

SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

FORM 10-K/A

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

FOR THE FISCAL YEAR ENDED DECEMBER 31, 2001

OR

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

COMMISSION FILE NUMBER 0-19871

STEMCELLS, INC.

(Exact name of Registrant as specified in its charter)

DELAWARE

94-3078125

(State or other jurisdiction  
of incorporation or organization)

(I.R.S. Employer Identification No.)

3155 PORTER DRIVE, PALO ALTO, CA 94304  
(Address of principal offices) (zip code)

Registrant's telephone number, including area code: (650) 475 3100

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

Securities registered pursuant to Section 12(g) of the Act:

COMMON STOCK, \$.01 PAR VALUE  
JUNIOR PREFERRED STOCK PURCHASE RIGHTS  
Title of class

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

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. /X/

Aggregate market value of Common Stock held by non-affiliates at February 25, 2002: \$66,606,700. Inclusion of shares held beneficially by any person should not be construed to indicate that such person possesses the power, direct or indirect, to direct or cause the direction of management policies of the registrant, or that such person is controlled by or under common control with the Registrant. Common stock outstanding at February 25, 2002: 24,220,618 shares

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's definitive Proxy Statement relating to the registrant's 2002 Annual Meeting of Stockholders to be filed with the Commission pursuant to Regulation 14A are incorporated by reference in Part III of this report.

FORWARD LOOKING STATEMENTS

THIS REPORT CONTAINS FORWARD-LOOKING STATEMENTS AS DEFINED UNDER THE FEDERAL SECURITIES LAWS. ACTUAL RESULTS COULD VARY MATERIALLY. FACTORS THAT COULD CAUSE ACTUAL RESULTS TO VARY MATERIALLY ARE DESCRIBED HEREIN AND IN OTHER DOCUMENTS FILED WITH THE SECURITIES AND EXCHANGE COMMISSION. READERS SHOULD PAY PARTICULAR ATTENTION TO THE CONSIDERATIONS DESCRIBED IN THE SECTION OF THIS REPORT ENTITLED

"MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS" AS WELL AS EXHIBIT 99 TO THIS REPORT, ENTITLED "CAUTIONARY FACTORS RELEVANT TO FORWARD-LOOKING INFORMATION." READERS SHOULD ALSO CAREFULLY REVIEW ANY RISK FACTORS DESCRIBED IN OTHER DOCUMENTS WE FILE FROM TIME TO TIME WITH THE SECURITIES AND EXCHANGE COMMISSION.

This amendment on Form 10-K/A amends the Annual Report of the Company on Form 10-K previously filed for the year ended December 31, 2001. This Annual Report on Form 10-K/A is filed in connection with the Company's restatement of its consolidated statements of operations for the year ended December 31, 2001 and its unaudited consolidated statements of operations for the quarters ended March 31, 2001 and June 30, 2001. The restatement is being made in order to record additional deemed dividends for the beneficial conversion feature of the Company's 6% Cumulative Convertible Preferred Stock. The additional deemed dividends arise as a result of the change to the effective conversion price resulting from the issuance in 2001 of adjustable warrants in connection with the common stock financing transaction with Millennium Partners, LP (See note 11 to the financial statements). Accordingly, in its restated financial statements, the Company has recorded additional deemed dividends of \$331,000 for the quarter ended March 31, 2001, \$471,000 for the quarter ended June 30, 2001 and \$802,000 for the year ended December 31, 2001 (see note 15 to the financial statements).

## ITEM 1. BUSINESS

### OVERVIEW

We are engaged in research aimed at the development of therapies that would use stem and progenitor cells derived from fetal or adult sources to treat, and possibly cure, human diseases and injuries such as Parkinson's disease, hepatitis, diabetes, and spinal cord injuries. The body uses certain key cells known as stem cells to produce all the functional mature cell types found in normal organs of healthy individuals. Progenitor cells are cells that have already developed from the stem cells, but can still produce one or more types of mature cells within an organ. We are not developing embryonic stem cells for therapeutic use.

Many diseases, such as Alzheimer's, Parkinson's, and other degenerative diseases of the brain or nervous system, involve the failure of organs that cannot be transplanted. Other diseases, such as hepatitis and diabetes, involve organs such as the liver or pancreas that can be transplanted, but there is a very limited supply of those organs available for transplant. We estimate, based on information available to us from the Alzheimer's Association, the National Institutes of Health, the Centers for Disease Control and Prevention, and the Parkinson's Action Network, that these conditions affect more than 20 million people in the United States and account for more than \$190 billion annually in health care costs.

We believe that our stem cell technologies, if successfully developed, may provide the basis for effective therapies for these and other conditions. Our aim is to return patients to productive lives and significantly reduce the substantial health care costs often associated with these diseases and disorders. We have made significant progress toward developing stem cell therapies for the nervous system by identifying and characterizing the human central nervous system stem cell. We have also made significant advances in our search for the stem cells of the liver and the pancreas by identifying markers, some of which are novel, on the surface of cells so they can be isolated and tested to determine whether they are stem cells. We have established an intellectual property position in all three areas of our stem cell research--the nervous system, the liver and the pancreas--by patenting our discoveries and entering into exclusive in-licensing arrangements. We believe that, if successfully developed, our platform of stem cell technologies may create the basis for therapies that would address a number of conditions with significant unmet medical needs. We intend to concentrate our in-house efforts on our neural and liver programs and, for the present, to pursue work on the pancreas primarily through external collaborators.

### CELL THERAPY BACKGROUND

#### ROLE OF CELLS IN HUMAN HEALTH AND TRADITIONAL THERAPIES

Cells maintain normal physiological function in healthy individuals by secreting or metabolizing substances, such as sugars, amino acids, neurotransmitters and hormones, which are essential to life. When cells are damaged or destroyed, they no longer produce, metabolize or accurately regulate those substances. Impaired cellular function is associated with the progressive

decline common to many degenerative diseases of the nervous system, such as Parkinson's disease and Alzheimer's disease. Recent advances in medical science have identified cell loss or impaired cellular function as leading causes of degenerative diseases. Biotechnology advances have led to the identification of some of the specific substances or proteins that are deficient. While administering these substances or proteins as medication does overcome some of the limitations of traditional pharmaceuticals such as lack of specificity, there is no existing technology that can deliver them to the precise sites of action and in the appropriate physiological regulation and quantities or for the duration required to cure the degenerative condition. Cells, however, can do this naturally. As a result, investigators have considered supplementing the failing cells that are no longer producing the needed substances or proteins by implanting stem or progenitor cells. Where there has been irreversible tissue damage or organ failure,

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transplantation of these stem or progenitor cells offers the possibility of generating new and healthy mature cells, thus potentially restoring the organ function and the patient's health.

#### THE POTENTIAL OF OUR STEM CELL-BASED THERAPY

We believe that, if successfully developed, stem cell-based therapy--the use of stem or progenitor cells to treat diseases--has the potential to provide a broad therapeutic approach comparable in importance to traditional pharmaceuticals and genetically engineered biologics.

Stem cells are rare and only available in limited supply, whether from the patients themselves or from donors. Cells obtained from the same person who will receive them may be abnormal if the patient is ill or the tissue is contaminated with disease-causing cells. Also, the cells can often be obtained only through significant surgical procedures. The challenge, therefore, has been three-fold:

- 1) to identify the stem cells;
- 2) to create techniques and processes that can be used to expand these rare cells in sufficient quantities for effective transplants; and
- 3) to establish a bank of normal human stem or progenitor cells that can be used for transplantation into individuals whose own cells are not suitable because of disease or other reasons.

We have discovered markers on the cell surface that identify the human CNS stem cells. This allows us to purify them and eliminate other unwanted cell types. We have also developed a process, based on a proprietary IN VITRO culture system in chemically defined media, and demonstrated that this process reproducibly grows normal human central nervous system, or CNS, stem and progenitor cells. We believe this is the first reproducible process for growing normal human CNS stem cells. Together, these discoveries enable us to select normal human CNS stem cells and to expand them in culture to produce a large number of pure stem cells. This process facilitates the banking of large quantities of individual vials of these cells which could then be used for distribution to transplant centers worldwide for administration to patients.

Because these cells have not been genetically modified, they may be especially suitable for transplantation and may provide a safer and more effective alternative to therapies that are based on cells derived from cancer cells, from cells modified by a cancer gene to make them grow, from an unpurified mixture of many different cell types, or from animal derived cells. We believe our proprietary stem cell technologies may enable therapies to replace specific cells that have been damaged or destroyed, permitting the restoration of function through the replacement of normal cells where this has not been possible in the past. In our research, we have shown that stem cells of the central nervous system transplanted into hosts are accepted, migrate, and successfully specialize to produce mature neurons and glial cells.

More generally, because the stem cell is the pivotal cell that produces all the functional mature cell types in an organ, we believe these cells, if successfully identified and developed for transplantation, may serve as platforms for five major areas of regenerative medicine and biotechnology:

- tissue repair and replacement,
- correction of genetic disorders,
- drug discovery and screening,
- gene discovery and use, and

- diagnostics.

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We intend to aggressively pursue a series of non-exclusive agreements whereby third parties would have access to our cells for use in diagnostics, gene discovery and use, drug discovery and screening, and correction of genetic disorders, while in connection with tissue repair and replacement, we intend to enter into exclusive agreements with larger entities for the development of the technology and use of the cells in transplantation on a disease-specific basis.

#### OUR PLATFORM OF STEM CELL TECHNOLOGIES

Stem cells have two defining characteristics:

- some of the cells developed from stem cells produce all the kinds of mature cells making up the particular organ; and
- they self renew--that is, other cells developed from stem cells are themselves new stem cells, thus permitting the process to continue again and again.

Stem cells are known to or thought to exist for many systems of the human body, including the blood and immune system, the central and peripheral nervous systems (including the brain), and the liver, pancreas endocrine, and the skin systems. These cells are responsible for organ regeneration during normal cell replacement and, to a more or less limited extent, after injury. We believe that further research and development will allow stem cells to be cultivated and administered in ways that enhance their natural function, so as to form the basis of therapies that will replace specific subsets of cells that have been damaged or lost through disease, injury or genetic defect.

We also believe that the person or entity that first identifies and isolates a stem cell and defines methods to culture any of the finite number of different types of human stem cells will be able to obtain patent protection for the methods and the composition, making the commercial development of stem cell treatment and possible cure of currently intractable diseases financially feasible.

Our strategy is to be the first to identify, isolate and patent multiple types of human stem and progenitor cells with commercial importance. Our portfolio of issued patents includes a method of culturing normal human central nervous system stem and progenitor cells in our proprietary chemically defined medium, and our published studies show that these cultured and expanded cells give rise to all three major cell types of the central nervous system. Also, a separate study sponsored by us using these cultured stem and progenitor cells showed that the cells are accepted, migrate, and successfully specialize to produce neurons and glial cells.

We have published the results of a study that showed that human central nervous system stem cells can be successfully isolated by markers present on the surface of freshly obtained brain cells. We believe this is the first reproducible process for isolating highly purified populations of well-characterized normal human central nervous system stem cells, and have applied for a composition of matter patent. Because the cells are highly purified and have not been genetically modified, they may be especially suitable for transplantation and may provide a safer and more effective alternative than therapies that are based on cells derived from cancer cells, or from cells modified by a cancer gene to make them grow, or from an unpurified mixture of many different cell types or cells derived from animals. We have also filed an improved process patent for the growth and expansion of these purified normal human central nervous system cells.

More recently, we announced the results of a new study in which we used novel human specific monoclonal antibodies to demonstrate the extent of engraftment, migration and site-specific formation of the human neural stem cells into mature neurons. These neuronal cells integrate in a 3-dimensional array within the normal architecture of the mouse brain. Astrocytes and oligodendrocytes, the other two principle types of central nervous system cells, are also generated from the human neural stem cells.

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Neurological disorders such as Parkinson's disease, Alzheimer's disease, the side effects of stroke, and the mental retardation that accompanies genetic disorders such as Gaucher's Disease, Tay-Sachs Disease, and Batten's Disease

affect a significant portion of the U.S. population and there currently are no effective long-term therapies for them. We believe that therapies based on our process for identifying, isolating and culturing neural stem and progenitor cells may be useful in treating such diseases. We are continuing our research into, and have initiated the development of, human central nervous system stem and progenitor cell-based therapies for some diseases of this kind.

We continue to advance our research programs to discover the liver stem cell and, through our outside collaborators, the islet stem cell in the human pancreas. Liver stem cells may be useful in the treatment of diseases such as hepatitis, liver failure, blood-clotting disorder, cirrhosis of the liver and liver cancer. Islet cells are the pancreas cells that produce insulin, so pancreatic stem cells may be useful in the treatment of Type 1 diabetes and those cases of Type 2 diabetes where insulin secretion is defective.

An important element of our stem cell discovery program is the further development of intellectual property positions with respect to stem and progenitor cells. We have also obtained rights to certain inventions relating to stem cells from, and are conducting stem cell related research at, several academic institutions. We expect to expand our search for new stem and progenitor cells and to seek to acquire rights to additional inventions relating to stem and progenitor cells from third parties.

#### EXPECTED ADVANTAGES OF OUR STEM CELL TECHNOLOGY

##### NO OTHER TREATMENT

To our knowledge, no one has developed an FDA-approved method for replacing lost or damaged tissues from the human nervous system. Replacement of tissues in other areas of the human body is mainly limited to those few sites, such as bone marrow or peripheral blood cell transplants, where transplantation of the patient's own cells is now feasible. In a few additional areas, including the liver, transplantation of donor organs is now used, but is limited by the scarcity of organs available through donation. We believe that our stem cell technologies have the potential to reestablish function in at least some of the patients who have suffered the losses referred to above.

##### REPLACED CELLS PROVIDE NORMAL FUNCTION

Because stem cells can duplicate themselves, or self-renew, and specialize into the multiple kinds of cells that are commonly lost in various diseases, transplanted stem cells may be able to migrate limited distances to the proper location within the body, to expand and specialize and to replace damaged or defective cells, facilitating the return to proper function. We believe that such replacement of damaged or defective cells by functional cells is unlikely to be achieved with any other treatment.

#### RESEARCH EFFORTS AND PRODUCT DEVELOPMENT PROGRAMS

##### OVERVIEW OF RESEARCH AND PRODUCT DEVELOPMENT STRATEGY

We have devoted substantial resources to our research programs to isolate and develop a series of stem and progenitor cells that we believe can serve as a basis for replacing diseased or injured cells. Our efforts to date have been directed at methods to identify, isolate and culture large varieties of stem and progenitor cells of the human nervous system, liver and pancreas and to develop therapies utilizing these stem and progenitor cells.

The following table lists the potential therapeutic indications for, and current status of, our primary research and product development programs and projects. The table is qualified in its entirety by reference to the more detailed descriptions of such programs and projects appearing elsewhere in this report. We continually evaluate our research and product development efforts and reallocate

resources among existing programs or to new programs in light of experimental results, commercial potential, availability of third party funding, likelihood of near-term efficacy, collaboration success or significant technology enhancement, as well as other factors. Our research and product development programs are at relatively early stages of development and will require substantial resources to commercialize.

#### RESEARCH AND PRODUCT DEVELOPMENT PROGRAMS

PROGRAM  
DESCRIPTION AND

OBJECTIVE  
STAGE/STATUS(1)  
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HUMAN NEURAL  
STEM CELL  
PRECLINICAL  
Repair or  
replace damaged  
central nervous  
- Demonstrated  
IN VITRO the  
ability to  
initiate and  
system tissue  
(including  
spinal cord,  
expand stem  
cell-containing  
human neural  
cultures  
stroke-damaged  
tissue, and  
tissue affected  
and  
specialization  
into three  
types of  
central by  
certain genetic  
disorders)  
nervous system  
cells -  
Demonstrated  
the ability to  
isolate  
neurosphere-  
initiating stem  
cells from  
human brain -  
Demonstrated in  
rodent studies  
that  
transplanted  
human brain-  
derived stem  
cells are  
accepted and  
properly  
specialized  
into the three  
major cell  
types of the  
central nervous  
system -  
Commenced  
preclinical  
testing of  
human neural  
stem cells in  
well-  
characterized  
small animal  
models of human  
diseases LIVER  
STEM CELL

RESEARCH Repair  
or replace  
liver tissue  
damaged or -  
Demonstrated  
the production  
of hepatocytes  
from destroyed  
by cirrhosis  
and certain

purified mouse  
hematopoietic  
stem cells  
metabolic  
genetic  
diseases -  
Identified IN  
VITRO culture  
assay for  
growth of human  
liver  
progenitor  
cells that  
express markers  
for both bile  
duct cells and  
hepatocytes -  
Showed that the  
IN VITRO  
culture of  
human liver  
progenitor  
cells can also  
grow human  
hepatitis virus  
- Demonstrated  
the engraftment  
and survival of  
human liver  
cells in an IN  
VIVO mouse  
model PANCREAS  
ISLET STEM CELL  
RESEARCH Repair  
or replace  
damaged  
pancreas islet  
- Identified  
markers on the  
surface of a  
rare tissue  
population of  
human  
pancreatic  
cells -  
Commenced  
testing  
enriched  
population of  
those cells in  
IN VITRO and IN  
VIVO small  
animal model -  
Established  
consortium of  
external  
collaborators

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(1) "Research" refers to early stage research and product development activities IN VITRO, including the selection and characterization of product candidates for preclinical testing. "Preclinical" refers to further testing of a defined product candidate IN VITRO and in animals prior to clinical studies.

RESEARCH AND DEVELOPMENT PROGRAMS

Our portfolio of stem cell technology results from our exclusive licensing of central nervous system, stem and progenitor cell technology, animal models for the identification and/or testing of stem and progenitor cells and our own research and development efforts to date. We believe that therapies using stem cells represent a fundamentally new approach to the treatment of diseases caused by lost or damaged tissue. We have assembled an experienced team of scientists and scientific advisors to consult with and advise our scientists on their continuing research and development of stem and progenitor cells. This team includes Irving L. Weissman, M.D., of Stanford University, Fred H. Gage, Ph.D.,

of The Salk Institute, David Anderson, Ph.D., of the California Institute of Technology and Ben Barres, Ph.D., of Stanford University, as well as other occasional consultants including William C. Mobley, M.D., Ph.D. and Seung Kim, M.D., Ph.D., both of Stanford University.

#### BRAIN STEM AND PROGENITOR CELL RESEARCH AND DEVELOPMENT PROGRAM

We began our work with central nervous system stem and progenitor cell cultures in collaboration with NeuroSpheres, Ltd., in 1992. We believe that NeuroSpheres was the first to invent these cultures. We are the exclusive, worldwide licensee from NeuroSpheres to such inventions and associated patents and patent applications for all uses, including transplantation in the human body, as embodied in these patents. See "License Agreements and Sponsored Research Agreements--NeuroSpheres, Ltd."

In 1997, our scientists invented a reproducible method for growing human CNS stem and progenitor cells in cultures. In preclinical IN VITRO and early IN VIVO studies, we demonstrated that these cells specialize into all three of the cell types of the central nervous system. Because of these results, we believe that these cells may form the basis for replacement of cells lost in certain degenerative diseases. We are continuing research into, and have initiated the development of, our human CNS stem and progenitor cell cultures. We have initiated the cultures and demonstrated that these cultures can be expanded for a number of generations IN VITRO in chemically defined media. In collaboration with us, Dr. Anders Bjorklund of Lund University, Sweden, showed that cells from these cultures can be successfully transplanted and accepted into the brains of rodents where they subsequently migrated and specialized into the appropriate cell types for the site of the brain into which they were placed.

Since then, we have expanded our preclinical efforts in this area by initiating programs aimed at the discovery and use of specific monoclonal antibodies to facilitate identification and isolation of CNS and other stem and progenitor cells or their specialized progeny. Our researchers have devised methods to advance the IN VITRO culture and passage of human CNS stem cells that resulted in a 100-fold increase in CNS stem and progenitor cell production after 6 passages. A U.S. patent on those methods issued in May, 2001 (patent No. 6238922, "Use of collagenase in the preparation of neural stem cell cultures"). We are expanding our preclinical efforts toward the goal of selecting the proper indications to pursue.

In December 1998, the US Patent and Trademark Office granted patent No. 5,851,832, covering our methods for the human CNS cell cultures containing central nervous system stem cells, for compositions of human CNS cells expanded by these methods, and for use of these cultures in human transplantation. These human CNS stem and progenitor cells expanded in culture may be useful for repairing or replacing damaged central nervous system tissue, including the brain and the spinal cord. US Patent No. 5,968,829, entitled "Human CNS Neural Stem Cells," which covers our composition of matter for human CNS stem cells, was granted in 1999, and US Patent No. 6,103,530, covering our media for culturing human CNS stem cells, was granted in 2000.

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We have a US patent application pending that covers our proprietary process for the direct isolation of normal human CNS stem cells based on the markers found to be present on the surface of freshly obtained brain cells. Since the filing of this patent application, our researchers have completed a study designed to identify, isolate and culture human CNS stem cells utilizing this proprietary process. Using our proprietary markers on the surface of the cell, our researchers have succeeded in identifying, isolating and purifying human CNS stem cells from brain tissue, and were able to expand the number of these cells in culture.

We believe that this was the first study to show a reproducible process for isolating highly purified populations of well-characterized normal human CNS stem cells. Because the cells are normal human CNS stem cells and have not been genetically modified, they may be especially suitable for transplantation and may provide a safer and more effective alternative to therapies that are based on cells derived from cancer cells or from an unpurified mix of many different cell types, or from animal derived cells. Even more importantly, in our view, our researchers have been able to take these purified and expanded stem cells and transplant them into the normal brains of immunodeficient mouse hosts, where they take hold and grow into neurons and glial cells.

During the course of this long-term study, the transplanted human CNS stem cells survived for as long as one year and migrated to specific functional domains of the host brain, with no sign of tumor formation or adverse effects on the animal recipients; moreover, the cells were still dividing. These findings show that when CNS stem cells isolated and cultured with our proprietary



processes are transplanted, they adopt the characteristics of the host brain and act like normal stem cells. In other words, the study suggests the possibility of a continual replenishment of normal human brain cells.

In 2001, we assembled and evaluated our long-term transplantation data, defined in-house disease targets for further evaluation for proof of principle, and established external collaborations with a number of academic laboratories to pursue other well-characterized disease models in small animals.

As noted above, human CNS stem and progenitor cells harvested and purified and expanded using our proprietary processes may be useful for creating therapies for the treatment of degenerative brain diseases such as Parkinson's and Alzheimer's diseases. These conditions affect about 5 million people in the United States and there are no effective long-term therapies currently available. We believe the ability to purify human brain stem cells directly from fresh tissue is important because:

- it provides an enriched source of normal stem cells, not contaminated by other unwanted or diseased cell types, that can be expanded in culture without fear of also expanding some unwanted cell types;
- it opens the way to a better understanding of the properties of these cells and how they might be manipulated to treat specific diseases. For example, in certain genetic diseases such as Tay Sachs and Gaucher's, a key metabolic enzyme required for normal development and function of the brain is absent. Brain-derived stem cells might produce enough enzyme after transplantation to degrade the toxic product build-up, or, if not enough enzyme is made naturally, the cells might be genetically modified to produce those proteins. The native or modified brain stem cells could be transplanted into patients with these genetic diseases;
- the efficient acceptance of these non-transformed normal human stem cells into host brains means that the cell product can be tested in animal models for its ability to correct deficiencies caused by various human neurological diseases. This technology could also provide a unique animal model for the testing of drugs that act on human brain cells either for effectiveness of the drug against the disease or its toxicity to human nerve cells.

