financial Data

	For Quarters-ended			
	December 31, 2002	September 30, 2002	June 30, 2002	March 31, 2002
Revenues	\$ 53,336	\$ 69,845	\$ 77,792	\$ 245,615
Gross Profit	23,927	44,545	39,279	136,629
Loss from Operations	(6,858,788)	(8,536,488)	(7,905,212)	(9,950,202)
Net loss	(9,886,002)	(12,649,493)	(9,687,005)	(11,244,905)
Net loss per Common Share	\$ (0.19)	\$ (0.24)	\$ (0.19)	\$ (0.22)

	For Quarters-ended			
	December 31, 2001	September 30, 2001	June 30, 2001	March 31, 2001
Revenues	\$ 202,221	\$ 224,768	\$ 191,698	\$ 73,438
Gross Profit	50,351	140,854	60,104	70,857
Loss from Operations	(9,922,017)	(11,227,427)	(11,722,600)	(14,448,277)
Net loss	(11,743,942)	(11,200,084)	(11,890,884)	(13,866,147)
Net loss per Common Share	\$ (0.23)	\$ (0.22)	\$ (0.24)	\$ (0.28)

CORPORATE INFORMATION

BOARD OF DIRECTORS

John E. Bagalay, Jr., Ph.D.
*Senior Advisor to the Chancellor
Boston University*

Nolan Bushnell
*Chairman
uWink.com Inc.*

George Gilder
*Chairman
Gilder Group*

John E. McConaughy, Jr.
*Chairman and CEO
JEMC Corp.*

Steven K. Sprague
*President and CEO
Wave Systems Corp.*

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Stock Exchange Listing
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CORPORATE OFFICERS

Steven K. Sprague
President and CEO

Gerard T. Feeney
*Senior VP, Finance & Administration
and CFO*

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