#### LIVER STEM CELLS DISCOVERY RESEARCH PROGRAMS

We initiated our discovery work for the liver stem and progenitor cell through a sponsored research agreement with Markus Grompe, Ph.D., of Oregon Health Sciences University. Dr. Grompe's work focuses on the discovery and development of a suitable method for identifying and assessing liver stem and progenitor cells for use in transplantation. We have also obtained rights to a novel mouse model of liver failure for evaluating cell transplantation developed by Dr. Grompe, and a worldwide exclusive license to U.S. Patent No. 6,132,708, claiming a method of regenerating a functional liver by transplantation of pancreas cells in mammals, including humans.

Approximately 1 in 10 Americans suffers from diseases and disorders of the liver for many of which there are currently no effective, long-term treatments. Our researchers continue to advance methods for establishing enriched cell populations suitable for transplantation in preclinical animal models. We are focused on discovering and utilizing proprietary methods to identify and isolate liver stem and progenitor cells and to evaluate these cells in culture and in preclinical animal models.

Our researchers have devised a culture assay that we will use in our efforts to identify liver stem and progenitor cells. In addition to supporting the growth of an early human liver bipotent progenitor cell, it is also possible to infect this culture with human hepatitis virus, providing a valuable system for study of the virus. This technology could also provide a unique IN VITRO model for the testing of drugs that act on, or are metabolized by, human liver cells.

There have been reports in the scientific community that bone marrow transplant patients show evidence of donor derived liver cells (hepatocytes). Our scientists (in conjunction with Markus Grompe, OHSU) showed that bone marrow derived hepatocytes are functional and can rescue mice in liver failure. Moreover, the only cells within the mouse bone marrow that are able to produce hepatocytes are highly purified hematopoietic stem cells--that is, stem cells of the blood and immune system, often referred to as HSCs. We believe that these studies in stem cell plasticity are the most rigorous studies performed to date and show the possibility of transitioning from one cell type to another.

In parallel with the studies performed using mouse HSCs, our scientist have

performed IN VITRO studies on human liver cells. To date, they have identified proprietary monoclonal antibodies that enrich for distinct subsets of fetal and/or pediatric liver cells. These cells are currently being tested in our IN VITRO and IN VIVO culture assays. Further analysis and enrichments are in progress.

#### PANCREAS STEM CELLS DISCOVERY RESEARCH PROGRAMS

Our pancreas discovery research program is directed to the identification, isolation and culturing of the pancreas stem and progenitor cells. We obtained an exclusive, worldwide license from The Scripps Research Institute (Scripps), to novel technology developed by Dr. Nora Sarvetnick, Ph.D., which may facilitate the identification and isolation of those cells by using a mouse model that continuously regenerates the pancreas. US patent number 6,242,666 was issued on the animal model on June 5, 2001. We believe that stem cells produce the regeneration, in which case this animal model may be useful for identifying specific markers on the cell surface unique to the pancreas stem cells. We believe this may lead to the development of cell-based treatments for Type 1 diabetes and that portion of Type 2 diabetes characterized by defective secretion of insulin. We also obtained licenses from Scripps to novel markers on the cell surface identified by Dr. Sarvetnick and her research team as being unique to the pancreas islet stem cell, for which we have now filed a US patent application. We have no current plans for further research collaborations with Scripps or Dr. Sarvetnick.

In 2001, we established a consortium of academic investigators to work in collaboration with us on the human pancreatic stem and progenitor cells. This consortium includes Drs. Raphael Scharfmann and Bruno Peault of INSERM, in Paris, France, and Dr. Seung Kim of Stanford University. Through this consortium we have access to unique animal models for transplantation of candidate stem/

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progenitor cells. We have identified key monoclonal antibodies that identify a rare subset of pancreatic cells that may be candidate stem cells. For the present, we will be pursuing the program primarily through the external members of the consortium.

#### WIND-DOWN OF ENCAPSULATED CELL THERAPY RESEARCH AND DEVELOPMENT PROGRAMS

Until mid-1999, our company, which was then known as CytoTherapeutics, engaged in research and development in encapsulated cell therapy technology, or ECT. In July 1999, we began the restructuring of our research operations to abandon all further ECT research and to concentrate our resources on the research and development of our proprietary platform of stem cell technology. We sold our intellectual property assets related to the ECT, retaining certain non-exclusive rights to use the ECT in combination with our proprietary stem cell technology and in the field of vaccines for prevention and treatment of infectious diseases, and a portion of certain revenues the buyer, Neurotech S.A., might receive in the future. (Subsequently, we sold the retained rights to such revenues to Modex Therapeutics, S.A.; see Note 5 to the Financial Statements below.) We relocated to California, and have subleased the two buildings that constituted our pilot manufacturing and cell processing facility in Rhode Island and approximately one-third of our former corporate headquarters building. We are actively seeking to sublease, assign or sell our remaining interests in the Rhode Island real estate.

#### SUBSIDIARY

##### STEMCELLS CALIFORNIA, INC.

On September 26, 1997, we acquired by merger StemCells California, Inc., a California corporation, in exchange for 1,320,691 shares of our common stock and options and warrants for the purchase of 259,296 common shares. Simultaneously with the acquisition, its President, Richard M. Rose, M.D., became our President, Chief Executive Officer and a director, and Irving L. Weissman, M.D., a founder of StemCells California, became a member of our board of directors.

#### CORPORATE COLLABORATIONS

##### CORPORATE INVESTMENT

In July 1996, we, together with certain founding scientists, established Modex Therapeutics SA (Modex), a Swiss biotherapeutics company, to pursue extensions of our former technology of ECT for certain applications outside the central nervous system. Modex, headquartered in Lausanne, Switzerland, was formed to integrate technologies developed by us and by several other institutions to develop products to treat diseases such as diabetes, obesity and anemia. After our disposition of the encapsulated cell technology in December

1999, we no longer had common research or development interests with Modex, but we held approximate 17% of its stock. Modex completed an initial public offering on June 23, 2000, in the course of which we realized a gain of approximately \$1.4 million from the sale of certain shares. By the end of May 2001 we had sold all our shares in Modex for a realized gain of approximately \$7.8 million.

## LICENSE AGREEMENTS AND SPONSORED RESEARCH AGREEMENTS

### SPONSORED RESEARCH AGREEMENTS

Under Sponsored Research Agreements with The Scripps Research Institute and Oregon Health Sciences University, we funded certain research in return for licenses or options to license the inventions resulting from the research. We have also entered into license agreements with the California Institute of Technology. All of these agreements relate largely to stem or progenitor cells and or to processes and methods for the isolation, identification, expansion or culturing of stem or progenitor cells.

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Our research agreement with Scripps expired at the end of 2000, and we do not intend to renew it at this time. It is our intention to pursue research on human stem and progenitor cells of the pancreas primarily through the consortium we have established with other academic researchers. Our license agreements with Scripps are not affected by the expiration of the research agreement. They will terminate upon expiration, revocation or invalidation of the patents licensed to us, unless governmental regulations require a shorter term. These license agreements also will terminate earlier if we breach our obligations under the agreement and do not cure the breach, or if we declare bankruptcy, and we can terminate the license agreements at any time upon notice. Upon the initiation of the Phase II trial for our first product using Scripps licensed technology, we must pay Scripps \$50,000 and upon completion of that Phase II trial we must pay Scripps an additional \$125,000. Upon approval of the first product for sale in the market, we must pay Scripps \$250,000. Our license agreements with the California Institute of Technology (Cal Tech) will expire upon expiration, revocation, invalidation or abandonment of the patents licensed to us. We can terminate any of these license agreements by giving 30 days' notice to Cal Tech. Either party can terminate these license agreements upon a material breach by the other party. Pursuant to the terms of our license agreement with Cal Tech and our acquisition of our wholly owned subsidiary, StemCells California, we issued 14,513 shares of our common stock to Cal Tech. We issued an additional 12,800 shares of common stock to Cal Tech with a market value of approximately \$40,000 in May 2000, upon execution of an amendment adding four families of patent applications to the license agreement. We must pay an additional \$10,000 upon the issuance of the patent licensed to us under the relevant agreement. We also will pay \$5,000 on the anniversary of the issuance of the patent licensed to us under the relevant agreement. These amounts are creditable against royalties we must pay under the license agreements. The maximum royalties that we will have to pay to the California Institute of Technology will be \$2 million per year, with an overall maximum of \$15 million. Once we pay the \$15 million maximum royalty, the licenses will become fully paid and irrevocable.

We and our wholly-owned subsidiary, StemCells California have entered into sponsored research and license agreements with the Oregon Health Sciences University (OHSU) beginning in March 1997. Pursuant to the terms of the license agreement and our acquisition of StemCells California, we issued 4,838 shares of our common stock and an option to purchase up to 62,888 additional shares to OHSU with an exercise price of \$.01 per share. The option has vested as to 9,675 shares by passage of time and the others will vest, if at all, on the achievement of specified milestones.

### LICENSE AGREEMENTS

We have entered into a number of license agreements with commercial and non-profit institutions, as well as a number of research-plus-license agreements with academic organizations. The research agreements provide that we will fund certain research costs, and in return, will have a license or an option for a license to the resulting inventions. Under the license agreements, we will typically be subject to obligations of due diligence and the requirement to pay royalties on products that use patented technology licensed under such agreements.

### SIGNAL PHARMACEUTICALS, INC.

In December 1997, we entered into two license agreements with Signal Pharmaceuticals, Inc. under which each party licensed to the other certain patent rights and biological materials for use in defined fields. An initial disagreement as to the interpretation of the licensed rights was resolved by the parties, and the agreements are operating in accordance with their terms. Signal

has now been acquired by Celgene. Each agreement with Signal will terminate at the expiration of all patents licensed under it, but the licensing party can terminate earlier if the other party breaches its obligations under the agreement or declares bankruptcy. Also, the party receiving the license can terminate the agreement at any time upon notice to the other party. Under these agreements, we must reimburse Signal for

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payments it must make to the University of California based on products we develop and for 50% of certain other payments Signal must make.

#### NEUROSPHERES, LTD.

In March 1994, we entered into a Contract Research and License Agreement with NeuroSpheres, Ltd., which was clarified in a License Agreement dated as of April 1, 1997. Under the agreement as clarified, we obtained an exclusive patent license from NeuroSpheres in the field of transplantation, subject to a limited right of NeuroSpheres to purchase a nonexclusive license from us, which right was not exercised and has expired. We have developed additional intellectual property relating to the subject matter of the license. We entered into an additional license agreement with NeuroSpheres as of October 30, 2000, under which we obtained an exclusive license in the field of non-transplant uses, such as drug discovery and drug testing. Together, our rights under the licenses are exclusive for all uses of the technology. We made up-front payments to NeuroSpheres of 65,000 shares of our common stock in October 2000 and \$50,000 in January 2001, and we will make additional cash payments when milestones are achieved in the non-transplant field, or in any products employing NeuroSpheres patents for generating cells of the blood and immune system from neural stem cells. In addition, in October 2000 we reimbursed NeuroSpheres for patent costs amounting to \$341,000. Milestone payments would total \$500,000 for each product that is approved for market. Our agreements with NeuroSpheres will terminate at the expiration of all patents licensed to us, but can terminate earlier if we breach our obligations under the agreement and do not cure the breach, or if we declare bankruptcy. We would have a security interest in the licensed technology in the event that NeuroSpheres declares bankruptcy.

#### MANUFACTURING

Because of the early stage of our stem and progenitor cell programs, we have made no decisions about the means by which potential future cell products will be manufactured, nor resolved the many issues that will affect our choices. We believe that our new facility in Palo Alto, however, has the capacity to be used for manufacture of cells under FDA-determined clinical Good Manufacturing Practices conditions in quantities sufficient for clinical trials, and we have developed a robust and replicable process for producing and processing the cells.

#### MARKETING

Because of the early stage of our stem and progenitor cell programs, we have not yet addressed questions of channels of distribution and commercialization of potential future products.

#### PATENTS, PROPRIETARY RIGHTS AND LICENSES

We believe that proprietary protection of our inventions will be critical to our future business. We vigorously seek out intellectual property that we believe might be useful in connection with our products, and have an aggressive program of protecting our intellectual property. We believe that our know-how will also provide a significant competitive advantage, and we intend to continue to develop and protect our proprietary know-how. We may also from time to time seek to acquire licenses to important externally developed technologies.

We have exclusive or non-exclusive rights to a portfolio of patents and patent applications related to various stem and progenitor cells and methods of deriving and using them. These patents and patent applications relate mainly to compositions of matter, methods of obtaining such cells, and methods for preparing, transplanting and utilizing such cells. Currently, our U.S. patent portfolio in the stem cell therapy area includes thirty issued U.S. patents, five of which issued in 2001. An additional twenty-five patent applications are pending, two of which have been allowed.

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We own, or have filed, the following United States Patents and patent applications: U.S. Patent Number 5,968,829 (Human CNS neural stem cells); U.S.

Patent Number 6,103,530 (Human CNS neural stem cells--culture media); Application Number WO 99/11758 (Cultures of human CNS neural stem cells); U.S. Patent Number 6,238,922 (Use of collagenase in the preparation of neural stem cell cultures); U.S. Patent Application Number WO 00/50572 (Use of collagenase in the preparation of neural stem cell cultures); Application Number WO 00/47762 (Enriched neural stem cell populations and methods of identifying, isolating, and enriching neural stem cells); Application Number WO 00/52143 (Isolation and enrichment of neural stem cells from uncultured tissue based on cell-surface marker expression); and Application Number WO 01/28574 (Method for inducing IN VIVO proliferation and migration of transplanted progenitor cells in the brain).

We have licensed the following United States Patents or pending patent applications from NeuroSpheres Holdings Ltd.: U.S. Patent Number 5,851,832 (IN VITRO proliferation); U.S. Patent Number 5,750,376 (IN VITRO genetic modification); U.S. Patent Number 5,981,165 (IN VITRO production of dopaminergic cells from mammalian central nervous system multipotent stem cell compositions); U.S. Patent Number 6,093,531 (Generation of hematopoietic cells from multipotent neural stem cells); U.S. Patent Number 5,980,885 (Methods for inducing IN VIVO proliferation of precursor cells); U.S. Patent Number 6,071,889 (Methods for IN VIVO transfer of a nucleic acid sequence to proliferating neural cells); U.S. Patent Number 6,294,346 (Methods for screening biological agents); U.S. Patent Number 6,165,783 (Methods of inducing differentiation of multipotent neural stem cells); Application Number WO 93/01275 (Mammalian central nervous system multipotent stem cell compositions); Application Number WO 94/09119 (Remyelination using mammalian central nervous system multipotent stem cell compositions); Application Number WO 94/10292 (Biological factors useful in differentiating mammalian central nervous system multipotent stem cell compositions); Application Number WO 94/16718 (Genetically engineered mammalian central nervous system multipotent stem cell compositions); Application Number WO 96/15224 (Differentiation of mammalian central nervous system multipotent stem cell compositions); Application Number WO 99/2196 (Erythropoietin-mediated neurogenesis); Application Number WO 99/16863 (Generation of hematopoietic cells); Application Number WO 98/22127 (Pretreatment with growth factors to protect against CNS damage); Application Number WO 97/3560 (IN SITU manipulation of cells of the hippocampus); Application Number WO 96/09543 (IN VITRO models of CNS functions and dysfunctions); Application Number WO 95/13364 (IN SITU modification and manipulation of stem cells of the CNS); Application Number WO 96/15226 (IN VITRO production of dopaminergic cells from mammalian central nervous system multipotent stem cell composition); and Application Number WO 96/15266 (Regulation of neural stem cell proliferation).

We have licensed the following United States Patents or pending patent applications from the University of California, San Diego: U.S. Patent Number 5,776,948 (Method of production of neuroblasts); U.S. Patent Number 6,265,175 (Method of production of neuroblasts); U.S. Patent Number 6,013,521 (Method of production of neuroblasts); U.S. Patent Number 6,020,197 (Method of production of neuroblasts); U.S. Patent Number 6,045,807 (Method of production of neuroblasts); and Application Number WO 94/16059 (Method of production of neuroblasts).

We have licensed the following United States Patents or pending patent applications from the California Institute of Technology: U.S. Patent Number 5,629,159 (Immortalization and disimmortalization of cells); Application Number WO 96/40877 (Immortalization and disimmortalization of cells); U.S. Patent Number 6,270,990 (Neuron restrictive silencer factor proteins); U.S. Patent Number 5,935,811 (Neuron restrictive silencer factor proteins); Application Number WO 96/27665 (Neuron restrictive silencer factor proteins); U.S. Patent Number 5,589,376 (Mammalian neural crest stem cells); U.S. Patent Number 5,824,489 (Methods for isolating mammalian multipotent neural crest stem cells); Application Number WO 94/02593 (Mammalian neural crest stem cells); U.S. Patent Number 5,654,183 (Genetically engineered mammalian neural crest stem cells); U.S. Patent Number 5,928,947 (Mammalian multipotent neural crest stem cells); U.S. Patent Number 5,693,482 (IN

VITRO neural crest stem cell assay); U.S. Patent Number 6,001,654 (Methods for differentiating neural stem cells to neurons or smooth muscle cells (TGFb)); Application Number WO 98/48001 (Methods for differentiating neural stem cells to neurons or smooth muscle cells (TGFb)); U.S. Patent Number 5,672,499 (Methods for immortalizing multipotent neural crest stem cells); U.S. Patent Number 5,849,553 (Immortalizing and disimmortalizing multipotent neural crest stem cells); and U.S. Patent Number 6,033,906 (Differentiating mammalian neural stem cells to glial cells using neuregulins).

We have licensed the following United States Patents or pending patent applications from the following other institutions: Number 6,242,666 (An animal model for identifying a common stem/progenitor to liver cells and pancreatic cells) and Application Number WO 00/36091 (An animal model for identifying a

common stem/progenitor to liver cells and pancreatic cells), licensed from The Scripps Research Institute; Application Number WO98/50526 (Generation, characterization, and isolation of neuroepithelial stem cells and lineage restricted intermediate precursor), licensed from the University of Utah; and Number 6,132,708 (Liver regeneration using pancreas cells), licensed from Oregon Health Sciences University.

We also rely upon trade-secret protection for our confidential and proprietary information and take active measures to control access to that information.

Our policy is to require our employees, consultants and significant scientific collaborators and sponsored researchers to execute confidentiality agreements upon the commencement of an employment or consulting relationship with us. These agreements generally provide that all confidential information developed or made known to the individual by us during the course of the individual's relationship with us is to be kept confidential and not disclosed to third parties except in specific circumstances. In the case of employees and consultants, the agreements generally provide that all inventions conceived by the individual in the course of rendering services to us shall be our exclusive property.

We have obtained rights from universities and research institutions to technologies, processes and compounds that we believe may be important to the development of our products. These agreements typically require us to pay license fees, meet certain diligence obligations and, upon commercial introduction of certain products, pay royalties. These include exclusive license agreements with NeuroSpheres, The Scripps Institute, the California Institute of Technology and the Oregon Health Sciences University, to certain patents and know-how regarding present and certain future developments in CNS, liver and pancreas stem cells.

The patent positions of pharmaceutical and biotechnology companies, including ours, are uncertain and involve complex and evolving legal and factual questions. The coverage sought in a patent application can be denied or significantly reduced before or after the patent is issued. Consequently, we do not know whether any of our pending applications will result in the issuance of patents, or if any existing or future patents will provide significant protection or commercial advantage or will be circumvented by others. Since patent applications are secret until the applications are published (usually eighteen months after filing), and since publication of discoveries in the scientific or patent literature often lags behind actual discoveries, we cannot be certain that we were the first to make the inventions covered by each of our pending patent applications or that we were the first to file patent applications for such inventions. There can be no assurance that patents will issue from our pending or future patent applications or, if issued, that such patents will be of commercial benefit to us, afford us adequate protection from competing products, or not be challenged or declared invalid.

In the event that a third party has also filed a patent application relating to inventions claimed in our patent applications, we may have to participate in interference proceedings declared by the United States Patent and Trademark Office to determine priority of invention, which could result in substantial uncertainties and cost for us, even if the eventual outcome is favorable to us. There can be no assurance that our patents, if issued, would be held valid by a court of competent jurisdiction.

A number of pharmaceutical, biotechnology and other companies, universities and research institutions have filed patent applications or have been issued patents relating to cell therapy, stem cells and other technologies potentially relevant to or required by our expected products. We cannot predict which, if any, of such applications will issue as patents or the claims that might be allowed. We are aware that a number of companies have filed applications relating to stem cells. We are also aware of a number of patent applications and patents claiming use of genetically modified cells to treat disease, disorder or injury. We are aware of two patents issued to a competitor claiming certain methods for treating defective, diseased or damaged cells in the mammalian CNS by grafting genetically modified donor cells from the same mammalian species.

If third party patents or patent applications contain claims infringed by our technology and such claims or claims in issued patents are ultimately determined to be valid, there can be no assurance that we would be able to obtain licenses to these patents at a reasonable cost, if at all, or be able to develop or obtain alternative technology. If we are unable to obtain such licenses at a reasonable cost, we may not be able to develop certain products commercially. There can be no assurance that we will not be obliged to defend ourselves in court against allegations of infringement of third party patents.

Patent litigation is very expensive and could consume substantial resources and create significant uncertainties. An adverse outcome in such a suit could subject us to significant liabilities to third parties, require disputed rights to be licensed from third parties, or require us to cease using such technology.

We have obtained rights from universities and research institutions to technologies, processes and compounds that we believe may be important to the development of our products. These agreements typically require us to pay license fees, meet certain diligence obligations and, upon commercial introduction of certain products, pay royalties. These include exclusive license agreements with NeuroSpheres, The Scripps Institute, the California Institute of Technology and the Oregon Health Sciences University to certain patents, applications and know-how regarding neural, liver and pancreatic stem cells. Our licenses may be canceled or converted to non-exclusive licenses if we fail to use the relevant technology or if we breach our agreements. Loss of such licenses could expose us to the risks of third party patents and/or technology. There can be no assurance that any of these licenses will provide effective protection against our competitors.

#### COMPETITION

The targeted disease states for our initial products in some instances currently have no effective long-term therapies. However, we do expect that our initial products will have to compete with a variety of therapeutic products and procedures. Major pharmaceutical companies currently offer a number of pharmaceutical products to treat neurodegenerative and liver diseases, diabetes and other diseases for which our technologies may be applicable. Many pharmaceutical and biotechnology companies are investigating new drugs and therapeutic approaches for the same purposes, which may achieve new efficacy profiles, extend the therapeutic window for such products, alter the prognosis of these diseases, or prevent their onset. We believe that our products, when and if successfully developed, will compete with these products principally on the basis of improved and extended efficacy and safety and their overall economic benefit to the health care system. The market for therapeutic products that address degenerative diseases is large, and competition is intense. We expect competition to increase. We believe that our most significant competitors will be fully integrated pharmaceutical companies and more established biotechnology companies. Smaller companies may also be significant competitors, particularly through collaborative arrangements with large pharmaceutical or biotechnology companies. Many of these competitors have significant products approved or in development that could be competitive with our potential products.

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Competition for our stem and progenitor cell products may be in the form of existing and new drugs, other forms of cell transplantation, ablative and simulative procedures, and gene therapy. We believe that some of our competitors are also trying to develop stem and progenitor cell-based technologies. We expect that all of these products will compete with our potential stem and progenitor cell products based on efficacy, safety, cost and intellectual property positions.

We may also face competition from companies that have filed patent applications relating to the use of genetically modified cells to treat disease, disorder or injury. We may be required to seek licenses from these competitors in order to commercialize certain of our proposed products, and such licenses may not be granted.

If we develop products that receive regulatory approval, they would then have to compete for market acceptance and market share. For certain of our potential products, an important success factor will be the timing of market introduction of competitive products. This is a function of the relative speed with which we and our competitors can develop products, complete the clinical testing and approval processes, and supply commercial quantities of a product to market. These competitive products may also impact the timing of clinical testing and approval processes by limiting the number of clinical investigators and patients available to test our potential products.

While we believe that the primary competitive factors will be product efficacy, safety, and the timing and scope of regulatory approvals, other factors include, in certain instances, obtaining marketing exclusivity under the Orphan Drug Act, availability of supply, marketing and sales capability, reimbursement coverage, price, and patent and technology position.

#### GOVERNMENT REGULATION

Our research and development activities and the future manufacturing and marketing of our potential products are, and will continue to be, subject to

regulation for safety and efficacy by numerous governmental authorities in the United States and other countries.

In the United States, pharmaceuticals, biologicals and medical devices are subject to rigorous Food and Drug Administration, or FDA, regulation. The Federal Food, Drug and Cosmetic Act, as amended, and the Public Health Service Act, as amended, the regulations promulgated thereunder, and other Federal and state statutes and regulations govern, among other things, the testing, manufacture, safety, efficacy, labeling, storage, export, record keeping, approval, marketing, advertising and promotion of our potential products. Product development and approval within this regulatory framework takes a number of years and involves significant uncertainty combined with the expenditure of substantial resources. In addition, the federal, state, and other jurisdictions have restrictions on the use of fetal tissue.

FDA APPROVAL

The steps required before our potential products may be marketed in the United States include:

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Preclinical  
laboratory  
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Preclinical  
tests include  
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the product  
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studies in  
specific  
disease  
models to  
assess the  
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safety and  
efficacy of  
the product  
and our  
formulation  
as well as  
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of the  
manufacturing  
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2.Submission to  
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preclinical  
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an  
Investigational



New Drug Exemption, or submitted to the FDA as part of an IND, and IND, which must become effective before U.S. the IND becomes effective 30 days following human clinical trials may commence its receipt by the FDA, as long as there are no questions, requests for delay or objections from the FDA. 3.

Adequate and well-controlled human Clinical trials involve the evaluation of the clinical trials to establish the safety and product in healthy volunteers or, as may be efficacy of the product the case with our potential products, in a small number of patients under the supervision of a qualified physician.

Clinical trials are conducted in accordance with protocols that detail the objectives of the study, the parameters to be used to monitor safety and the efficacy criteria to be evaluated. Any product administered in a U.S. clinical trial must be manufactured in accordance with clinical Good Manufacturing Practices, or cGMP, determined by the FDA. Each protocol is submitted to the FDA as part of the IND. The protocol for each clinical study must be approved by an independent

Institutional Review Board, or IRB, at the institution at which the study is conducted and the informed consent of all participants must be obtained. The IRB will consider, among other things, the existing information on the product, ethical factors, the safety of human subjects, the potential benefits of the therapy and the possible liability of the institution.

Clinical development is traditionally conducted in three sequential phases, which may overlap: - In Phase I, products are typically introduced into healthy human subjects or into selected patient populations to test for adverse reactions, dosage tolerance, absorption and distribution, metabolism, excretion and clinical pharmacology. - Phase II involves studies in a limited patient population to (i) determine the efficacy of the product for specific targeted indications and populations, (ii) determine optimal dosage and dosage tolerance and (iii) identify possible adverse effects and safety risks. When a dose is chosen and a candidate product is

found to be effective and to have an acceptable safety profile in Phase II evaluations, Phase III trials can be initiated. - Phase III trials are undertaken to demonstrate clinical efficacy and to test

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-- further for safety within an expanded patient population, generally at multiple study sites. The FDA can review the clinical trial plans and results and may suggest changes or may require discontinuance of the trials at any time if significant safety issues arise. 4. Submission to the FDA of marketing The results of the preclinical studies and authorization applications clinical studies are submitted to the FDA in the form of marketing approval authorization applications. 5. FDA approval of the application(s) prior The testing and

approval process will require to any commercial sale or shipment of the substantial time, effort and expense. The drug. Biologic product manufacturing time for approval is affected by a number of establishments located in certain states also factors, including relative risks and may be subject to separate regulatory and benefits demonstrated in clinical trials, the licensing requirement availability of alternative treatments and the severity of the disease. Additional animal studies or clinical trials may be requested during the FDA review period, which might add to that time.

After FDA approval for the product, the manufacturing and the initial indications, further clinical trials may be required to gain approval for the use of the product for additional indications. The FDA may also require unusual or restrictive post-marketing testing and surveillance to monitor for adverse effects, which could involve significant expense, or may elect to grant only conditional approvals.

#### FDA MANUFACTURING REQUIREMENTS

Among the conditions for product licensure is the requirement that the prospective manufacturer's quality control and manufacturing procedures conform to the FDA's current good manufacturing practice (cGMP) requirement. Even after product licensure approval, the manufacturer must comply with cGMP on a continuing basis, and what constitutes cGMP may change as the state of the art of manufacturing changes. Domestic manufacturing facilities are subject to regular FDA inspections for cGMP compliance, which are normally held at least every two years. Foreign manufacturing facilities are subject to periodic FDA inspections or inspections by the foreign regulatory authorities with reciprocal inspection agreements with the FDA. Domestic manufacturing facilities may also be subject to inspection by foreign authorities.

#### ORPHAN DRUG ACT

The Orphan Drug Act provides incentives to drug manufacturers to develop and manufacture drugs for the treatment of diseases or conditions that affect fewer

than 200,000 individuals in the United States. Orphan drug status can also be sought for treatments for diseases or conditions that affect more than 200,000 individuals in the United States if the sponsor does not realistically anticipate its product becoming profitable from sales in the United States. We may apply for orphan drug status for certain of our therapies. Under the Orphan Drug Act, a manufacturer of a designated orphan product can seek tax benefits, and the holder of the first FDA approval of a designated orphan product will be granted a seven-year period of marketing exclusivity in the United States for that product for the orphan indication. While the marketing exclusivity of an orphan drug would prevent other sponsors from obtaining approval of the same compound for the same indication, it would not prevent other types of products from being approved for the same use including, in some cases, slight variations on the originally designated orphan product.

#### PROPOSED FDA REGULATIONS

Our research and development is based on the use of human stem and progenitor cells. The FDA has published a "Proposed Approach to Regulation of Cellular and Tissue-Based Products" which relates to the use of human cells. As part of this approach, the FDA has published final rules for registration of establishments that engage in the recovery, screening, testing, processing, storage or distribution of human cells, tissues, and cellular and tissue-based products, and for the listing of such products. These products specifically include hematopoietic stem cells (stem cells that are progenitors of blood cells); however, the FDA makes no explicit statement regarding the inclusion of other types of stem cells. In addition, the FDA has published proposed rules for making suitability determinations for donors of cells and tissue and for current good tissue practice for manufacturers using them. We cannot now determine the full effects of this regulatory initiative, including precisely how it may affect the clarity of regulatory obligations and the extent of regulatory burdens associated with pluripotent stem cell research (for stem cells that give rise to various tissue types, including blood), and the manufacture and marketing of stem cell products.

#### OTHER REGULATIONS

In addition to safety regulations enforced by the FDA, we are also subject to regulations under the Occupational Safety and Health Act, the Environmental Protection Act, the Toxic Substances Control Act and other present and potential future foreign, Federal, state and local regulations.

Outside the United States, we will be subject to regulations that govern the import of drug products from the United States or other manufacturing sites and foreign regulatory requirements governing human clinical trials and marketing approval for our products. The requirements governing the conduct of clinical trials, product licensing, pricing and reimbursements vary widely from country to country. In particular, the European Union, or EU, is revising its regulatory approach to high tech products, and representatives from the United States, Japan and the EU are in the process of harmonizing and making more uniform the regulations for the registration of pharmaceutical products in these three markets.

#### REIMBURSEMENT AND HEALTH CARE COST CONTROL

Reimbursement for the costs of treatments and products such as ours from government health administration authorities, private health insurers and others both in the United States and abroad is a key element in the success of new health care products. Significant uncertainty often exists as to the reimbursement status of newly approved health care products.

The revenues and profitability of some health care-related companies have been affected by the continuing efforts of governmental and third party payers to contain or reduce the cost of health care through various means. Payers are increasingly attempting to limit both coverage and the level of reimbursement for new therapeutic products approved for marketing by the FDA, and are refusing, in some cases, to provide any coverage for uses of approved products for disease indications for which the FDA has not granted marketing approval. For example, in certain foreign markets, pricing or profitability of prescription pharmaceuticals is subject to government control. In the United States, there have been a number of Federal and state proposals to implement government control over health care costs.

#### EMPLOYEES

As of December 31, 2001, we had thirty-three full-time employees, of whom nine have Ph.D. degrees. Twenty-two full-time employees work in research and development and laboratory support services. A number of our employees have held

companies or have worked in university research programs. No employees are covered by collective bargaining agreements.

#### SCIENTIFIC ADVISORY BOARD

Members of our Scientific Advisory Board provide us with strategic guidance in regard to our research and product development programs, as well as assistance in recruiting employees and collaborators. Each Scientific Advisory Board member has entered into a consulting agreement with us. These consulting agreements specify the compensation to be paid to the consultant and require that all information about our products and technology be kept confidential. All of the Scientific Advisory Board members are employed by employers other than us and may have commitments to or consulting or advising agreements with other entities that limit their availability to us. The Scientific Advisory Board members have generally agreed, however, for so long as they serve as consultants to us, not to provide any services to any other entities that would conflict with the services the member provides to us. We are entitled to terminate the arrangement if we determine that there is such a conflict. Members of the Scientific Advisory Board offer consultation on specific issues encountered by us as well as general advice on the directions of appropriate scientific inquiry for us. In addition, Scientific Advisory Board members assist us in assessing the appropriateness of moving our projects to more advanced stages. The following persons are members of our Scientific Advisory Board:

- Irving L. Weissman, M.D., is the Karel and Avice Beekhuis Professor of Cancer Biology, Professor of Pathology and Professor of Developmental Biology at Stanford University, Stanford California. Dr. Weissman was a cofounder of SyStemix, Inc., and Chairman of its Scientific Advisory Board. He has served on the Scientific Advisory Boards of Amgen Inc., DNAX and T-Cell Sciences, Inc. Dr. Weissman is Chairman of the Scientific Advisory Board of StemCells.
- David J. Anderson, Ph.D., is Professor of Biology, California Institute of Technology, Pasadena, California and Investigator, Howard Hughes Medical Institute.
- Fred H. Gage, Ph.D., is Professor, Laboratory of Genetics, The Salk Institute for Biological Studies, La Jolla, California and Adjunct Professor, Department of Neurosciences, University of California, San Diego, California.
- Ben A. Barres, Ph.D., is Associate Professor of Neurobiology and of Developmental Biology, Stanford University, Stanford California.

#### ITEM 2. PROPERTIES

We entered into a 5-year lease, as of February 1, 2001, for a 40,000 square foot facility, located in the Stanford Research Park in Palo Alto, California. This facility includes space for animals as well as laboratories, offices, and a Good Manufacturing Practices suite, signifying that the facility can be used to manufacture materials for clinical trials. The new facility will better enable us to achieve our goal of utilizing genetically unmodified human stem cells for the treatment of disorders of the nervous system, liver, and pancreas. We have space-sharing agreements for part of the animal facility not needed for our own use with Stanford University and with Celtrans, Inc.

We continue to lease the following facilities in Lincoln, Rhode Island obtained in connection with our former encapsulated cell technology: our former research laboratory and corporate headquarters building which contains 65,000 square feet of wet labs, specialty research areas and administrative offices held on a lease agreement that goes through June 2013, as well as a 21,000 square-foot pilot manufacturing facility and a 3,000 square-foot cell processing facility financed by bonds issued by the Rhode Island Industrial Facilities Corporation. In 2001 we subleased the 3,000 square foot facility and effective in 2002 we have subleased the 21,000 square-foot facility. We have also subleased

approximately one-third of the 65,000 square foot facility. We are actively seeking to sublease, assign or sell our remaining interests in these properties.

#### ITEM 3. LEGAL PROCEEDINGS

None.

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

None.

PART II

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

The common stock of StemCells is traded on the National Market System of NASDAQ under the Symbol STEM (Previously traded under the Symbol CTII until May 2000). The quarterly ranges of high and low bid prices for the last two fiscal years as reported by NASDAQ are shown below:

2001 HIGH LOW - ---- -	-----	-----	First
Quarter.....			
	\$3.56	\$1.75	Second
Quarter.....			
	\$5.41	\$1.56	Third
Quarter.....			
	\$7.00	\$1.94	Fourth
Quarter.....			
	\$4.15	\$2.07	

2000 HIGH LOW - ---- -	-----	-----	First
Quarter.....			
	\$20.00	\$1.38	Second
Quarter.....			
	\$ 8.06	\$2.00	Third
Quarter.....			
	\$11.67	\$3.53	Fourth
Quarter.....			
	\$ 6.75	\$2.25	

No cash dividends have been declared on the Company common stock since the Company's inception.

As of February 25th, 2001, there were approximately 362 holders of record of the common stock.

On December 4, 2001, we issued 5,000 shares of 3% Cumulative Convertible Preferred Stock to Riverview Group, L.L.C., a wholly owned subsidiary of Millennium Partners, L.P. This preferred stock is convertible into shares of our common stock at a conversion price of \$2.00 per share of common stock; there is a mandatory redemption provision under which any preferred stock outstanding on December 4, 2003, shall be redeemed on that date. The conversion price may be below the trading market price of the stock at the time of conversion. Also on December 4, 2001, in connection with the preferred stock agreement, we issued to Riverview Group a warrant to purchase 350,877 shares of our common stock at a price of \$3.42 per share. The warrant expires on December 4, 2005. Riverview Group paid \$5,000,000 for the preferred stock and warrant. We also issued to Cantor Fitzgerald & Co., our financial advisor in connection with the transaction, a warrant for 146,199 shares exercisable at \$3.42 per share. These transactions were exempt from registration under the Securities Act of 1933 pursuant to Regulation D thereunder.

ITEM 6. SELECTED FINANCIAL DATA

The following selected historical information has been derived from the audited financial statements of the Company. The financial information as of December 2001 and 2000 and for each of

the three years in the period ended December 31, 2001 are derived from audited financial statements included elsewhere in this Form 10-K/A.

YEAR ENDED DECEMBER 31, -----			
-----	2001	2000	
1999 1998 1997 -----			
-----	(IN THOUSANDS, EXCEPT PER		

SHARE AMOUNTS) Consolidated Statement of Operations Revenue from collaborative and licensing agreements(1)..... \$ -- \$ 74 \$ 5,022 \$ 8,803 \$10,617 Revenue from grants..... 505 -- -- -- Revenue from assignment of rights to technology..... 300 --- ----- Total revenue..... 805 74 5,022 8,803 10,617 Research and development expenses..... 8,603 5,979 9,984 17,659 18,604 Acquired research and development..... -- -- -- -- 8,344 Encapsulated Cell Technology wind-down and corporate relocation(2)..... -- 3,327 6,048 -- -- Net loss before cumulative effect of change in accounting principle..... (3,447) (11,125) (15,709) (12,628) (18,114) Basic and diluted net loss per share available to common shareholders before cumulative effect of an accounting change..... \$ (0.22) \$ (0.57) \$ (0.84) \$ (0.69) \$ (1.08) Cumulative effect of a change in accounting principle..... -- \$ (0.01) -- -- -- ----- Net loss per share applicable to common shareholders (4)..... \$ (0.22) \$ (0.58) \$ (0.84) \$ (0.69) \$ (1.08) Shares used in computing basic and diluted net loss per share..... 22,242 20,068 18,708 18,291 16,704

DECEMBER 31 -----  
----- 2001 2000  
1999 1998 1997 -----  
----- (IN THOUSANDS)  
Consolidated Balance Sheet Cash and cash equivalents.....  
\$13,697 \$ 6,069 \$ 4,760 \$17,386  
\$29,050 Restricted investments..... --  
16,356 -- -- -- Total assets.....  
20,803 29,795 15,781 32,866 44,301  
Long-term debt, including capital leases..... 2,316 2,605 2,937 3,762  
4,108 Redeemable common stock..... -- --  
5,249 5,249 5,583 Redeemable preferred stock(3)..... 2,663 1,283  
5,249 5,249 5,583 Stockholders' equity..... 13,208  
21,699 3,506 17,897 28,900

(1) See footnote 3 in the consolidated financial statements

(2) See footnote 2 in the consolidated financial statements

(3) See footnote 11 in the consolidated financial statements

(4) 2001 amounts have been restated for additional deemed dividends to preferred shareholders, see Notes 1 and 11 in the accompanying consolidated financial statements

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

The following discussion of our financial condition and results of operations should be read in conjunction with the accompanying financial statements and the related footnotes thereto.



This report contains forward looking statements within the meaning of Section 27A of the Securities Act and Section 21E of the Securities Exchange Act that involve substantial risks and

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uncertainties. Such statements include, without limitation, all statements as to expectation or belief and statements as to our future results of operations, the progress of our research, product development and clinical programs, the need for, and timing of, additional capital and capital expenditures, partnering prospects, costs of manufacture of products, the protect of and the need for additional intellectual property rights, effects of regulations, the need for additional facilities and potential market opportunities. Our actual results may vary materially from those contained in such forward-looking statements because of risks to which we are subject, such as failure to obtain a corporate partner or partners to support the development of our stem cell programs, our ability to sell, assign or sublease our interest in our facilities related to our encapsulated cell technology program, risks of delays in, or adverse results from, our research, development and clinical testing programs, obsolescence of our technology, lack of available funding, competition from third parties, intellectual property rights of third parties, failure of our collaborators to perform, regulatory constraints, litigation and other risks to which we are subject. See "Cautionary Factors Relevant to Forward-Looking-Information" filed herewith as Exhibit 99 and incorporated herein by reference.

#### OVERVIEW

Since our inception in 1988, we have been primarily engaged in research and development of human therapeutic products. As a result of a restructuring in the second half of 1999, our sole focus is now on our stem cell technology.

We have not derived any revenues from the sale of any products, and we do not expect to receive revenues from product sales for at least several years. We have not commercialized any product and in order to do so we must, among other things, substantially increase our research and development expenditures as research and product development efforts accelerate and clinical trials are initiated. We have incurred annual operating losses since inception and expect to incur substantial operating losses in the future. As a result, we are dependent upon external financing from equity and debt offerings and revenues from collaborative research arrangements with corporate sponsors to finance our operations. There are no such collaborative research arrangements at this time and there can be no assurance that such financing or partnering revenues will be available when needed or on terms acceptable to us.

In 2001, we entered into two significant financing agreements: In May, we entered into an equity line enabling us to draw up to \$30,000,000 subject to various restrictions, and we did draw down \$4,000,000 in July; and in December, we issued 3% convertible preferred stock for \$5,000,000 gross. In addition, under the terms of the financing agreement we entered into in 2000 with Millennium Partners, LP, Millennium exercised its final option to purchase \$2,000,000 of our common stock; that agreement has now terminated. (See "Liquidity and Capital Resources" below for further detail on each of these transactions.)

In addition, we received two grants from the National Institutes of Health, one for work on hepatitis to be carried out jointly by us and Stanford University, and one focusing on the effort to identify liver stem and progenitor cells for the treatment of liver diseases. Although the grants are relatively small (\$300,000 a year for two years and \$225,000 a year for four years, respectively, and dependent on availability of funds and satisfactory progress), we are very pleased by this recognition of our work by the agency.

Our results of operations have varied significantly from year to year and quarter to quarter and may vary significantly in the future due to the occurrence of material recurring and nonrecurring events, including without limitation the receipt and payment of recurring and nonrecurring licensing payments, the initiation or termination of research collaborations, the on-going expenses to lease and maintain our facilities in Rhode Island and the increasing costs associated with our move to a larger facility in California. To expand and provide high quality systems and support to our Research and

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Development programs, we will need to hire more personnel, which will lead to higher operating expenses.

The Company believes the following critical accounting policies affect its more significant judgments and estimates used in the preparation of its consolidated financial statements:

#### USE OF ESTIMATES

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States, that requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements. Actual results could differ from these estimates.

#### STOCK-BASED COMPENSATION

The Company's employee stock option plan is accounted for under Accounting Principles Board Opinion No. 25 ("APB 25"), "Accounting for Stock Issued to Employees." The Company grants qualified stock options for a fixed number of shares to employees with an exercise price equal to the fair market value of the shares at the date of grant. In accordance with APB 25, the Company recognizes no compensation expense for qualified stock option grants. The Company also issues non-qualified stock options for a fixed number of shares to employees with an exercise price less than the fair market value of the shares at the date of grant. When such options vest, the Company recognizes the difference between the exercise price and fair market value as compensation expense in accordance with APB 25.

For certain stock options granted to non-employees, the Company accounts for these grants in accordance with FAS No. 123--accounting for stock-based compensation and EITF 96-18--accounting for equity instruments that are issued to other than employees for acquiring, or in conjunction with selling, goods or services, and accordingly, recognizes as expense the estimated fair value of such options as calculated using the Black-Scholes valuation model, and is remeasured during the service period. Fair value is determined using methodologies allowable by FAS No. 123. The cost is amortized over the vesting period of each option or the recipient's contractual arrangement, if shorter.

#### LONG-LIVED ASSETS

The Company routinely evaluates the carrying value of its long-lived assets. The Company records impairment losses on long-lived assets used in operations when events and circumstances indicate that assets may be impaired and the undiscounted cash flows estimated to be generated by the assets are less than the carrying amount of those assets. If an impairment exists, the charge to operations is measured as the excess of the carrying amount over the fair value of the assets.

#### RESEARCH AND DEVELOPMENT COSTS

The Company expenses all research and development costs as incurred. Research and Development costs include costs of personnel, external services, supplies, facilities and miscellaneous other costs.

#### RESULTS OF OPERATIONS

##### YEARS ENDED DECEMBER 31, 2001, 2000 AND 1999

Revenues totaled \$805,000, \$74,000 and \$5,022,000 for the years ending December 31, 2001, 2000 and 1999, respectively. Revenues for 2001 are from grants received from the National Institute of Health's Small Business Innovation Research (SBIR) office for research relating to our Neural & Liver stem cell programs (\$505,000) and from the assignment to Modex Therapeutics, Ltd., of our retained

rights to a portion of certain possible future revenues arising out of our sale of our former Encapsulated Cell Technology (ECT) to Neurotech, S.A.(\$300,000). Revenues for 2000 were from Neurotech, SA. in return for that sale of our ECT intellectual property assets described above under "Research and Development Programs" above. Revenues for 1999 were from collaborative agreements, earned primarily from a Development, Marketing and License Agreement with AstraZeneca Group plc, which was signed in March 1995 and which related to the ECT. The decrease in revenues from 1999 to 2000 resulted primarily from the June 1999 termination of the agreement with AstraZeneca. The increase from 2000 to 2001 was primarily due to the receipt of money from grants. There were no receipts from grants in 2000.

Research and development expenses totaled \$8,603,000 in 2001, as compared to \$5,979,000 in 2000 and \$9,984,000 in 1999. The increase of \$2,624,000, or 44%,

from 2000 to 2001 was primarily attributable to the costs related to leasing a larger facility and an increase in personnel to facilitate the expansion of our research and initiate development. Our program in neural stem and progenitor cells has entered the preclinical stage, as we focus increasingly on testing human neural stem cells in small animal models of human diseases, both in-house and through external academic collaborators. In our liver stem cell program, we are intensifying our efforts to identify liver stem and progenitor cells. In part, we will do this by following up studies we have done showing that purified blood stem cells can give rise to liver tissue, to seek a possible transitional cell transitional between the blood stem cells and the mature liver cells. Our pancreas program is concentrated on the use of animal models, available through a consortium of academic collaborators, to attempt to identify and test candidate stem cells for use in the treatment of diseases such as certain types of diabetes, and is being carried on for the present primarily through those collaborators. The decrease of \$4,005,000 or 40%, from 1999 to 2000, was primarily attributable to the wind-down of research activities relating to our ECT, precipitated by termination of the agreement with AstraZeneca.

General and administrative expenses were \$3,788,000 in 2001, compared with \$3,361,000 in 2000 and \$4,927,000 in 1999. The increase of \$427,000 or 13%, from 2000 to 2001 was primarily attributable to the related costs of an increase in personnel, which included the hiring of senior management personnel as part of the reorganization and consolidation of our operations in California, and the costs related to leasing a larger facility. The decrease of \$1,566,000 or 32% from 1999 to 2000 was due to the wind-down of our ECT and relocation of our headquarters in October 1999 from Rhode Island to California.

Wind-down expenses related to our ECT research, our Rhode Island operations and the transfer of our headquarters to California totaled \$0, \$3,327,000 and \$6,048,000 for 2001, 2000 and 1999, respectively. 1999 expenses included accruals of approximately \$1.6 million for employee severance costs, \$1.9 million in losses and reserves for the write-down of related patents and fixed assets, \$1.2 million for our costs of settlement of a 1989 funding agreement with the Rhode Island Industrial Recreational Building Authority, \$700,000 of estimated additional carrying costs through June 30, 2000, and other related expenses totaling \$760,000.

During 2000, we incurred approximately \$290,000 of costs in excess of the amounts accrued as of December 31, 1999 for the carrying costs, including lease payments, property taxes and utilities, through the expected June 30, 2000 disposition of the Rhode Island facilities. During the third and fourth quarters of 2000 we incurred additional \$1.3 million in carrying costs for the Rhode Island facilities, as we were unable to dispose of them as expected. We created a reserve of \$1,780,000 related to the carrying costs for the Rhode Island facilities through 2001. In the year 2001 we utilized all of the reserve. We have subleased substantial portions of the facilities and are actively seeking to sublease, assign or sell our remaining interests in the properties. However, there can be no assurance that we will be able to dispose of these facilities in a reasonable time, if at all. As we cannot predict the exact disposal date of these properties, we will record all future expenses as they incur as normal operating expenses.

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Interest income for the years ended December 31, 2001, 2000 and 1999 totaled \$201,000, \$304,000 and \$564,000, respectively. The average cash and cash equivalents were \$9,034,000, \$5,668,000 and \$10,663,000 in 2001, 2000 and 1999, respectively. The decrease in interest income from 2000 to 2001 was attributable to the lower interest rate on overnight and money market funds. The decrease in interest income from 1999 to 2000 to 2001 was attributable to lower average balances.

In 2001, interest expense was \$246,000, compared to \$273,000 in 2000 and \$335,000 in 1999. Interest expense for year 2001 was charged against the wind-down reserve, as the expense was part of the bond payments related to the Rhode Island facilities. The decrease from 1999 to 2000 to 2001 was attributable to lower outstanding debt and capital lease balances.

Gain on sale of short-term investments relates to the sale of Modex shares. On January 9, 2001, we sold 22,616 Modex shares for a net price of 182.00 Swiss francs per share, which converted to \$112.76 per share, for total proceeds and a realized gain of \$2,550,230. On April 30, 2001, we sold our remaining shares in Modex for a net price of 87.30 Swiss Francs per share, which converted to approximately \$50.51 for total proceeds and a realized gain of \$5,232,000, net of commissions and fees. We no longer hold any shares of Modex.

The net loss in 2001, 2000 and 1999 was \$3,446,000, \$11,125,000, and \$15,709,000, respectively. The loss per share applicable to common shareholders was \$0.22, \$.57 and \$.84 in 2001, 2000 and 1999, respectively. The decrease from

2000 to 2001 is primarily attributable to a realized gain of \$7,782,000 from our sale of Modex shares in 2001, offset by an increase in operating expenses attributable to an increase in personnel and our move to a larger facility. The decrease from 1999 to 2000 was primarily attributable to the wind-down of our encapsulated cell technology research and our Rhode Island operations and offset by the elimination of revenue from the Astra Agreement.

#### DEEMED DIVIDENDS RELATED TO CONVERTIBLE PREFERRED STOCK.

In 2001, we recorded a deemed dividend of \$743,667 related to the 3% Cumulative Convertible Preferred Stock (see note 11 to the financial statements) which includes the accretion of common stock warrants, the accretion of the beneficial conversion feature and the accretion of related issuance costs. The aggregate accretion value associated with the warrants, beneficial conversion feature and issuance costs were included in the calculation of net loss applicable to common stockholders.

In 2000 we recorded an initial deemed dividend aggregating \$481,000 related to the 6% Cumulative Convertible Preferred Stock (see note 11 to the financial statements). The dividend reflects the value of warrants issued and the beneficial conversion feature. In November 2000, the FASB issued Emerging Issues Task Force Issue No. 00-27, "Application of EITF Issue No. 98-5, Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios, to Certain Convertible Instruments" ("EITF 00-27"). Prior to the adoption of EITF 00-27, we recognized \$216,000 of deemed dividends on preferred stock. Upon adoption of the new accounting principle, we have presented an additional deemed dividend of \$265,000 as a cumulative effect of a change in accounting principle as allowed for in EITF 00-27.

This Form 10-K/A reflects additional deemed dividends of \$802,000 for the beneficial conversion feature of the 6% Cumulative Convertible Preferred Stock which resulted from the subsequent change to the effective conversion price of those shares due to the issuance in 2001 of adjustable warrants in connection with the common stock financing transaction with Millennium Partners, LP. The 2001 consolidated financial statements have been restated to reflect the additional deemed dividends (see Notes 1 and 11 to the financial statements).

#### LIQUIDITY AND CAPITAL RESOURCES

Since our inception, we have financed our operations through the sale of common and preferred stock, the issuance of long-term debt and capitalized lease obligations, revenues from collaborative agreements, research grants and interest income.

We had cash and cash equivalents totaling \$13,697,000 at December 31, 2001. Cash equivalents are invested in US Treasuries with maturities of less than 90 days. We used \$10.5 million, \$6.3 million, and \$11.9 million of cash, in 2001, 2000 and 1999 respectively, in our operating activities. The increase in cash used in 2001 is the result of increased research and development spending in 2001 over 2000.

Our liquidity and capital resources were, in the past, significantly affected by our relationships with corporate partners, which were related to our former ECT. These relationships are now terminated, and we have not yet established corporate partnerships with respect to our stem cell technology. Our liquidity and capital resources have, in the past, also been affected by our holdings of Modex, all of which holdings have now been sold, resulting in proceeds to us of \$7,782,000 in 2001.

On April 13, 2000, we sold 1,500 shares of our 6% cumulative convertible preferred stock plus warrants for a total of 75,000 shares of our common stock to two members of our Board of Directors for \$1,500,000, on terms more favorable to us than we were able to obtain from outside investors. The face value of the shares of preferred stock is convertible at the option of the holders into common stock at an initial conversion price of \$3.77 per share. The conversion price is subject to adjustment upon certain equity transactions, as defined in the applicable agreement. The holders of the preferred stock have liquidation rights equal to their original investments plus accrued but unpaid dividends. Any unconverted preferred stock will be converted, at the applicable conversion price, on April 13, 2002. The warrants expire on April 13, 2005. The preferred stock is redeemable in the event of liquidation or change of control of the Company. A purchaser could acquire a majority of the voting power of the outstanding stock, without Company approval, thereby triggering a redemption. Accordingly, the Company has reclassified the 6% cumulative convertible

preferred stock out of permanent equity for all periods presented, in accordance with the transition guidance of EITF D-98.

On August 3, 2000, we completed a \$4 million common stock financing transaction with Millennium Partners, LP at \$4.33 per share. In the purchase agreement, we granted Millennium an option to purchase up to an additional \$3 million of our common stock. Millennium exercised its option to purchase \$1 million of our common stock on Aug 23, 2000 at \$5.53 per share. On June 8, 2001, Millennium exercised its remaining option to purchase \$2 million of our common stock at \$4.3692 per share. As a result of the financing agreement, Millennium received five year warrants to purchase 101,587 shares of common stock at \$4.725 per share, 19,900 shares of common stock at \$6.03 per share, and 50,352 shares at \$4.7664 per share. We may call the warrants at any time at \$7.875, \$10.05 and \$7.944 per underlying share respectively. In addition to the afore-mentioned warrants, Millennium was issued adjustable warrants in connection with the original \$4 million purchase, each of which entitled Millennium to receive additional shares on eight dates beginning six months from the respective closing dates and every three months thereafter. The exercisable price per share under the adjustable warrant was \$0.01. Millennium exercised the first of the adjustable warrants to purchase 463,369, 622,469, and 25,804 shares on March 30, 2001, July 26, 2001 and August 15, 2001 respectively at \$0.01 per share. On December 4, 2001, we entered into an agreement with Millennium under which we issued 176,101 shares of our common stock as a final cashless exercise of all outstanding adjustable warrants that Millennium was entitled to or would be entitled to. Immediately following delivery of these shares, any further right to acquire common stock under these adjustable warrants were cancelled by the agreement.

On May 10, 2001, we entered into a common stock purchase agreement with Sativum Investments Limited for the potential future issuance and sale of up to \$30,000,000 of our common stock, subject to restrictions and other obligations. We, at our sole discretion, may draw down on this facility, sometimes termed an equity line, from time to time, and Sativum is obligated to purchase shares of our common stock at a 6% discount to a volume weighted average market price over the 20 trading days following the draw-down notice. We are limited with respect to how often we can exercise a draw down and the amount of each draw down. We delivered a draw down notice to Sativum Investments Limited, dated as of July 11, 2001, exercising our right to draw down up to \$5,000,000 at a market-based share price not less than \$5.00 per share beginning July 12, 2001. Sativum purchased a total of 707,947 shares of our common stock at an average purchase price of \$5.65 per share, net of Sativum's discount of six percent. Because the market based price of our common stock was less than \$5.00 for 4 trading days during the draw down period, pursuant to the terms of our with Sativum agreement, our \$5,000,000 request was reduced to \$4,000,000. Our placement agents, Pacific Crest Securities, Inc. and Granite

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Financial Group, Inc., received \$80,000 and \$40,000, respectively, as placement fees in connection with this draw down, resulting in net proceeds to us of \$3,603,407, after paying escrow fees and other associated costs. In connection with our execution of the common stock purchase agreement with Sativum, we issued three three-year warrants to purchase an aggregate of 350,000 shares of our common stock at \$2.38 per share to Sativum (250,000 shares), Pacific Crest Securities Inc. (75,000 shares) and Granite Financial Group, Inc. (25,000 shares). Our placement agents have exercised their warrants in full, and we have received payment of \$238,050 for the shares issued to them.

On December 4, 2001, we issued 5,000 shares of 3% Cumulative Convertible Preferred Stock to Riverview Group, L.L.C., a wholly owned subsidiary of Millennium Partners. We received total proceeds of \$4,727,515 net of the fee to Cantor Fitzgerald and other associated costs. This preferred stock is convertible into shares of our common stock at a current conversion price of \$2.00 per share of common stock. There is a mandatory redemption provision in the preferred stock under which any preferred stock remaining on December 4, 2003, is redeemed on that date. The conversion price may be below the trading market price of the stock at the time of conversion. In connection with the preferred stock agreement, we issued to Riverview Group a warrant to purchase 350,877 shares of our common stock at a price of \$3.42 per share. The warrant expires on December 4, 2005. We paid Cantor Fitzgerald & Co., our financial advisor in connection with the transaction, a fee of \$200,000 and issued them a warrant for 146,199 shares exercisable at \$3.42 per share.

We continue to have outstanding obligations in regard to our former facilities in Lincoln, Rhode Island, including lease payments and operating costs of approximately \$1,000,000 for 2002, net of subtenant income. We have subleased a portion of these facilities and are actively seeking to sublease, assign or sell our remaining interests in these facilities. Failure to do so within a reasonable period of time will have a material adverse effect on our

liquidity and capital resources. Our total operating lease payments for the years 2002 to 2013 amounts to \$25,141,000, and our total capital lease payments for the years 2002 to 2014 amounts to \$4,107,000.

We have limited liquidity and capital resources and must obtain significant additional capital resources in the future in order to sustain our product development efforts, for acquisition of technologies and intellectual property rights, for preclinical and clinical testing of our anticipated products, pursuit of regulatory approvals, acquisition of capital equipment, laboratory and office facilities, establishment of production capabilities and for general and administrative expenses. Our ability to obtain additional capital will be substantially dependent on our ability to obtain partnering support for our stem cell technology and, in the near term, on our ability to realize proceeds from the sale, assignment or sublease of our facilities in Rhode Island. Failure to do so will have a material effect on our liquidity and capital resources. Until our operations generate significant revenues from product sales, we must rely on cash reserves and proceeds from equity and debt offerings, proceeds from the transfer or sale of our intellectual property rights, equipment, facilities or investments, and government grants and funding from collaborative arrangements, if obtainable, to fund our operations.

We intend to pursue opportunities to obtain additional financing in the future through equity and debt financings, grants and collaborative research arrangements. The source, timing and availability of any future financing will depend principally upon market conditions, interest rates and, more specifically, on our progress in our exploratory, preclinical and future clinical development programs. Funding may not be available when needed--at all, or on terms acceptable to us. While our cash requirements may vary, we currently expect that our existing capital resources will be sufficient to fund our operations through December of 2002. Lack of necessary funds may require us to delay, scale back or eliminate some or all of our research and product development programs and/or our capital expenditures or to license our potential products or technologies to third parties.

With the exception of operating leases for facilities, we have not entered into any off balance sheet financial arrangements and have not established any special purpose entities. We have not guaranteed

any debts or commitments of other entities or entered into any options on non-financial assets. During 2001, we were party to a space-sharing agreement entered into between us and Celtrans, LLC. Dr. Irving Weissman, a member of our Board of Directors and Chairman of our Scientific Advisory Board, was interim Chief Executive Officer and is a member of the Board of Managers of Celtrans, a privately-owned biotechnology company that is also a tenant in the building in which the Company is located. Under the agreement, which was effective as of September 1, 2001, Celtrans or, with our approval, a subtenant of Celtrans, may use certain animal space in our facility, which we do not currently require for our own use. Celtrans pays the Company \$16,122 per month under the space-sharing agreement, at the same rate per square foot as we receive from Stanford University, with which we also have an agreement for sharing the animal facility. In addition, Dr. Weissman remains a consultant to us under an agreement entered in 1997.

#### RECENT ACCOUNTING PRONOUNCEMENTS

In July 2001, the FASB issued Statement of Financial Accounting Standards No. 141, "Business Combinations" (Statement 141). This Statement addresses financial accounting and reporting for business combinations. Statement 141 supersedes APB Opinion No. 16, Business Combinations, and amends or supersedes a number of interpretations of that Opinion. Statement 141 requires that (1) all business combinations be accounted for by a single method--the purchase method, (2) all intangible assets acquired in a business combination are to be recognized as assets apart from goodwill if they meet one of two criteria--the contractual-legal criterion or the separability criterion and (3) in addition to the disclosure requirements in Opinion 16, disclosure of the primary reasons for a business combination and the allocation of the purchase price paid to the assets acquired and liabilities assumed by major balance sheet caption. When the amounts of goodwill and intangible assets acquired are significant in relation to the purchase price paid, disclosure of other information about those assets is required, such as the amount of goodwill by reportable segment and the amount of the purchase price assigned to each major intangible asset class. The provisions of Statement 141 apply to all business combinations initiated after June 30, 2001. Statement 141 also applies to all business combinations accounted for using the purchase method for which the date of acquisition is July 1, 2001, or later. The Company will adopt the provisions of Statement 141 for any business combinations that may be initiated.

In July 2001, the FASB issued Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangibles" ("Statement 142"). Under Statement 142, goodwill and indefinite lived intangible assets are no longer amortized but are reviewed annually (or more frequently if impairment indicators arise) for impairment. Separable intangible assets that are not deemed to have an indefinite life will continue to be amortized over their estimated useful lives. StemCells has not recorded any goodwill or indefinite lived intangible assets prior to December 31, 2001. The adoption of this statement as of January 1, 2002 will not have a material impact on the Company's financial position, results of operations or cash flow.

In October 2001, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" ("Statement 144"), which addresses financial accounting and reporting for the impairment or disposal of long-lived assets and supersedes Statement 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of", and the accounting and reporting provisions of APB Opinion No. 30, "Reporting the Results of Operations for a disposal of a segment of a business." Statement 144 is effective for fiscal years beginning after December 15, 2001. The Company will adopt Statement 144 as of January 1, 2002 and it does not expect that the adoption of the Statement will have a significant impact on the Company's financial position and results of operations.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We have sold all our shares of Modex Therapeutics, Ltd., referred to in our Form 10-K for the year ended December 31, 2000. We have no other financial instruments with significant market risk. Cash equivalents consist of U.S. Treasury instruments with maturities of less than 90 days.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

STEMCELLS, INC.  
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REPORT OF ERNST & YOUNG LLP, INDEPENDENT AUDITORS

Stockholders and Board of Directors  
StemCells, Inc.

We have audited the accompanying consolidated balance sheets of StemCells, Inc. as of December 31, 2001 and 2000, and the related consolidated statements of operations, changes in redeemable preferred stock and stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2001. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An

audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

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

As discussed in Note 1, the financial statements for the year ended December 31, 2001 have been restated.

/s/ ERNST & YOUNG LLP

Palo Alto, California  
February 12, 2002, except for Note 1 - Restatement of Financial Statements, as to which the date is July 29, 2002

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STEMCELLS, INC.

CONSOLIDATED BALANCE SHEETS

DECEMBER 31,	-----	2001	2000	-----
-----	ASSETS			
	Current assets: Cash and cash equivalents.....		\$ 13,697,195	\$
	6,068,947 Short-term restricted investments.....	--	16,356,334	Accrued interest receivable.....
	16,725 Other receivable.....		49,590	
	-- Other current assets.....		361,636	
	524,509 -----			Total current assets.....
	22,966,515 Property held for sale.....		3,203,491	
	3,203,491 Property, plant and equipment, net.....		1,219,319	1,451,061 Other assets, net.....
	2,267,207 2,173,912 -----			Total assets.....
			\$ 29,794,979	=====
	LIABILITIES, REDEEMABLE CONVERTIBLE PREFERRED STOCK, AND STOCKHOLDERS' EQUITY			
	Current liabilities: Accounts payable.....		\$ 578,270	
	\$ 526,191 Accrued expenses.....		499,165	
	837,358 Accrued wind-down costs.....		--	1,780,579
	Current maturities of capital lease obligations.....		289,167	332,083 -----
	3,476,211 Capital lease obligations, less current maturities.....		2,315,833	2,605,000
	Deposits.....		129,897	26,000 Deferred rent.....
	1,120,005 705,746 -----			Total liabilities.....
	4,932,337 6,812,957 Redeemable Convertible Preferred Stock, \$0.01 par value; 1,000,000 shares authorized issuable in series: 3% Cumulative Convertible Preferred Stock, 5,000 shares issued and 4,000 shares outstanding at December 31, 2001, none at December 31, 2000 (aggregate liquidation preference of \$5,000,000 at December 31, 2001).....		1,379,682	-- 6% Cumulative Convertible Preferred Stock, 2,626 designated as 6%, 1,500 shares issued and outstanding at December 31, 2001 and 2000 (aggregate liquidation preference of \$1,500,000 at December 31, 2001).....
	1,283,250 1,283,250 Stockholders' equity: Common stock, \$0.01 par value; 45,000,000 shares authorized; 24,220,021 and 20,956,887 shares issued and outstanding at December 31, 2001 and 2000, respectively.....		242,200	209,569 Additional paid-in



capital.....	149,180,388
138,366,817 Accumulated	
deficit.....	
(133,944,684) (130,498,187) Accumulated other comprehensive	
income.....	-- 16,356,334 Deferred
compensation.....	
(2,270,097) (2,735,761) ----- Total	
stockholders' equity.....	
13,207,807 21,698,772 ----- Total	
liabilities, redeemable convertible preferred stock, and	
stockholders' equity.....	\$
20,803,076 \$ 29,794,979 =====	=====

SEE ACCOMPANYING NOTES TO CONSOLIDATED FINANCIAL STATEMENTS.

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STEMCELLS, INC.  
CONSOLIDATED STATEMENTS OF OPERATIONS

YEAR ENDED DECEMBER 31, -----	2001	2000	1999 (RESTATED) -----
----- Revenue from			
collaborative and licensing			
agreements.....	\$ --	\$ 74,300	\$ 5,021,707
grants.....			505,231
Revenue from assignment of rights to			
technology.....	300,000		-----
----- Total			
revenues.....	805,231	74,300	5,021,707
Operating expenses:			
Research and			
development.....	8,603,444		
5,979,007 9,984,027 General and			
administrative.....	3,787,759		
3,361,231 4,927,303 Encapsulated Cell Therapy			
wind-down and corporate			
relocation.....			
-- 3,327,360 6,047,806 -----			
----- 12,391,203 12,667,598 20,959,136 ---			
----- Loss from			
operations.....	(11,585,972)	(12,593,298)	(15,937,429)
income (expense): Interest			
income.....	200,766		
303,746 564,006 Interest			
expense.....	--	--	--
(272,513) (335,203) Gain on sale of short-term			
investment.....	7,782,398	1,427,686	--
Loss on disposal of property, plant and			
equipment.....			
(30,477) -- -- Other			
income.....			
186,788 8,902 -- -----			
----- 8,139,475 1,467,821 228,803 -----			
----- Net loss before deemed			
dividends and accounting			
change.....	(3,446,497)	(11,125,477)	(15,708,626)
Deemed			
dividend to preferred shareholders.....			
(1,545,917) (265,000) -- Net loss applicable to			
common shareholders before cumulative effect of			
change in accounting			
principle.....	(4,992,414)	(11,390,477)	(15,708,626)
Cumulative			
effect of a change in accounting			
principle.....	--	--	--
\$ (216,000) -- -----			
----- Net loss applicable to common share			
holders.....	\$ (4,992,414)	\$(11,606,477)	
\$(15,708,626) =====			
===== Basic and diluted net loss per share			
applicable to common shareholders before			
cumulative effect.....	\$ (0.22)	\$ (0.57)	\$
(0.84) Cumulative effect of a change in			
accounting			

principle.....  
 -- \$ (0.01) -- Basic and diluted net loss per  
 share applicable to common  
 shareholders..... \$  
 (0.22) \$ (0.58) \$ (0.84) =====  
 ===== Shares used in  
 computing basic and diluted net loss per  
 share.....  
 22,241,564 20,067,760 18,708,838 =====  
 =====

SEE ACCOMPANYING NOTES TO CONSOLIDATED FINANCIAL STATEMENTS.

STEM CELLS, INC.  
 CONSOLIDATED STATEMENTS OF CHANGES IN REDEEMABLE CONVERTIBLE PREFERRED STOCK AND  
 STOCKHOLDERS' EQUITY

REDEEMABLE COMMON STOCK	COMMON STOCK	COMMON STOCK
ADDITIONAL	-----	-----
----- PAID-IN ACCUMULATED SHARES	-----	-----
AMOUNT SHARES AMOUNT CAPITAL DEFICIT	-----	-----
-----	-----	-----
----- Balances, December		
31, 1998.....	524,337	
\$5,248,610	17,800,323	\$178,003
\$122,861,606	\$(103,664,084)	Issuance of
196,213	1,962	318,221 Issuance of common
57,398	574	41,619 -- Common stock issued
90,798	908	102,502 -- Exercise of stock
4,908	513,534	-- Deferred compensation-
		amortization and
		cancellations.....
-- -- -- --	80,276	-- Change in unrealized
		losses on marketable
securities.....		
		-- -- -- -- Net
loss.....		
-- -- -- --	(15,708,626)	Comprehensive
loss.....		
-----	-----	-----
----- Balances, December 31,		
1999.....	524,337	\$5,248,610
18,635,565	\$186,355	\$123,917,758
	\$(119,372,710)	
ACCUMULATED OTHER TOTAL COMPREHENSIVE		
DEFERRED STOCKHOLDERS' INCOME (LOSS)		
COMPENSATION EQUITY	-----	-----
----- Balances, December		
31, 1998.....	\$(5,198)	
\$(1,472,919)	\$17,897,408	Issuance of
42,193		320,183
103,410		Exercise of stock
		-- -- 518,442
		Deferred compensation-amortization and
		cancellations.....
-- 247,919	328,195	Change in unrealized
		losses on marketable
securities.....		
	5,198	-- 5,198 Net
loss.....		
-- -- (15,708,626)		Comprehensive
loss.....		

(15,703,428) -----  
 -- Balances, December 31,  
 1999..... \$ -- \$(1,225,000) \$  
 3,506,403

STEMCELLS, INC.

CONSOLIDATED STATEMENTS OF CHANGES IN REDEEMABLE PREFERRED STOCK AND STOCKHOLDERS' EQUITY (CONTINUED)

REDEEMABLE STOCK	REDEEMABLE STOCK	COMMON STOCK	COMMON STOCK
ADDITIONAL	PAID-IN	SHARES	AMOUNT
SHARES	AMOUNT	SHARES	AMOUNT
AMOUNT	CAPITAL		
-----			
- Balances, December			
31,1999.....	524,337	\$	
5,248,610	-- --	18,635,565	
\$186,355	\$123,917,758	Issuance	
		of common stock to Millennium	
		Partners LP, net of issuance	
		costs of \$598,563.....	-- --
-- --	1,104,435	11,044	4,390,393
		Issuance of common stock	
		related to license	
		agreements.....	-- --
-- --	77,800	778	364,222
		Common	
		stock issued pursuant to	
		employee benefit	
		plan.....	-- --
6,672	68	27,112	Exercise of
			employee stock
options.....			
-- --		608,078	6,081
651,828		Redeemable common stock	
conversion.....			
(524,337)	(5,248,610)	-- --	
524,337	5,243	5,243,367	
		Issuance of 6% convertible	
		preferred	
		stock.....	-- --
1,500	1,283,250	-- --	216,750
		Deferred	
compensation.....			
-- --		3,555,387	
		Amortization of deferred	
compensation.....			
-- --		Unrealized	
		gain on short-term restricted	
investments.....			
-- --		Net	
loss.....			
-- --			
		Comprehensive	
income.....			
-----			
Balances, December 31,			
2000.....	-- --	1,500	
\$1,283,250	20,956,887	\$209,569	
	\$138,366,817		
ACCUMULATED OTHER TOTAL			
ACCUMULATED COMPREHENSIVE			
DEFERRED STOCKHOLDERS' DEFICIT			
INCOME (LOSS) COMPENSATION			
EQUITY			
-----			
- Balances, December 31,			
1999.....	\$(119,372,710)	\$ --	
	\$(1,225,000)	\$ 3,506,403	
		Issuance of common stock to	
		Millennium Partners LP, net of	
		issuance costs of	
		\$598,563.....	-- --

4,401,437	Issuance of common stock related to license agreements.....	-- -- --	
365,000	Common stock issued pursuant to employee benefit plan.....	-- -- --	27,180
	Exercise of employee stock options.....	-- -- --	657,909
	Redeemable common stock conversion.....	-- -- --	5,248,610
	Issuance of 6% convertible preferred stock.....	-- -- --	216,750
	Deferred compensation.....	-- --	(3,555,387)
	Amortization of deferred compensation.....	-- --	2,044,626
	Unrealized gain on short-term restricted investments.....	--	16,356,334
	Net loss.....	-- --	(11,125,477)
	Comprehensive income.....		5,230,857
-----			
	Balances, December 31, 2000.....		
			\$(130,498,187)
			\$16,356,334
			\$(2,735,761)
			\$ 21,698,772

SEE ACCOMPANYING NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

STEMCELLS, INC.

CONSOLIDATED STATEMENTS OF CHANGES IN REDEEMABLE PREFERRED STOCK AND STOCKHOLDERS' EQUITY (CONTINUED)

	REDEEMABLE	REDEEMABLE	COMMON STOCK	PREFERRED	STOCK	COMMON STOCK	ADDITIONAL
	AMOUNT	SHARES	AMOUNT	SHARES	AMOUNT	CAPITAL	DEFICIT
	-----	-----	-----	-----	-----	-----	-----
	Balances at, December 31, 2000.....						
	-- --	1,500	\$1,283,250				
		20,956,887	\$209,569				
			\$138,366,817				
			\$(130,498,187)				
			Issuance of common stock related to equity financing net of issuance cost				
	\$396,593						
	-- --	707,947	7,079				
		3,596,328					
			Exercise of warrants.....				
	-- --	1,856,333	18,563				
		2,230,603					
			Issuance of redeemable 3% convertible preferred stock, net of issuance cost				
	\$272,485						
	-- --	5000	1,542,515				
		3,185,000					
			Conversion of redeemable convertible preferred shares to common stock.....				
	-- --		(1,000)				



options..... -- --  
     552,349 Deferred  
 compensation..... --  
 (776,744) -- Amortization  
     of deferred  
 compensation.....  
     -- 1,242,408 1,242,408  
     Realized gain on short-  
         term  
 investments.....  
 (7,782,398) -- (7,782,398)  
 Unrealized loss on short-  
     term  
 investments.....  
 (8,573,936) -- (8,573,936)  
     Net  
 loss.....  
 -- -- (3,446,497) -----  
     --- Comprehensive  
     loss..... -- --  
 (12,020,433) -----  
     -----  
 Balances, December 31,  
 2001.....  
     \$ -- \$(2,270,097)  
     \$13,207,807

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STEMCELLS, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

YEAR ENDED DECEMBER 31, -----  
 ----- 2001 2000 1999 -----  
     ----- CASH FLOWS  
     FROM OPERATING ACTIVITIES: Net  
 loss.....  
     \$ (3,446,497) \$ (11,125,477) \$ (15,708,626)  
 Adjustments to reconcile net loss to net cash  
 used in operating activities: Depreciation and  
 amortization..... 648,273 738,593  
     1,717,975 Amortization of deferred  
     compensation..... 1,242,408 2,044,627  
     328,195 Compensation expense related to the  
         grant of stock  
 options..... 563,872  
 -- -- Fair market adjustment for property held  
     for  
 sale..... --  
     -- 300,000 Other non-cash  
 charges..... -- -- 320,183  
 Gain on sale of short-term investments.....  
     (7,782,398) (1,427,686) -- Gain on sale of  
     rights to technology..... (300,000) -- --  
 Loss on disposal of fixed assets.....  
     30,477 -- 1,117,286 Loss on sale of  
     intangibles..... -- -- 440,486  
 Changes in operating assets and liabilities:  
 Accrued interest receivable.....  
     12,087 25,488 164,397 Other  
 receivable..... (49,590)  
     3,000,000 -- Other current  
 assets..... 162,873 315,213  
     283,000 Other assets,  
 net..... (196,432) -- --  
 Accounts payable and accrued expenses.....  
     (1,919,195) (92,255) 1,344,142 Accrued  
     rent..... 414,259  
     203,393 279,680  
 Deposits.....  
     103,896 -- -- Deferred  
     revenue..... -- --  
 (2,500,000) -----  
     ----- Net cash used in operating  
     activities..... (10,515,967)  
     (6,318,104) (11,913,282) CASH FLOWS FROM  
 INVESTING ACTIVITIES: Proceeds from sale of

short-term investments.....	7,782,398		
1,427,686 -- Purchases of marketable securities.....	-- --	(4,397,676)	
Proceeds from sales of marketable securities.....	-- --	13,923,813	Purchases of property, plant and equipment..... (334,321)
(151,212) (192,747) Proceeds on sale of fixed assets.....	40,795 --	746,448	
Acquisition of other assets.....	(50,344)		
(886,751) (558,311) Proceeds from sale of rights to technology, net... 300,000 --	--		
Disposal of other assets.....	-- --	440,486	
-----			Net cash provided by investing activities.....
7,738,528 389,723 9,962,013			CASH FLOWS FROM FINANCING ACTIVITIES: Proceeds from issuance of common stock, net..... 5,852,573 4,401,437
145,603 Proceeds from the exercise of stock options.....	157,682 685,089	518,442	Common stock issued for agreements..... --
365,000 -- Proceeds from issuance of preferred stock, net... 4,727,515 1,500,000 --	--		Change in debt service fund..... --
609,905 -- Repayments of debt and lease obligations.....	(332,083)	(324,167)	
(1,817,500) -----			Net cash provided by (used in) financing activities.....
10,405,687 7,237,264 (1,153,455) -----			Increase (decrease) in cash and cash equivalents.....
7,628,248 1,308,883 (3,104,724)			Cash and cash equivalents at beginning of year.... 6,068,947
4,760,064 7,864,788 -----			Cash and cash equivalents at end of the year..... \$ 13,697,195 \$ 6,068,947 \$ 4,760,064
=====			Supplemental disclosure of cash flow information: Interest paid..... \$ 246,328 \$ 272,513 \$ 335,203

SEE ACCOMPANYING NOTES TO CONSOLIDATED FINANCIAL STATEMENTS.

STEMCELLS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2001

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

NATURE OF BUSINESS

StemCells, Inc. (the "Company") is a biopharmaceutical company that operates in one segment, engaged in the development of novel stem cell therapies designed to treat human diseases and disorders. Since inception, the Company has incurred annual losses and negative cash flows from operations and has an accumulated deficit of approximately \$133.9 million at December 31, 2001. The Company has not derived revenues from the sale of products, and does not expect to receive revenues from product sales for at least several years.

PRINCIPLES OF CONSOLIDATION

The consolidated financial statements include accounts of the Company and StemCells California, Inc., a wholly owned subsidiary. Significant inter-company balances and transactions have been eliminated on consolidation.

USE OF ESTIMATES

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States, that requires management to make estimates and assumptions that affect the amounts reported in

the consolidated financial statements. Actual results could differ from these estimates.

#### CASH AND CASH EQUIVALENTS

The Company considers cash equivalents to be only those investments that are highly liquid, readily convertible to cash and which mature within three months from the date of purchase.

#### AVAILABLE-FOR-SALE SECURITIES

The Company determines the appropriate classification of securities at the time of purchase and reevaluates such designation as of each balance sheet date. The Company classifies such holdings as available-for-sale securities, which are carried at fair value, with unrealized gains and losses reported as a separate component of stockholders' equity. At December 31, 2000, the Company owned 126,193 shares of Modex. The Company sold all of its shares of Modex in 2001 for a realized gain of \$7.8 million. The Company no longer holds any shares of Modex.

#### COMPREHENSIVE INCOME

Comprehensive income is comprised of net income and other comprehensive income. The only component of other comprehensive income is unrealized gains and losses on our available-for-sale securities. Comprehensive income has been disclosed in the statement of changes in redeemable preferred stock and stockholders' equity.

#### PROPERTY, PLANT AND EQUIPMENT

As a result of the Company's decision to wind down the encapsulated cell technology and relocate its corporate headquarters to California, certain property considered by management to no longer be

### STEMCELLS, INC.

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

DECEMBER 31, 2001

#### 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

necessary has been made available for sale or lease. The aggregate carrying value of such property has been reviewed by management, subject to appraisal and adjusted downward to estimated market value.

Property, plant and equipment, including that held under capital lease obligations, is stated at cost and depreciated using the straight-line method over the estimated life of the respective asset, or the lease term if shorter, as follows:

Building and improvements.....	3 - 15 years
Machinery and equipment.....	3 - 10 years
Furniture and fixtures.....	3 - 10 years

Leasehold improvements are amortized on a straight-line basis over the shorter of their estimated useful lives or lease terms.

#### PATENT AND LICENSE COSTS

Prior to fiscal year 2001, the Company capitalizes certain patent costs related to patent applications. Accumulated costs are amortized over the estimated economic life of the patents, not to exceed 17 years, using the straight-line method, commencing at the time the patent is issued. Costs related to patent applications are charged to expense at the time such patents are deemed to have no continuing value. Effective in 2001 the Company expenses all patent costs as incurred. At December 31, 2001 and 2000, total costs capitalized were \$980,000 and \$638,000 and the related accumulated amortization was \$125,000 and \$9,000, respectively. The increase in year 2001 was a result of a reclassification from licenses to patents. Patent expense totaled \$647,000, \$305,000, and \$539,000 in 2001, 2000 and 1999, respectively. License costs are capitalized and amortized over the period of the license agreement.

#### STOCK BASED COMPENSATION

The Company's employee stock option plan is accounted for under Accounting Principles Board Opinion No. 25 ("APB 25"), "Accounting for Stock Issued to



Employees." The Company grants qualified stock options for a fixed number of shares to employees with an exercise price equal to the fair market value of the shares at the date of grant. In accordance with APB 25, the Company recognizes no compensation expense for qualified stock option grants. The Company also issues non-qualified stock options for a fixed number of shares to employees with an exercise price less than the fair market value of the shares at the date of grant. When such options vest, the Company recognizes the difference between the exercise price and fair market value as compensation expense in accordance with APB 25.

The company accounts for stock options granted to non-employees in accordance with FAS No. 123--ACCOUNTING FOR STOCK-BASED COMPENSATION AND EITF 96-18--ACCOUNTING FOR EQUITY INSTRUMENTS THAT ARE ISSUED TO OTHER THAN EMPLOYEES FOR ACQUIRING, OR IN CONJUNCTION WITH SELLING, GOODS OR SERVICES, and accordingly, recognizes as expense the estimated fair value of such options as calculated using the Black-Scholes valuation model. The fair value is remeasured during the service period, and is amortized over the vesting period of each option or the recipient's contractual arrangement, if shorter.

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STEMCELLS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

DECEMBER 31, 2001

#### 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

##### LONG LIVED ASSETS

The Company routinely evaluates the carrying value of its long-lived assets. The Company records impairment losses on long-lived assets used in operations when events and circumstances indicate that assets may be impaired and the undiscounted cash flows estimated to be generated by the assets are less than the carrying amount of those assets. If an impairment exists, the charge to operations is measured as the excess of the carrying amount over the fair value of the assets.

##### INCOME TAXES

The liability method is used to account for income taxes. Deferred tax assets and liabilities are determined based on differences between financial reporting and income tax bases of assets and liabilities as well as net operating loss carry forwards and are measured using the enacted tax rates and laws that are expected to be in effect when the differences reverse. Deferred tax assets may be reduced by a valuation allowance to reflect the uncertainty associated with their ultimate realization.

##### REVENUE RECOGNITION

Revenues from collaborative agreements and grants are recognized as earned upon either the incurring of reimbursable expenses directly related to the particular research plan or the completion of certain development milestones as defined within the terms of the collaborative agreement. Payments received in advance of research performed are designated as deferred revenue. The Company recognizes non-refundable upfront license fees and certain other related fees on a straight-line basis over the development period. Fees associated with substantive at risk, performance based milestones are recognized as revenue upon their completion, as defined in the respective agreements. Incidental assignment of technology rights are recognized as revenue at time of receipt.

##### RECENT ACCOUNTING PRONOUNCEMENTS

In July 2001, the FASB issued Statement of Financial Accounting Standards No. 141, "Business Combinations" (Statement 141). This Statement addresses financial accounting and reporting for business combinations. Statement 141 supersedes APB Opinion No. 16, Business Combinations, and amends or supersedes a number of interpretations of that Opinion. Statement 141 requires that (1) all business combinations be accounted for by a single method--the purchase method, (2) all intangible assets acquired in a business combination are to be recognized as assets apart from goodwill if they meet one of two criteria--the contractual-legal criterion or the separability criterion and (3) in addition to the disclosure requirements in Opinion 16, disclosure of the primary reasons for a business combination and the allocation of the purchase price paid to the assets acquired and liabilities assumed by major balance sheet caption. When the amounts of goodwill and intangible assets acquired are significant in relation to the purchase price paid, disclosure of other information about those assets is required, such as the amount of goodwill by reportable segment and the amount

of the purchase price assigned to each major intangible asset class. The provisions of Statement 141 apply to all business combinations initiated after June 30, 2001. Statement 141 also applies to all business combinations accounted for using the purchase method for which the date of acquisition is July 1, 2001, or later. The Company will adopt the provisions of Statement 141 for any business combinations that may be initiated.

STEMCELLS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

DECEMBER 31, 2001

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

In July 2001, the FASB issued Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangibles" ("Statement 142"). Under Statement 142, goodwill and indefinite lived intangible assets are no longer amortized but are reviewed annually (or more frequently if impairment indicators arise) for impairment. Separable intangible assets that are not deemed to have an indefinite life will continue to be amortized over their estimated useful lives. The Company has not recorded any goodwill or indefinite lived intangible assets prior to December 31, 2001. The adoption of this statement as of January 1, 2002 will not have a material impact on the Company's financial position, results of operations or cash flow.

In October 2001, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" ("Statement 144"), which addresses financial accounting and reporting for the impairment or disposal of long-lived assets and supersedes Statement 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of", and the accounting and reporting provisions of APB Opinion No. 30, "Reporting the Results of Operations for a disposal of a segment of a business." Statement 144 is effective for fiscal years beginning after December 15, 2001. The Company will adopt Statement 144 as of January 1, 2002 and it does not expect that the adoption of the Statement will have a significant impact on the Company's financial position and results of operations.

RESEARCH AND DEVELOPMENT COSTS

The Company expenses all research and development costs as incurred. Research and Development costs include costs of personnel, external services, supplies, facilities and miscellaneous other costs.

NET LOSS PER SHARE

Basic and diluted net loss per share has been computed using the weighted-average number of shares of common stock outstanding during the period. The Company has excluded outstanding stock options and warrants from the calculation of diluted loss per common share because all such securities are anti-dilutive for all applicable periods presented.

RESTATEMENT OF FINANCIAL STATEMENTS

The Company has restated its consolidated statements of operations for the year ended December 31, 2001 and its unaudited consolidated statements of operations for the quarters ended March 31, 2001 and June 30, 2001. The restatement is being made in order to record additional deemed dividends for the beneficial conversion feature of the 6% Cumulative Convertible Preferred Stock which should have been recorded in connection with the subsequent change to the effective conversion price resulting from the issuance in 2001 of adjustable warrants in connection with the common stock financing transaction with Millennium Partners, LP (See note 11). Accordingly, in its restated financial statements, the Company has recorded additional deemed dividends of \$331,000 for the quarter ended March 31, 2001, \$471,000 for the quarter ended June 30, 2001 and \$802,000 for the year ended December 31, 2001 (see note 15).

2. WIND-DOWN OF ENCAPSULATED CELL TECHNOLOGY RESEARCH AND DEVELOPMENT PROGRAM

Until mid-1999, the Company engaged in research and development in encapsulated cell therapy technology, including a pain control program funded by AstraZeneca Group plc. The results from the 85-patient double-blind, placebo-controlled trial of our encapsulated bovine cell implant for the

treatment of severe, chronic pain in cancer patients did not, however, meet the criteria AstraZeneca had established for continuing trials for the therapy, and in June 1999 AstraZeneca terminated the collaboration, as allowed under the terms of the original collaborative agreement signed in 1995.

As a result of termination, management determined in July 1999 to restructure its research operations to abandon all further encapsulated cell technology research and concentrate its resources on the research and development of its proprietary platform of stem cell technologies.

The Company wound down its research and manufacturing operations in Lincoln, Rhode Island, and relocated its remaining research and development activities, and its corporate headquarters, to the

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STEMCELLS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

DECEMBER 31, 2001

2. WIND-DOWN OF ENCAPSULATED CELL TECHNOLOGY RESEARCH AND DEVELOPMENT PROGRAM  
(CONTINUED)

facilities of its wholly owned subsidiary, StemCells California, Inc., in California, in October 1999. The Company terminated legal, professional and consulting contractual arrangements in support of ECT research. The Company had used these legal, professional and consulting contractual arrangements to meet regulatory requirements in support of its research work, to support contractual arrangements with clinical sites, to provide assistance at clinical sites in administering therapy and documenting activities, and to assist in compliance with FDA and other regulations regarding its clinical trials. ECT related patent law work was also terminated. The Company also engaged professional consultants in connection with the determination to exit its ECT activities and restructure its operations, which concluded with the exit from ECT activities and relocation of its corporate headquarters to California. The Company reduced its workforce by approximately 58 employees who had been focused on ECT programs and 10 administrative employees. As a result, the Company sold excess furniture and equipment in December 1999 and is seeking to sublease the science and administrative facility and to sell the pilot manufacturing facility.

Wind-down expenses totaled \$0, \$3,327,360 and \$6,047,806, for the year ended December 31, 2001, 2000 and 1999, respectively. These expenses relate to the wind-down of our encapsulated cell technology research and other Rhode Island operations and the transfer of the corporate headquarters to California.

At December 31, 1999, the Company's \$1.6 million wind-down reserve included approximately \$1.2 million for the RIPSAT settlement and approximately \$0.4 million for Rhode Island facility for the estimated lease payments and operating costs of the Rhode Island facilities through an expected disposal date of June 30, 2000. In 2000 the Company settled with RIPSAT, paid \$1.2 million and paid 0.4 million related to Rhode Island facilities. The Company did not sublet the Rhode Island facilities in 2000 and therefore made a change in estimate to accrue additional expenses of \$3.3 million to cover operating lease payments, utilities, taxes, insurance, maintenance, interest and other non-employee expenses through 2001. In the year 2001 the Company paid \$1.7 million of expenses which were recorded against the reserve. There is no reserve remaining at December 31, 2001. Even though it is the intent of the Company to dispose of these facilities at the earliest possible time, it cannot determine with certainty a fixed date by which such disposal will occur. In light of this uncertainty, for the year 2002 and beyond, the Company will record further costs as operating expenses as incurred.

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STEMCELLS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

DECEMBER 31, 2001

2. WIND-DOWN OF ENCAPSULATED CELL TECHNOLOGY RESEARCH AND DEVELOPMENT PROGRAM  
(CONTINUED)

A description of wind-down expenses, including the amounts and periods of

recognition, are as follows:

YEAR ENDED	YEAR ENDED	DECEMBER 31,	DECEMBER
31, 2000	1999	-----	-----
		Employee severance costs..... --	
\$1,554,000		Impairment losses(1): Fixed assets.....	
		-- 800,000 ECT	
patents.....			
-- 260,000		-----	-- 1,060,000
		Rhode Island facilities carrying costs(2):	
		Corporate	
		headquarters.....	
\$3,327,000	702,000	Pilot manufacturing plant..... -- 562,000 ---	
		-----	3,327,000 1,264,000
		Employee	
outplacement.....			
		- 200,000 RIPSAT	
settlement(3).....			
-- 1,172,000		Loss on sale of assets(4): Fixed assets.....	
		-- 318,000 ECT	
patents.....			
-- 180,000		-----	-- 498,000
		Write-down of pilot	
plant(5).....			
		-----	-- 300,000 -
		-----	\$3,327,000 \$6,048,000
		=====	=====

- 
- (1) Management's estimate of the fixed asset impairment was derived from communications with an outside auction house. The patent impairment loss was based on preliminary negotiations with parties interested in acquiring the patents.
  - (2) Facilities carrying costs include operating lease payments, utilities, property taxes, insurance, maintenance, interest and other non-employee related expenses necessary to maintaining these facilities through December 31, 2001
  - (3) The Company originally received funding from the Rhode Island Partnership for Science and Technology (RIPSAT) for purposes of conducting ECT activities conditioned upon maintaining the operation within the state. RIPSAT claimed that the Company's decision to exit ECT activities and close the Rhode Island operation was in violation of the funding arrangement and that the Company was obligated to return a portion of the funding proceeds. Although the Company disputed these claims, during the fourth quarter of 1999, management determined it was in the best interest of the Company to settle the issue.
  - (4) The Company held an auction to sell all ECT fixed assets. Proceeds from that sale resulted in a loss, which was related to machinery and equipment (\$292,000), and furniture and fixtures (\$26,000).

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STEMCELLS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

DECEMBER 31, 2001

2. WIND-DOWN OF ENCAPSULATED CELL TECHNOLOGY RESEARCH AND DEVELOPMENT PROGRAM (CONTINUED)

- (5) The write-down of the pilot plant was based on an independent property appraisal.

Property held for sale at December 31, 2001 and 2000, consisted of \$3.2 million relating to the Company's pilot plant facility located in Lincoln, Rhode Island. The Company suspended depreciation of these assets in 1999. The balance reflected a \$300,000 impairment loss included as part of the additional wind-down expenses.

3. STEMCELLS CALIFORNIA, INC.

In September 1997, a merger of a wholly owned subsidiary of the Company and StemCells California, Inc. was completed. As part of the acquisition of StemCells, Richard M. Rose, M.D., became President, Chief Executive Officer and director of the Company and Dr. Irving Weissman became a director of the Company. Upon consummation of the merger, the Company entered into consulting arrangements with the principal scientific founders of StemCells: Dr. Irving Weissman, Dr. Fred H. Gage and Dr. David Anderson. Additionally, in connection with the merger, the Company was granted an option by the former shareholders of StemCells to repurchase 500,000 of the Company's shares of Common Stock exchanged for StemCells shares, upon the occurrence of certain events. To attract and retain Drs. Rose, Weissman, Gage and Anderson, and to expedite the progress of the Company's stem cell program, the Company awarded these individuals options to acquire a total of approximately 1.6 million shares of the Company's common stock, at an exercise price of \$5.25 per share, the quoted market price at the grant date. The Company also designated a pool of 400,000 options to be granted to persons in a position to make a significant contribution to the success of the stem cell program. Under the original grants, approximately 100,000 of these options were exercisable immediately on the date of grant, 1,031,000 of these options would vest and become exercisable only upon the achievement of specified milestones related to the Company's stem cell development program and the remaining 468,750 options would vest over eight years. In connection with the 468,750 options issued to a non-employee, Dr. Anderson, the Company recorded deferred compensation of \$1,750,000, the fair value of such options at the date of grant, which will be amortized over an eight-year period. The deferred compensation expense associated with the unvested portion of the grants as of December 31, 2001 was \$968,000. The fair value was determined using the Black-Scholes method.

Effective October 31, 2000, the Company agreed with Drs. Weissman and Gage to revise their 468,750 milestone-vesting stock options to time-based vesting, on the same schedule as Dr. Anderson's option. Under each of the revised options, 168,750 shares vested immediately, and the remaining 300,000 shares will vest at 50,000 per year on September 25, until September 25, 2005, when the final 100,000 shares will vest. The exercise price remains \$5.25 per share. The Company recorded \$1,647,000 and \$692,000 for the year 2000 and 2001 respectively, as compensation expense for the fair market value of the vested portion of such options in an amount determined using the Black-Scholes method. The deferred compensation expense associated with the unvested portion of the grants was determined to be approximately \$1,104,000 at December 31, 2001. As part of the revision of the options, Drs. Weissman and Gage relinquished all rights under an agreement. These individuals had the right to license the non-brain stem cell technology in exchange for a payment to the Company equal to all prior funding for such research plus royalty payments. The Company plans to revalue the options using the Black-Scholes method on a quarterly basis and recognize additional compensation expense accordingly.

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STEMCELLS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

DECEMBER 31, 2001

#### 4. INVESTMENTS

In October 1997, the Company completed a series of transactions, which resulted in the establishment of its previously 50%-owned Swiss subsidiary, Modex Therapeutics, Ltd., (Modex) as an independent company.

In April 1998, Modex completed an additional equity offering, in which the Company did not participate. This resulted in a reduction in the Company's ownership to less than 20% ownership; therefore, the Company accounted for this investment under the cost method from that date. On June 23, 2000, Modex completed an initial public offering of its common stock. At December 31, 2000, the Company owned 126,193 shares of Modex. On January 9, 2001, the Company sold 22,616 Modex shares for a net price of 182.00 Swiss francs per share, which converts to \$112.76 per share, for total proceeds of \$2,550,230. On May 01, 2001, the Company sold its remaining shares in Modex for a net price of 87.30 Swiss Francs per share, which converts to approximately \$50.51 per share, for total proceeds of approximately \$5,232,168, net of commissions and fees. The Company no longer holds any shares of Modex.

#### 5. ASSIGNMENT OF RIGHTS

On April 30, 2001, in consideration for \$300,000 received from Modex and the assistance of Modex in executing the sale of StemCells' holding of Modex shares, StemCells agreed to assign to Modex the rights concerning future payments under

the Asset Purchase and License Agreement between the Company and Neurotech SA, by which Neurotech SA purchased the Company's former encapsulated cell therapy technology.

6. PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment consists of the following:

DECEMBER 31, -----		
- 2001	2000	-----
	Building and	
improvements.....		
\$ 715,397	\$ 703,095	Machinery and
equipment.....		
1,884,581	1,766,448	Furniture and
fixtures.....		
273,999	188,736	-----
--	2,873,977	2,658,279
	Less	
	accumulated depreciation and	
	amortization.....	(1,654,658)
(1,207,218)	-----	-----
1,219,319	\$ 1,451,061	=====
	=====	

Depreciation expense was \$495,000, \$451,000, and \$1,436,000 for the years ending December 31, 2001, 2000 and 1999, respectively.

Certain property, plant and equipment in Rhode Island were acquired under capital lease obligations. These assets totaled \$5,827,000 at December 31, 2001 and 2000, respectively, with related accumulated amortization of \$2,747,000 at December 31, 2001 and 2000, respectively. As a result of the Company's decision to wind down its operations in Rhode Island and relocate to California, this property has been classified as held for sale.

STEMCELLS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

DECEMBER 31, 2001

7. OTHER ASSETS, NET

Other assets are as follows:

DECEMBER 31, -----	2001	
2000 -----	Patents,	
net.....		
\$ 854,974	\$ 629,203	License agreements,
net.....	380,092	
669,000	Security deposit--building	
lease.....	752,500	750,000
	Deposit--	
other.....		
4,641	16,321	Deferred financing costs,
net.....	--	109,388
	Restricted Cash--(Letter of	
Credit).....	275,000	--
-----	\$2,267,207	\$2,173,912
	=====	=====

At December 31, 2001 and 2000, accumulated amortization was \$1,293,000 and \$1,140,000, respectively, for patents and license agreements.

8. ACCRUED EXPENSES

Accrued expenses are as follows:

DECEMBER 31, -----	2001	2000	-----
	External		
services.....			\$
	88,649	\$219,051	Employee
compensation.....		173,645	
	109,007		
Other.....			

9. LEASES

The Company has undertaken direct financing transactions with the State of Rhode Island and received proceeds from the issuance of industrial revenue bonds totaling \$5,000,000 to finance the construction of its pilot manufacturing facility. The related leases are structured such that lease payments will fully fund all semiannual interest payments and annual principal payments through maturity in August 2014. Fixed interest rates vary with the respective bonds' maturities, ranging from 5.1% to 9.5%. The bonds contain certain restrictive covenants which limit, among other things, the payment of cash dividends and the sale of the related assets.

STEMCELLS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

DECEMBER 31, 2001

9. LEASES (CONTINUED)

The Company entered into a fifteen-year lease for a laboratory facility in connection with a sale and leaseback arrangement in 1997. The lease has a rent escalation clause and accordingly, the Company is recognizing rent expense on a straight-line basis. At December 31, 2001, the Company had \$918,528 in deferred rent expense for this facility.

As of February 1, 2001, the Company entered into a 5-year lease for a 40,000 square foot facility located in the Stanford Research Park in Palo Alto, CA. The new facility includes space for animals, laboratories, offices, and a GMP (Good Manufacturing Practices) suite. GMP facilities can be used to manufacture materials for clinical trials. The rent will average approximately \$3.15 million per year over the term of the lease. In addition the Company has issued a letter of credit amounting to \$275,000 to serve as a deposit for the duration of the lease. The lease has a rent escalation clause and accordingly, the Company is recognizing rent expense on a straight-line basis. At December 31, 2001 the Company had \$201,477 in deferred rent expense for this facility. The lease on the Company's former Sunnyvale headquarters was terminated on August 31, 2001.

As of December 31, 2001, future minimum lease payments and sublease income under operating and capital leases and principal payments on equipment loans are as follows:

	CAPITAL	OPERATING	SUBLEASE	LEASES
	LEASES	LEASES	LEASES	INCOME
2002.....	\$ 519,719	\$ 2,308,838	\$1,265,692	
2003.....	436,909	4,568,274	2,000,746	
2004.....	425,713	4,677,197	2,016,578	
2005.....	412,587	4,789,388	2,072,545	
2006.....	401,289	1,268,120	675,653	
Thereafter.....	1,910,288	7,529,296		
	----- Total minimum lease payments.....			4,106,505
	\$25,141,113	\$8,031,214	Less amounts representing interest.....	1,501,505
	----- Present value of minimum lease payments.....			2,605,000
		-- --	Less current maturities.....	289,167
	----- Capitalized lease obligations, less current maturities.....			\$2,315,833
		-- --	=====	=====
			=====	

Rent expense for the years ended December 31, 2001, 2000 and 1999, was \$2,629,000, \$1,111,000 and \$947,000 respectively.

#### 10. GRANTS

In February 2001, the Company was awarded a two-year, \$300,000 per year grant from the National Institutes of Health's Small Business Innovation Research (SBIR) office. The grant, which will support joint work with virologist Dr. Jeffrey Glenn at Stanford University, is aimed at characterizing the human cells that can be infected by human hepatitis viruses and to develop a small animal model using the cells that are most infectable by these viruses to develop screening assays and identify novel drug for the disease. The Company received \$300,000, of which \$150,367 represents the Company's

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STEMCELLS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

DECEMBER 31, 2001

#### 10. GRANTS (CONTINUED)

share of the joint effort through June 30, 2001 and has been recognized as revenue. The remainder, \$149,633, was paid to Stanford University as its share of the joint effort. In addition the Company received and recognized as revenue \$298,614 for research from a prior SBIR grant relating to the neural program.

On September 30 2001, the Company was awarded a four-year, \$225,000 per year grant from the National Institute of Diabetes & Digestive & Kidney Disorders of the National Institutes of Health for the Company's liver stem cell program which focuses on identifying liver stem and progenitor cells for the treatment of liver diseases. The grant is subject to the availability of funds and satisfactory progress of the project. As of December 31, 2001 the Company has recognized \$56,250 related to this award.

#### 11. STOCKHOLDERS' EQUITY

##### SALE OF COMMON STOCK

On August 3, 2000, the Company completed a \$4 million common stock financing transaction with Millennium Partners, LP at \$4.33 per share. In the purchase agreement, the Company granted Millennium an option to purchase up to an additional \$3 million of its common stock. Millennium exercised its option to purchase \$1 million of the Company's common stock on August 23, 2000 at \$5.53 per share. On June 8, 2001, Millennium exercised its remaining option to purchase \$2 million of the Company's common stock at \$4.3692 per share. As a result of the financing agreement, Millennium received five year warrants to purchase 101,587 shares of common stock at \$4.725 per share, 19,900 shares of common stock at \$6.03 per share, and 50,352 shares at \$4.7664 per share. The warrants are callable by StemCells any time at \$7.875, \$10.05 and \$7.944 per underlying share respectively. The calculated value of these callable warrants using the Black-Scholes method is \$701,073, which is accounted for as stock issuance cost.

In addition to the above, Millennium was issued adjustable warrants in connection with the original \$4 million purchase, each of which entitled Millennium to receive additional shares on eight dates beginning six months from the respective closing dates and every three months thereafter. The adjustable warrants could be exercised at any time prior to the thirtieth day after the last of such dates. The number of additional shares Millennium was entitled to on each date was based on the number of shares of common stock Millennium continued to hold on each date and the market price of the Company's common stock over a period prior to each date. The exercise price per share under the adjustable warrant was \$0.01. Millennium exercised the first of the adjustable warrants to purchase 463,369, 622,469, and 25,804 shares on March 30, 2001, July 26, 2001 and August 15, 2001 respectively at \$0.01 per share. The Company has accounted for the sale of the stock and warrants by adding that portion of the proceeds equal to the par value of the new shares to common stock and the balance including the value of the warrants to additional paid in capital. On December 4, 2001, the Company entered into an agreement with Millennium under which it issued 176,101 shares of the Company's common stock as a final cashless exercise of all outstanding adjustable warrants that Millennium was entitled to or would be entitled to. Immediately following delivery of these shares, any further right to acquire common stock under these adjustable warrants was cancelled by the agreement.



## STEMCELLS, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

DECEMBER 31, 2001

## 11. STOCKHOLDERS' EQUITY (CONTINUED)

## EQUITY LINE

On May 10, 2001, the Company entered into a common stock purchase agreement with Sativum Investments Limited for the potential future issuance and sale of up to \$30,000,000 of the Company's common stock, subject to restrictions and other obligations. The Company, at its sole discretion, may draw down on this facility, from time to time, and Sativum is obligated to purchase shares of the Company's common stock at a 6% discount to a volume weighted average market price over the 20 trading days following the draw-down notice. The Company's volume weighted average market price is calculated by adding the total dollars traded in every transaction in a given trading day and dividing that number by the total number of shares traded during that trading day. The Company is limited with respect to how often it can exercise a draw down and the amount of each draw down.

In connection with the Company's execution of the common stock purchase agreement with Sativum, the Company issued three three-year warrants to purchase an aggregate of 350,000 shares of the Company's common stock at \$2.38 per share to Sativum (250,000 shares), Pacific Crest Securities Inc. (75,000 shares) and Granite Financial Group, Inc. (25,000 shares). The Company has valued the warrants using the Black-Scholes method and recorded the fair value in stockholders' equity. These amounts are \$522,500, \$167,750 and \$55,250 respectively. The exercise price and number of shares are subject to adjustment for subdivisions, combinations, stock dividends and reorganizations.

The Company cannot sell more than 3,922,606 shares pursuant to the common stock purchase agreement without stockholder approval. The Company delivered a draw down notice to Sativum Investments Limited, dated as of July 11, 2001, exercising the Company's right to draw down up to \$5,000,000 at a market-based share price not less than \$5.00 per share beginning July 12, 2001. Sativum purchased a total of 707,947 shares of the Company's common stock at an average purchase price of \$5.65 per share, net of Sativum's discount of six percent. Because the market based price of the Company's common stock was less than \$5.00 for four trading days during the draw down period, the \$5,000,000 request was reduced to \$4,000,000. The Company's placement agents, Pacific Crest Securities, Inc. and Granite Financial Group, Inc. received \$80,000 and \$40,000, respectively, as placement fees in connection with this draw down, resulting in net proceeds to the Company of \$3,603,407, after paying escrow fees and other associated costs. The Company's placement agents have exercised their warrants in full, and the Company has received payment of \$238,050 for the shares issued to them.

## 3% CUMULATIVE CONVERTIBLE PREFERRED STOCK

On December 4, 2001, the Company issued 5,000 shares of 3% cumulative convertible preferred stock to Riverview Group, L.L.C., (Riverview Group), a wholly owned subsidiary of Millennium Partners, L.P. plus a 5-year warrant to purchase 350,877 shares of common stock at \$3.42 per share. The Company received net proceeds of \$4,727,515. This preferred stock is convertible into shares of the Company's common stock at a conversion price of \$2.00 per share at the option of Riverview Group. The preferred stock contains a mandatory redemption feature where the Company will redeem unconverted preferred stock on December 4, 2003. The conversion price is subject to adjustment for stock splits, dividends, distributions, reclassifications and similar events. The conversion price may be below the trading market price at the time of the conversion. The final closing on the NASDAQ National Market of the Company's common stock on December 4, 2001 was \$2.90 per share. The

## STEMCELLS, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

DECEMBER 31, 2001

## 11. STOCKHOLDERS' EQUITY (CONTINUED)

company has valued the warrants and the beneficial conversion feature reflecting the Dec 4, 2001 commitment date and the most beneficial per share discount available to the preferred shareholders. As the preferred shares contain a stated redemption, such value of \$3,185,000, including issuance costs of \$272,485, is recorded as a discount to the preferred shares. The preferred shares will be accreted to its mandatory redemption amount and the accretion will result in a deemed dividend. The deemed dividend has been reflected as an adjustment to net loss applicable to common stockholders. The Company filed a registration statement on Form S-3 covering the shares of common stock underlying the 3% Cumulative Convertible Preferred Stock, and the SEC declared it effective on January 10, 2002. On December 7, 2001, Riverview Group converted 1,000 shares of its 3% cumulative convertible preferred stock for 500,125 shares of the Company's common stock. The holders of the preferred stock have liquidation rights equal to their original investment plus accrued but unpaid dividends.

#### 6% CUMULATIVE CONVERTIBLE PREFERRED STOCK

On April 13, 2000 the Company issued 1,500 shares of 6% cumulative convertible preferred stock plus a warrant for 75,000 shares of our common stock to two members of its Board of Directors for \$1,500,000 on terms more favorable to the Company than it was then able to obtain from outside investors. The shares are initially convertible at the option of the holders into common stock at \$3.77 per share (based on the face value of the preferred shares), and will be converted automatically on April 13, 2002 if they have not been converted before then. The conversion price is subject to adjustment upon certain equity transactions, as defined by the applicable agreement and may be below the trading market price of the stock at the time of conversion. The Company has valued the beneficial conversion feature reflecting the April 13, 2000 commitment date and the most beneficial per share discount available to the preferred shareholders. Such value was \$481,000 and is treated as a deemed dividend as of the commitment date. The holders of the preferred stock have liquidation rights equal to their original investment plus accrued but unpaid dividends.

During the first and second quarters of 2001, the conversion price was reduced as a result of the issuance of adjustable warrants to Millennium LP, as described above. The Company has revalued the beneficial conversion feature reflecting the reduced conversion prices and the most beneficial per share discount available to the preferred shareholders and has recorded additional deemed dividends aggregating \$802,000 as of the applicable reset dates.

In July 2001, the SEC staff made a staff announcement, "Classification and Measurement of Redeemable Securities", (EITF D-98) which clarifies Rule 5-02.28 of Regulation S-X, which was previously adopted in accounting series Release No. 268, "Presentation in Financial Statements of Redeemable Preferred Stock". This announcement addresses financial statement classification and measurement of securities subject to mandatory redemption requirements or whose redemption is outside of the control of the issuer. Rule 5-02.28 requires preferred securities that are redeemable for cash or other assets to be classified outside of permanent equity if they are redeemable (1) at a fixed or determinable price on a fixed or determinable date (2) at the option of the holder, or (3) upon the occurrence of an event that is not solely within the control of the issuer.

The 6% cumulative convertible preferred stock issued in April 2000 was classified with stockholders' equity since issuance. The agreement provides that a mandatory redemption is triggered if a change in control occurs. A purchaser could acquire a majority of the voting power of the outstanding stock, without Company approval, thereby triggering a redemption. Accordingly the Company has reclassified the 6% cumulative convertible preferred stock outside of permanent equity for all periods presented, in accordance with the transition guidance of EITF D-98. Since a majority of the outstanding stock of the Company is the control of outside investors, a hostile takeover or other sale could occur outside the control of the Company and thereby trigger a change in control and ultimately a redemption. There is no accretion of the fair value of the preferred shares to its

#### 11. STOCKHOLDERS' EQUITY (CONTINUED)

redemption amount because the redemption is uncertain. The redemption only takes place when the Company's outside investors vote for a takeover or a sale and



1,287,918 \$3.74 731,523 \$ 4.01  
 594,216 \$3.44 =====  
 =====

FAS 123 DISCLOSURES

The Company has adopted the disclosure provisions only of Statement of Financial Accounting Standards No. 123, ACCOUNTING FOR STOCK-BASED COMPENSATION ("FAS 123") and accounts for its stock option plans in accordance with the provisions of APB 25, ACCOUNTING FOR STOCK ISSUED TO EMPLOYEES.

The following table presents weighted average price and life information about significant option groups outstanding at December 31, 2001:

OPTIONS OUTSTANDING  
 OPTIONS EXERCISABLE ---  
 -----  
 -----  
 ----- WEIGHTED  
 AVERAGE WEIGHTED  
 WEIGHTED REMAINING  
 AVERAGE AVERAGE NUMBER  
 CONTRACTUAL EXERCISE  
 NUMBER EXERCISE RANGE  
 OF EXERCISE PRICES  
 OUTSTANDING LIFE (YRS.)  
 PRICE EXERCISABLE PRICE  
 - - - - -  
 - - - - -  
 - - - - -  
 -- ----- Less than  
 \$5.00.....  
 1,884,560 8.71 \$ 2.53  
 832,046 \$ 2.32 \$5.01 -  
 \$10.00.....  
 1,687,000 5.88 5.25  
 374,872 5.28 Greater  
 than  
 \$10.00.....  
 81,000 0.94 11.03  
 81,000 11.03 -----  
 ----- 3,652,560  
 1,287,918 =====  
 =====

Pursuant to the requirements of FAS 123, the following are the pro forma net loss and net loss per share amounts for 2001, 2000, and 1999, as if the compensation cost for the option plans and the stock purchase plan had been determined based on the fair value at the grant date for grants in 2001, 2000, and 1999, consistent with the provisions of FAS 123:

2001 2000 1999 -  
 -----  
 -----  
 -----  
 -----  
 -----  
 -----  
 AS REPORTED PRO  
 FORMA AS  
 REPORTED PRO  
 FORMA AS  
 REPORTED PRO  
 FORMA -----  
 - - - - -  
 - - - - -  
 - - - - -  
 - - - - -  
 - - - - -  
 - Net

loss.....  
 \$(3,446,497)  
 \$(5,201,774)  
 \$(11,125,477)  
 \$(12,160,752)  
 \$(15,708,626)  
 \$(15,764,569)  
 Net loss per  
 share... \$ (.22)  
 \$ (.30) \$ (.58)



STEMCELLS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

DECEMBER 31, 2001

12. RESEARCH AGREEMENTS (CONTINUED)

in 2000, and \$0 in 2001. In addition, the Company agreed to issue to Scripps 4,837 shares of the Company's common stock and a stock option to purchase 9,674 shares of the Company's Common Stock with an exercise price of \$.01 per share upon the achievement of specified milestones. Under the Agreement, StemCells has an option for an exclusive license to the inventions resulting from the sponsored research, subject to the payment of royalties and certain other amounts, and is obligated to make payments totaling \$425,000 for achievement of certain milestones. The Company also entered a Sponsored Research Agreement and a License Agreement with Oregon Health Sciences University ("OHSU") in March 1997, relating to other certain research concerning liver repopulating cells. Under subsequent Sponsored Research Agreements with OHSU, StemCells paid OHSU approximately \$80,500 in 2000 and \$105,000 in 2001. In addition, the Company issued 4,838 shares of common stock and an option to purchase up to 62,888 additional shares to OHSU with an exercise price of \$.01 per share, 9,675 of which have vested by passage of time and the others of which will vest, if at all, on the achievement of specified milestones.

In 2001, the Company entered into a collaboration with Stanford University to pursue certain additional research funded by the National Institutes of Health under an SBIR grant discussed above. Pursuant to its agreement, the Company paid Stanford approximately \$150,000 in 2001.

13. INCOME TAXES

Deferred income taxes reflect net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant components of the Company's deferred tax assets and liabilities are as follows:

DECEMBER 31,	-----	2001	2000	-----
	-----			-----
		Deferred tax assets: Capitalized		
		research and development costs..... \$		
		3,770,000	\$ 6,000,000	Net operating
				losses..... 43,700,000
		44,000,000		Research and development
			4,460,000	credits..... 4,260,000
				Other.....
		80,000	893,000	----- Deferred tax
				liabilities: Unrealized gain on
				investments..... -- (6,543,000)
				Valuation
				allowance.....
		(52,010,000)	(48,610,000)	=====
				===== Net
				deferred tax assets.....
		\$ --	\$ --	=====

Realization of deferred tax assets is dependent upon future earnings, if any, the timing and amount of which are uncertain. Accordingly, the net deferred tax assets have been fully offset by a valuation allowance. The valuation allowance increased by \$3,400,000, \$1,084,000 and \$6,272,000 during 2001, 2000 and 1999, respectively.

As of December 31, 2001 the Company had net operating loss carryforwards for federal income tax purposes of approximately \$110,000,000 which expire in the years 2004 through 2021, and federal research and development tax credits of approximately \$4,100,000 which expire in the year 2004 through 2021.

STEMCELLS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

DECEMBER 31, 2001

13. INCOME TAXES (CONTINUED)

Utilization of the Company's net operating loss may be subject to substantial annual limitation due to ownership change limitations provided by the Internal Revenue Code and similar state provisions. Such an annual limitation could result in the expiration of the net operating loss before utilization.

14. EMPLOYEE RETIREMENT PLAN

The Company has a qualified defined contribution plan covering substantially all employees. Participants are allowed to contribute a fixed percentage of their annual compensation to the plan and the Company matches 50% of employee contributions, up to a maximum of 6% of the employee's compensation, with the Company's common stock. The related expense was \$63,000, \$33,000, and \$103,000 for the years ended December 31, 2001, 2000 and 1999, respectively.

15. QUARTERLY FINANCIAL INFORMATION (UNAUDITED)

QUARTER	FIRST	SECOND	THIRD	FOURTH (RESTATED)	(RESTATED)	
						-----
						(IN THOUSANDS, EXCEPT
						PER SHARE DATA) 2001: Total
revenue.....		\$ 100	\$ 300	\$ 276	\$ 129	Operating
expenses.....		3,959	2,119	3,672		Net income
(loss).....		1,595	(1,787)	(3,524)		Basic and diluted net
						income(loss) per share applicable to common
Shareholders, as reported.....		\$ 0.07	\$ (0.08)	\$ (0.19)		Basic and diluted net income
						(loss) per share applicable to common Shareholders,
						restated (1)..... * \$ 0.05 \$ (0.08) \$
						(0.19) 2000: Net
revenue.....		\$ --	\$ --	\$ --	\$ 74	Operating
expenses.....		1,939	2,553	6,378		Net
loss.....		(1,794)	(532)	(2,539)	(6,260)	Basic and diluted net
						loss per share applicable to common
shareholders.....		\$(0.09)	\$(0.04)	\$( 0.13)	\$( 0.30)	Cumulative effect of
						a change in accounting principle.... -- -- -- \$ (0.01)

\* Less than \$(0.01) per share

(1) The unaudited quarterly financial information for the first and second quarters of 2001 have been restated to reflect additional deemed dividends to preferred shareholders of \$331,000 for the quarter ended March 31, 2001 and \$471,000 for the quarter ended June 30, 2001.

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

Not applicable.

PART III

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT, PROMOTERS AND CONTROL

The information required by this Item is incorporated by reference from our Proxy Statement for the Annual Meeting of Shareholders to be held on May 2, 2002.

ITEM 11. EXECUTIVE COMPENSATION

The information required by this Item is incorporated by reference from our Proxy Statement for the Annual Meeting of Shareholders to be held on May 2, 2002.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

The information required by this Item is incorporated by reference from our Proxy Statement for the Annual Meeting of Shareholders to be held on May 2,

2002.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

The information required by this Item is incorporated by reference from our Proxy Statement for the Annual Meeting of Shareholders to be held on May 2, 2002.

PART IV

ITEM 14. EXHIBITS, FINANCIAL STATEMENT SCHEDULES AND REPORTS ON FORM 8-K

(a) DOCUMENTS FILED AS PART OF THIS FORM 10-K/A.

(1) Financial Statements:

The financial statements filed as part of this Report are listed and indexed under Item 8 above.

(2) Financial Statement Schedules:

Schedules not included herein are omitted because they are not applicable or the required information appears in the Financial Statements or Notes thereto.

(3) Exhibits.

EXHIBIT NO.  
TITLE OR  
DESCRIPTION

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3.1\*  
Restated  
Certificate  
of  
Incorporation  
of the  
Registrant

3.2++  
Amended and  
Restated By-  
Laws of the  
Registrant.

4.1\*  
Specimen  
Common Stock  
Certificate.

4.2++++ Form  
of Warrant  
Certificate  
issued to a  
certain  
purchaser of  
the

Registrant's  
Common Stock  
in April  
1995. 4.3X

Warrant to  
Purchase  
Common  
Stock--Mark

Angelo 4.4X  
Warrant to  
Purchase  
Common  
Stock--

Robert  
Farrell 4.5X  
Warrant to  
Purchase  
Common  
Stock--

Joseph  
Donahue





Preferences and  
Relative,  
Participating,  
Optional and  
other Special  
Rights of  
Preferred Stock  
and  
Qualifications,  
Limitations and  
Restrictions  
Thereof of 3%  
Cumulative  
Convertible  
Preferred Stock  
for StemCells,  
Inc. 4.17{\*\*}  
Warrant to  
Purchase Common  
Stock--  
Riverview  
Group, LLC  
4.18XXXX  
Warrant to  
Purchase Common  
Stock--Cantor  
Fitzgerald &  
Co. 10.1\*  
Amendment to  
Registration  
Rights dated as  
of February 14,  
1992 among the  
Registrant and  
certain of its  
stockholders.  
10.2\* Form of  
at-will  
Employment  
Agreement  
between the  
Registrant and  
most of its  
employees.  
10.3\* Form of  
Agreement for  
Consulting  
Services  
between the  
Registrant and  
members of its  
Scientific  
Advisory Board.  
10.4\* Form of  
Nondisclosure  
Agreement  
between the  
Registrant and  
its  
Contractors.  
10.5\* Master  
Lease and  
Warrant  
Agreement dated  
April 23, 1991  
between the  
Registrant and  
PacifiCorp  
Credit, Inc.  
10.6\* 1988  
Stock Option  
Plan. 10.7\*  
1992 Equity  
Incentive Plan.  
10.8\* 1992  
Stock Option  
Plan for Non-  
Employee  
Directors.  
10.9\*!!!! 1992  
Employee Stock

Purchase Plan.  
10.12++  
Research  
Agreement dated  
as of March 16,  
1994 between  
NeuroSpheres,  
Ltd. and  
Registrant.  
10.13++ Term  
Loan Agreement  
dated as of  
September 30,  
1994 between  
The First  
National Bank  
of Boston and  
Registrant.

EXHIBIT NO.  
TITLE OR  
DESCRIPTION - --

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10.14++ Lease  
Agreement  
between the  
Registrant and  
Rhode Island  
Industrial  
Facilities  
Corporation,  
dated as of  
August 1, 1992.

10.15++ First  
Amendment to  
Lease Agreement  
between  
Registrant and  
The Rhode Island  
Industrial  
Facilities  
Corporation  
dated as of  
September 15,  
1994.

10.17\*\*++++  
Development,  
Marketing and  
License  
Agreement, dated  
as of March 30,  
1995 between  
Registrant and  
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10.18++++ Form  
of Unit Purchase  
Agreement to be  
executed by the  
purchasers of  
the Common Stock  
and Warrants  
offered in April  
1995.

10.19+++  
Form of Common  
Stock Purchase  
Agreement to be  
executed among  
the Registrant  
and certain  
purchasers of  
the Registrant's  
Common Stock.

10.22### Lease Agreement dated as of November 21, 1997 by and between Hub RI Properties Trust, as Landlord, and CytoTherapeutics, Inc., as Tenant.

10.24!! CTI individual stockholders option agreement dated as of July 10, 1996 among the Company and the individuals listed therein.

10.25!! CTI Valoria option agreement dated of July 10, 1996 between the Company and the Societe Financiere Valoria SA.

10.26!!! Term Loan Agreement dated as of October 22, 1996 between The First National Bank of Boston and the Registrant.

10.27\*\*\* Agreement and Plan of Merger dated as of August 13, 1997 among StemCells, Inc., the Registrant and CTI Acquisition Corp. 10.28\*\*\*

Consulting Agreement dated as of September 25, 1997 between Dr. Irving Weissman and the Registrant.

10.29### Letter Agreement among each of Dr. Irving Weissman and Dr. Fred H. Gage and the Registrant.

10.32\*\*\*\* StemCells, Inc. 1996 Stock Option Plan.

10.33\*\*\*\* 1997 StemCells Research Stock Option Plan (the "1997 Plan")

10.34\*\*\*\* Form of Performance-Based Incentive Option Agreement issued under the 1997 Plan.

10.35### Employment Agreement dated as of September 25, 1997 between

Dr. Richard M.  
Rose and the  
Registrant.  
10.38{\*} Rights  
Agreement, dated  
as of July 27,  
1998 between  
Bank Boston,  
N.A. as Rights  
Agent and the  
Registrant.  
10.40\$\*\*  
Consulting  
Services  
Agreement dated  
as of July 27,  
1998, as amended  
December 19,  
1998 between Dr.  
John J. Schwartz  
and the  
Registrant.  
10.41\$\*\* Letter  
Agreement dated  
as of December  
19, 1998 between  
John J. Schwartz  
and the  
Registrant.  
10.42\$\*\* License  
Agreement dated  
as of October  
27, 1998 between  
The Scripps  
Research  
Institute and  
the Registrant.  
10.43\$\*\* License  
Agreement dated  
as of October  
27, 1998 between  
The Scripps  
Research  
Institute and  
the Registrant.

EXHIBIT NO.  
TITLE OR  
DESCRIPTION  
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- - - - -  
- - - - -  
10.44\$\*\*  
License  
Agreement  
dated as of  
November  
20, 1998  
between The  
Scripps  
Research  
Institute  
and the  
Registrant.  
10.45\$\*\*  
Purchase  
Agreement  
and License  
Agreement  
dated as of

December  
29, 1999  
between  
Neurotech  
S.A. and  
the  
Registrant.  
10.46\*\*  
License  
Agreement  
dated as of  
June 1999  
between The  
Scripps  
Research  
Institute  
and the  
Registrant.  
10.47\*\*  
License  
Agreement  
dated as of  
June 1999  
between The  
Scripps  
Research  
Institute  
and the  
Registrant.  
10.48X Form  
of  
Registration  
Rights  
Agreement  
dated as of  
July 31,  
2000  
between the  
Registrant  
and  
investors.  
10.49X  
Subscription  
Agreement  
dated as of  
July 31,  
2000  
between the  
Registrant  
and  
Millennium  
Partners,  
L.P.  
10.50XXX  
Common  
Stock  
Purchase  
Agreement,  
dated as of  
May 10,  
2001,  
between the  
Registrant  
and Sativum  
Investments  
Limited.  
10.51XXX  
Escrow  
Agreement,  
dated as of  
May 10,  
2001, among  
the  
Registrant,  
Sativum  
Investments  
Limited and  
Epstein,  
Becker &  
Green, P.C.  
10.52XX

License Agreement, dated as of October 30, 2000, between the Registrant and NeuroSpheres Ltd.

10.53XX Letter Agreement, dated January 2, 2001, between the Registrant and Martin McGlynn

10.54XX Lease, dated February 1, 2001, between the Board of Trustees of Stanford University and the Registrant.

10.55XXX Registration Rights Agreement, dated as of June 21, 2001, by and between the Registrant and Millennium Partners, L.P.

10.56XXX Subscription Agreement, dated as of June 21, 2001, by and between the Registrant and Millennium Partners, L.P.

10.57\$\$\$ 2001 Equity Incentive Plan

10.58{\*\*} Subscription Agreement, dated as of December 4, 2001 between the Registrant and Riverview Group, L.L.C.

10.59{\*\*} Registration Rights Agreement, dated as of December 4,

2001  
between the  
Registrant  
and  
Riverview  
Group,  
L.L.C.  
10.60{\*\*}  
Agreement  
dated as of  
December 4,  
2001  
between the  
Registrant  
and  
Millennium  
Partners,  
L.P.  
10.61{\*\*}  
Agreement  
dated as of  
December 4,  
2001 among  
the  
Registrant,  
Millennium  
Partners,  
L.P. and  
Riverview  
Group,  
L.L.C. 21X  
Subsidiaries  
of the  
Registrant.

EXHIBIT NO.  
TITLE OR  
DESCRIPTION

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23.1  
Consent of  
Ernst &  
Young LLP,  
Independent  
Auditors.  
99.1XX Side  
Letter,  
dated March  
17, 2001,  
between the  
Company and  
Oleh S.  
Hnatiuk  
regarding  
NeuroSpheres  
License  
Agreement,  
dated  
October 30,  
2000.

- - - - -

++ Previously filed with the Commission as Exhibits to, and incorporated herein by reference to, the Registrant's Registration Statement on Form S-1, File No. 33-85494.

+++ Previously filed with the Commission as Exhibits to, and incorporated



herein by reference to, the Registrant's Registration Statement on Form S-3, File No. 33-97272.

++++ Previously filed with the Commission as Exhibits to, and incorporated herein by reference to, the Registrant's Registration Statement on Form S-1, File No. 33-91228.

\* Previously filed with the Commission as Exhibits to, and incorporated herein by reference to, Registration Statement on Form S-1, File No. 33-45739.

# Previously filed with the Commission as Exhibits to, and incorporated herein by reference to, the Registrant's Annual Report on Form 10-K for fiscal year ended December 31, 1992 and filed March 30, 1993.

\*\* Confidential treatment requested as to certain portions. The term "confidential treatment" and the mark "\*\*\*" as used throughout the indicated Exhibits mean that material has been omitted and separately filed with the Commission.

## Previously filed with the Commission as Exhibits to, and incorporated herein by reference to, the Registrant's Quarterly Report on Form 10-Q for the quarter ended March 31, 1994 and filed on May 14, 1994.

+ Previously filed with the Commission as Exhibits to, and incorporated herein by reference to, the Registrant's Annual Report on Form 10-K for the fiscal year ended December 31, 1993 and filed on March 30, 1994.

! Previously filed with the Commission as an Exhibit to and incorporated by reference to, the Registrant's Quarterly Report on Form 10-Q for the quarter ended March 31, 1996.

!! Previously filed with the Commission as an Exhibit to and incorporated by reference to, the Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 1996.

!!! Previously filed with the Commission as an Exhibit to, and incorporated herein by reference to, the Registrant's Annual Report on Form 10-K for the fiscal year ended December 31, 1996 and filed on March 31, 1997.

!!!! Previously filed with the Commission as an Exhibit to, and incorporated herein by reference to, the Registrant's Annual Report on Form 10-K for the fiscal year ended December 31, 1995.

\*\*\* Previously filed with the Commission as Exhibits to, and incorporated herein by reference to, the Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 1997 and filed on November 14, 1997.

\*\*\*\* Previously filed with the Commission as Exhibits to, and incorporated herein by reference to, the Registrant's Registration Statement on Form S-8, File No. 333-37313.

#### Previously filed with the Commission as an Exhibit to, and incorporated herein by reference to, the Registrant's annual report on Form 10-K for the fiscal year ended December 31, 1997 and filed on March 30, 1998.

63

{\*} Previously filed with the Commission as an Exhibit to, and incorporated herein by reference to, the Registrant's current report on Form 8-K filed on August 3, 1998.

{\*\*} Previously filed with the Commission as an Exhibit to, and incorporated herein by reference to, the Registrant's current report on Form 8-K filed on December 7, 2001.

\$ Previously filed with the Commission as an Exhibit to, and incorporated herein by reference to, the Registrant's annual report on Form 10-K for the fiscal year ended December 31, 1998 and filed on March 31, 1999.

\$\$ Previously filed with the Commission as an Exhibit to, and incorporated herein by reference to, the Registrant's current report on Form 8-K on January 14, 2000.

\$\$\$ Previously filed with the Commission as an Exhibit to, and incorporated herein by reference to, the Registrant's definitive proxy statement filed May 1, 2001.

X Previously filed with the Commission as an Exhibit to, and incorporated

herein by reference to, the Registrant's Registration Statement on Form S-1, File No. 333-45496.

- XX Previously filed with the Commission as an Exhibit to, and incorporated herein by reference to, the Registrant's Annual Report on Form 10-K for the fiscal year ended December 31, 2000 and filed on April 2, 2001.
- XXX Previously filed with the Commission as an Exhibit to, and incorporate herein by reference to, the Registrant's Registration Statement filed on Form S-1 as amended to Form S-3, File No. 333-61726.
- XXXX Previously filed with the Commission as an Exhibit to, and incorporated herein by reference to, the Registrant's Registration Statement filed on Form S-3, File No. 333-75806.

(b) CURRENT REPORTS ON FORM 8-K.

A current report on Form 8-K was filed by the Registrant on December 7, 2001. In that report, under Item 5, the Registrant reported: (a) the cancellation of all adjustable warrants previously issued to Millennium Partners, L.P. in connection with an exercise of the warrants by Millennium, and (b) the issuance of preferred stock and a warrant to purchase common stock to a wholly owned subsidiary of Millennium.

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.

STEMCELLS, INC.

By: /s/ MARTIN MCGLYNN  
 -----  
 Martin McGlynn  
 PRESIDENT AND CHIEF EXECUTIVE OFFICER

Dated: August 2, 2002

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

SIGNATURE  
 CAPACITY  
 DATE -----  
 -----  
 ---  
 President  
 and Chief  
 /s/ MARTIN  
 MCGLYNN  
 Executive  
 Officer  
 and -----  
 -----  
 -----  
 Director  
 (principal  
 August 2,  
 2002  
 Martin  
 McGlynn  
 executive  
 officer)  
 Controller  
 and Acting  
 Chief /s/  
 GEORGE  
 KOSHY  
 Financial  
 Officer --

-----  
-----  
-----  
-----  
-  
(principal  
financial  
August 2,  
2002  
George  
Koshy  
officer  
and  
principal  
accounting  
officer)  
/s/ JEAN-  
JACQUES  
BIENAIME -  
-----  
-----  
-----

--  
Director  
August 2,  
2002 Jean-  
Jacques  
Bienaime -  
-----  
-----  
-----

--  
Director  
August 2,  
2002  
Ricardo B.  
Levy,  
Ph.D. /s/  
ROGER  
PERLMUTTER,  
M.D. -----  
-----  
-----

-----  
Director  
August 2,  
2002 Roger  
Perlmutter,  
M.D. -----  
-----  
-----

-----  
Director,  
Chairman  
of the  
August 2,  
2002 John  
J.  
Schwartz,  
Ph.D.  
Board /s/  
IRVING L.  
WEISSMAN,  
M.D. -----  
-----  
-----

-----  
Director  
August 2,  
2002  
Irving L.  
Weissman,  
M.D.



Singer 4.7X  
Warrant to  
Purchase Common  
Stock--May  
Davis 4.8X  
Common Stock  
Purchase  
Warrant 4.9X  
Callable  
Warrant 4.10XXX  
Registration  
Rights  
Agreement dated  
as of May 10,  
2001 between  
the Registrant  
and Sativum  
Investments  
Limited.  
4.11XXX  
Warrant, dated  
May 10, 2001,  
to Purchase  
Common Stock  
issued to  
Sativum  
Investments  
Limited.  
4.12XXX  
Warrant, dated  
May 10, 2001,  
to Purchase  
Common Stock  
issued to  
Pacific Crest  
Securities,  
Inc. 4.13XXX  
Warrant dated  
May 10, 2001 to  
Purchase Common  
Stock issued to  
Granite  
Financial  
Group, Inc.  
4.14XXX  
Callable  
Warrant, dated  
June 21, 2001,  
issued to  
Millennium  
Partners, L.P.  
4.15XXX Common  
Stock Purchase  
Warrant, Class  
A, dated June  
21, 2001,  
issued to  
Millennium  
Partners, L.P.  
4.16{\*\*}  
Certificate of  
Designations of  
the Powers,  
Preferences and  
Relative,  
Participating,  
Optional and  
other Special  
Rights of  
Preferred Stock  
and  
Qualifications,  
Limitations and  
Restrictions  
Thereof of 3%  
Cumulative  
Convertible  
Preferred Stock  
for StemCells,  
Inc. 4.17{\*\*}  
Warrant to

Purchase Common  
Stock--  
Riverview  
Group, LLC  
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Warrant to  
Purchase Common  
Stock--Cantor  
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Employment  
Agreement  
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Registrant and  
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Contractors.  
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Lease and  
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Agreement dated  
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Credit, Inc.  
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Stock Option  
Plan.

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10.7\* 1992  
Equity Incentive  
Plan. 10.8\* 1992  
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Plan for Non-  
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Employee Stock  
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and Registrant.

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between the  
Registrant and  
Rhode Island  
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Facilities  
Corporation,  
dated as of  
August 1, 1992.

10.15++ First  
Amendment to  
Lease Agreement  
between  
Registrant and  
The Rhode Island  
Industrial  
Facilities  
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Stock Purchase  
Agreement to be  
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and certain  
purchasers of  
the Registrant's  
Common Stock.

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Properties  
Trust, as  
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Inc., as Tenant.

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option agreement  
dated as of July  
10, 1996 among  
the Company and  
the individuals  
listed therein.

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Valoria option  
agreement dated  
of July 10, 1996

between the  
Company and the  
Societe  
Financiere  
Valoria SA.  
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Loan Agreement  
dated as of  
October 22, 1996  
between The  
First National  
Bank of Boston  
and the  
Registrant.

10.27\*\*\*  
Agreement and  
Plan of Merger  
dated as of  
August 13, 1997  
among StemCells,  
Inc., the  
Registrant and  
CTI Acquisition  
Corp. 10.28\*\*\*  
Consulting  
Agreement dated  
as of September  
25, 1997 between  
Dr. Irving  
Weissman and the  
Registrant.

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Agreement among  
each of Dr.  
Irving Weissman  
and Dr. Fred H.  
Gage and the  
Registrant.

10.32\*\*\*\*  
StemCells, Inc.  
1996 Stock  
Option Plan.

10.33\*\*\*\* 1997  
StemCells  
Research Stock  
Option Plan (the  
"1997 Plan")

10.34\*\*\*\* Form  
of Performance-  
Based Incentive  
Option Agreement  
issued under the  
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Employment  
Agreement dated  
as of September  
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Rose and the  
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Agreement, dated  
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1998 between  
Bank Boston,  
N.A. as Rights  
Agent and the  
Registrant.

10.40\$\*\*  
Consulting  
Services  
Agreement dated  
as of July 27,  
1998, as amended  
December 19,  
1998 between Dr.  
John J. Schwartz  
and the  
Registrant.



EXHIBIT NO.  
TITLE OR  
DESCRIPTION  
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10.41\$\*\*  
Letter  
Agreement  
dated as of  
December  
19, 1998  
between  
John J.  
Schwartz  
and the  
Registrant.

10.43\$\*\*  
License  
Agreement  
dated as of  
October 27,  
1998  
between The  
Scripps  
Research  
Institute  
and the  
Registrant.

10.45\$\*\*  
Purchase  
Agreement  
and License  
Agreement  
dated as of  
December  
29, 1999  
between  
Neurotech  
S.A. and  
the  
Registrant.

10.46\*\*  
License  
Agreement  
dated as of  
June 1999  
between The  
Scripps  
Research  
Institute  
and the  
Registrant.

10.47\*\*  
License  
Agreement  
dated as of  
June 1999  
between The  
Scripps  
Research  
Institute  
and the  
Registrant.

10.48X Form  
of  
Registration  
Rights  
Agreement  
dated as of  
July 31,  
2000  
between the

Registrant  
and  
investors.  
10.49X  
Subscription  
Agreement  
dated as of  
July 31,  
2000

between the  
Registrant  
and  
Millennium  
Partners,  
L.P.  
10.50XXX  
Common  
Stock  
Purchase  
Agreement,  
dated as of  
May 10,  
2001,  
between the  
Registrant  
and Sativum  
Investments  
Limited.

10.51XXX  
Escrow  
Agreement,  
dated as of  
May 10,  
2001, among  
the  
Registrant,  
Sativum  
Investments  
Limited and  
Epstein,  
Becker &  
Green, P.C.

10.52XX  
License  
Agreement,  
dated as of  
October 30,  
2000,  
between the  
Registrant  
and  
NeuroSpheres  
Ltd.

10.53XX  
Letter  
Agreement,  
dated  
January 2,  
2001,  
between the  
Registrant  
and Martin  
McGlynn

10.54XX  
Lease,  
dated  
February 1,  
2001,  
between the  
Board of  
Trustees of  
Stanford  
University  
and the  
Registrant.

10.55XXX  
Registration  
Rights  
Agreement,  
dated as of  
June 21,

2001, by  
and between  
the  
Registrant  
and  
Millennium  
Partners,  
L.P.

10.56XXX  
Subscription  
Agreement,  
dated as of  
June 21,  
2001, by  
and between  
the  
Registrant  
and  
Millennium  
Partners,  
L.P.

10.57\$\$\$  
2001 Equity  
Incentive  
Plan

10.58{\*\*}  
Subscription  
Agreement,  
dated as of  
December 4,  
2001  
between the  
Registrant  
and  
Riverview  
Group,  
L.L.C.

10.59{\*\*}  
Registration  
Rights  
Agreement,  
dated as of  
December 4,  
2001  
between the  
Registrant  
and  
Riverview  
Group,  
L.L.C.

10.60{\*\*}  
Agreement  
dated as of  
December 4,  
2001  
between the  
Registrant  
and  
Millennium  
Partners,  
L.P.

10.61{\*\*}  
Agreement  
dated as of  
December 4,  
2001 among  
the  
Registrant,  
Millennium  
Partners,  
L.P. and  
Riverview  
Group,  
L.L.C. 21X  
Subsidiaries  
of the  
Registrant.

TITLE OR  
DESCRIPTION  
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23.1

Consent of  
Ernst &  
Young LLP,  
Independent  
Auditors.  
99.1XX Side  
Letter,  
dated March  
17, 2001,  
between the  
Company and  
Oleh S.  
Hnatiuk  
regarding  
NeuroSpheres  
License  
Agreement,  
dated  
October 30,  
2000.

- 
- ++ Previously filed with the Commission as Exhibits to, and incorporated herein by reference to, the Registrant's Registration Statement on Form S-1, File No. 33-85494.
  - +++ Previously filed with the Commission as Exhibits to, and incorporated herein by reference to, the Registrant's Registration Statement on Form S-3, File No. 33-97272.
  - ++++ Previously filed with the Commission as Exhibits to, and incorporated herein by reference to, the Registrant's Registration Statement on Form S-1, File No. 33-91228.
  - \* Previously filed with the Commission as Exhibits to, and incorporated herein by reference to, Registration Statement on Form S-1, File No. 33-45739.
  - # Previously filed with the Commission as Exhibits to, and incorporated herein by reference to, the Registrant's Annual Report on Form 10-K for fiscal year ended December 31, 1992 and filed March 30, 1993.
  - \*\* Confidential treatment requested as to certain portions. The term "confidential treatment" and the mark "\*\*\*" as used throughout the indicated Exhibits mean that material has been omitted and separately filed with the Commission.
  - ## Previously filed with the Commission as Exhibits to, and incorporated herein by reference to, the Registrant's Quarterly Report on Form 10-Q for the quarter ended March 31, 1994 and filed on May 14, 1994.
  - + Previously filed with the Commission as Exhibits to, and incorporated herein by reference to, the Registrant's Annual Report on Form 10-K for the fiscal year ended December 31, 1993 and filed on March 30, 1994.
  - ! Previously filed with the Commission as an Exhibit to and incorporated by reference to, the Registrant's Quarterly Report on Form 10-Q for the quarter ended March 31, 1996.
  - !! Previously filed with the Commission as an Exhibit to and incorporated by reference to, the Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 1996.
  - !!! Previously filed with the Commission as an Exhibit to, and incorporated herein by reference to, the Registrant's Annual Report on Form 10-K for the fiscal year ended December 31, 1996 and filed on March 31, 1997.
  - !!!! Previously filed with the Commission as an Exhibit to, and incorporated

herein by reference to, the Registrant's Annual Report on Form 10-K for the fiscal year ended December 31, 1995.

- \*\*\* Previously filed with the Commission as Exhibits to, and incorporated herein by reference to, the Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 1997 and filed on November 14, 1997.
- \*\*\*\* Previously filed with the Commission as Exhibits to, and incorporated herein by reference to, the Registrant's Registration Statement on Form S-8, File No. 333-37313.
- ### Previously filed with the Commission as an Exhibit to, and incorporated herein by reference to, the Registrant's annual report on Form 10-K for the fiscal year ended December 31, 1997 and filed on March 30, 1998.
- {\*} Previously filed with the Commission as an Exhibit to, and incorporated herein by reference to, the Registrant's current report on Form 8-K filed on August 3, 1998.
- {\*\*} Previously filed with the Commission as an Exhibit to, and incorporated herein by reference to, the Registrant's current report on Form 8-K filed on December 7, 2001.
- \$ Previously filed with the Commission as an Exhibit to, and incorporated herein by reference to, the Registrant's annual report on Form 10-K for the fiscal year ended December 31, 1998 and filed on March 31, 1999.
- \$\$ Previously filed with the Commission as an Exhibit to, and incorporated herein by reference to, the Registrant's current report on Form 8-K on January 14, 2000.
- \$\$\$ Previously filed with the Commission as an Exhibit to, and incorporated herein by reference to, the Registrant's definitive proxy statement filed May 1, 2001.
- X Previously filed with the Commission as an Exhibit to, and incorporated herein by reference to, the Registrant's Registration Statement on Form S-1, File No. 333-45496.
- XX Previously filed with the Commission as an Exhibit to, and incorporated herein by reference to, the Registrant's Annual Report on Form 10-K for the fiscal year ended December 31, 2000 and filed on April 2, 2001.
- XXX Previously filed with the Commission as an Exhibit to, and incorporate herein by reference to, the Registrant's Registration Statement filed on Form S-1 as amended to Form S-3, File No. 333-61726.
- XXXX Previously filed with the Commission as an Exhibit to, and incorporated herein by reference to, the Registrant's Registration Statement filed on Form S-3, File No. 333-75806.

CONSENT OF ERNST & YOUNG LLP, INDEPENDENT AUDITORS

We consent to the incorporation by reference in the Registration Statement (Form S-8 No. 333-66700) pertaining to the 2001 Equity Incentive Plan, in the Registration Statements (Form S-8 No. 333-49524 and 333-29335) pertaining to the 1998 Incentive Stock Plan, 1992 Equity Incentive Plan, 1992 Employee Stock Purchase Plan and 1992 Stock Option Plan for Non-Employee Directors, in the Registration Statement (Form S-8 No. 333-10773) pertaining to the 1992 Equity Incentive Plan, in the Registration Statement (Form S-8 No. 333-37313) pertaining to the 1996 StemCells, Inc. Stock Option Plan and the 1997 CytoTherapeutics, Inc. StemCells Research Stock Option Plan, in the Registration Statements (Form S-3 No. 333-75806, No. 333-66692, No. 333-61726 and No. 333-83992) of Stemcells, Inc. and in the Registration Statements (Form S-3 No. 333-68900 and No. 333-91228) of CytoTherapeutics, Inc. and in the related Prospectuses of our report dated February 12, 2002, except for Note 1--Restatement of Financial Statements, as to which the date is July 29, 2002, with respect to the consolidated financial statements of StemCells, Inc. included in the Annual Report (Form 10-K/A) for the year ended December 31, 2001.

/s/ Ernst & Young LLP

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Palo Alto, California  
July 30, 2002

## CAUTIONARY FACTORS RELEVANT TO FORWARD-LOOKING INFORMATION

YOU SHOULD CAREFULLY CONSIDER THE RISKS DESCRIBED BELOW BEFORE MAKING AN INVESTMENT DECISION REGARDING STEMCELLS, INC. WE MAY FACE OTHER RISKS NOT DESCRIBED BELOW THAT WE DO NOT PRESENTLY KNOW ABOUT OR THAT WE CURRENTLY DEEM IMMATERIAL.

Our business, financial condition or results of operations could be materially adversely affected by any of these risks. Consequentially, the trading price of our common stock could decline, resulting in the loss of all or part of your investment.

OUR TECHNOLOGY IS AT AN EARLY STAGE OF DISCOVERY AND DEVELOPMENT, AND WE MAY FAIL TO DEVELOP ANY COMMERCIALY ACCEPTABLE PRODUCTS.

Our stem cell technology is at the early pre-clinical stage for the brain stem cell and at the discovery phase for the liver and pancreas stem cells and has not yet led to the development of any product. We may fail to discover the stem cells we are seeking, to develop any products, to obtain regulatory approvals, to enter clinical trials, or to commercialize any products. Any product using stem cell technology may fail to:

- survive and persist in the desired location;
- provide the intended therapeutic benefits;
- properly integrate into existing tissue in the desired manner; or
- achieve therapeutic benefits equal to or better than the standard of treatment at the time of testing.

In addition, our products may cause undesirable side effects. Results of early pre-clinical research may not be indicative of the results that will be obtained in later stages of pre-clinical or clinical research. If regulatory authorities do not approve our products, or if we fail to maintain regulatory compliance, we would have limited ability to commercialize our products, and our business and results of operations would be harmed. Furthermore, because stem cells are a new form of therapy, the marketplace may not accept any products we may develop. If we do succeed in developing products, we will face many potential obstacles such as the need to obtain regulatory approvals, and to develop or obtain manufacturing, marketing and distribution capabilities. In addition, we will face substantial additional risks such as product liability.

WE HAVE PAYMENT OBLIGATIONS RESULTING FROM REAL PROPERTY OWNED OR LEASED BY US IN RHODE ISLAND, WHICH DIVERTS FUNDING FROM OUR STEM CELL RESEARCH AND DEVELOPMENT.

Prior to our reorganization in 1999 and the consolidation of our business in California, we carried out our encapsulated cell therapy programs in Lincoln, Rhode Island, where we also had our administrative offices. Although we have vacated the Rhode Island facilities, we remain obligated to make lease payments and payments for operating costs of approximately \$1,200,000 per year for our former science and administrative facility, which we have leased through June 30, 2013, and debt service payments and payments for operating costs of approximately \$1,000,000 per year for our former encapsulated cell therapy pilot manufacturing facility, which we own. We have currently subleased a portion of the science and administrative facility, but cannot be sure that we will be able to do so for the entire duration of our obligation. We are seeking to sublease the remaining portion of the science and administrative facility. We have currently subleased the entire pilot manufacturing facility, but may not be able to sublease or sell the facility in the future once the current sublease agreements expire. These continuing costs significantly reduce our cash resources and adversely affect our ability to fund further development of our stem cell technology.

WE MAY NEED BUT FAIL TO OBTAIN PARTNERS TO SUPPORT OUR STEM CELL DEVELOPMENT EFFORTS AND TO COMMERCIALIZE OUR TECHNOLOGY.

Equity and debt financings alone may not be sufficient to fund the cost of developing our stem cell technologies, and we may need to rely on our ability to reach partnering arrangements to provide financial support for our stem cell discovery and development efforts. In addition, in order to successfully develop and commercialize our technology, we may need to enter into a wide variety of arrangements with corporate sponsors, pharmaceutical companies, universities, research groups and others. While we have engaged, and expect to continue to

engage, in discussions regarding such arrangements, we have not reached any agreement, and we may fail to obtain any such agreement on terms acceptable to us. Even if we enter into these arrangements, we may not be able to satisfy our obligations under them or renew or replace them after their original terms expire. Furthermore, these arrangements may require us to grant certain rights to third parties, including exclusive marketing rights to one or more products, may require us to issue securities to our collaborators or may contain other terms that are burdensome to us. If any of our collaborators terminates its relationship with us or fails to perform its obligations in a timely manner, the development or commercialization of our technology and potential products may be adversely affected.

WE HAVE A HISTORY OF OPERATING LOSSES AND WE MAY FAIL TO OBTAIN REVENUES OR BECOME PROFITABLE.

We expect to continue to incur substantial operating losses in the future in order to conduct our research and development activities, and, if those activities are successful, to fund clinical trials and other expenses. These expenses include the cost of acquiring technology, product testing, acquiring regulatory approvals, establishing production, marketing, sales and distribution programs and administrative expenses. We have not earned any revenues from sales of any product. All of our past revenues have been derived from, and any revenues we may obtain for the foreseeable future are expected to be derived from, cooperative agreements, research grants, investments and interest on invested capital. We currently have no cooperative agreements and we have received only two research grants for our stem cell technology, and we may not obtain any such agreements or additional grants in the future or receive any revenues from them.

IF WE ARE UNABLE TO PROTECT OUR PATENTS AND PROPRIETARY RIGHTS, OUR BUSINESS, FINANCIAL CONDITION AND RESULTS OF OPERATION WILL BE HARMED.

We own or license a number of patents and pending patent applications covering human nerve stem cell cultures, central nervous system stem cell cultures, neuroblast cultures, peripheral nervous system stem cell cultures, and an animal model for liver failure. Patent protection for products such as those we propose to develop is highly uncertain and involves complex and continually evolving factual and legal questions. The governmental authorities that consider patent applications can deny or significantly reduce the patent coverage requested in an application before or after issuing the patent. Consequently, we do not know whether any of our pending applications will result in the issuance of patents, or if any existing or future patents will provide sufficient protection or significant commercial advantage or if others will circumvent these patents. We cannot be certain that we were the first to make the inventions covered by each of our pending patent applications or that we were the first to file patent applications for such inventions because patent applications are secret until patents are issued in the United States or until the applications are published in foreign countries, and because publication of discoveries in the scientific or patent literature often lags behind actual discoveries. Patents may not issue from our pending or future patent applications or, if issued, may not be of commercial benefit to us, or may not afford us adequate protection from competing products. In addition, third parties may challenge our patents or governmental authorities may declare them invalid. In the event that a third party has also filed a patent application relating to inventions claimed in our patent applications, we may have to participate in proceedings to determine priority of invention. This could result in substantial uncertainties and cost for us, even if the eventual outcome is favorable to us, and the outcome might not be favorable to us. Even if a patent issues, a court could decide that the patent was

issued invalidly. Further, patents issue for a limited term and our patents may expire before we utilize them profitably.

Proprietary trade secrets and unpatented know-how are also important to our research and development activities. We cannot be certain that others will not independently develop the same or similar technologies on their own or gain access to our trade secrets or disclose such technology, or that we will be able to meaningfully protect our trade secrets and unpatented know-how and keep them secret. We require our employees, consultants, and significant scientific collaborators and sponsored researchers to execute confidentiality agreements upon the commencement of an employment or consulting relationship with us. These agreements may, however, fail to provide meaningful protection or adequate remedies for us in the event of unauthorized use, transfer or disclosure of such information or inventions.

IF OTHERS ARE FIRST TO DISCOVER AND PATENT THE STEM CELLS WE ARE SEEKING TO DISCOVER, WE COULD BE BLOCKED FROM FURTHER WORK ON THOSE STEM CELLS.

Because the first person or entity to discover and obtain a valid patent to a particular stem or progenitor cell may effectively block all others, it will



be important for us or our collaborators to be the first to discover any stem cell that we are seeking to discover. Failure to be the first could prevent us from commercializing all of our research and development affected by that patent.

IF WE ARE UNABLE TO OBTAIN NECESSARY LICENSES TO THIRD PARTY PATENTS AND OTHER RIGHTS, WE MAY NOT BE ABLE TO COMMERCIALY DEVELOP OUR EXPECTED PRODUCTS.

A number of pharmaceutical, biotechnology and other companies, universities and research institutions have filed patent applications or have received patents relating to cell therapy, stem cells and other technologies potentially relevant to or necessary for our expected products. We cannot predict which, if any, of the applications will issue as patents. If third party patents or patent applications contain claims infringed by our technology and these claims are valid, we may be unable to obtain licenses to these patents at a reasonable cost, if at all, and may also be unable to develop or obtain alternative technology. If we are unable to obtain such licenses at a reasonable cost, our business could be significantly harmed. We have obtained rights from universities and research institutions to technologies, processes and compounds that we believe may be important to the development of our products. Licensors may cancel our licenses or convert them to non-exclusive licenses if we fail to use the relevant technology or otherwise breach these agreements. Loss of these licenses could expose us to the risks of third party patents and/or technology. We can give no assurance that any of these licenses will provide effective protection against our competitors.

WE COMPETE WITH COMPANIES THAT HAVE SIGNIFICANT ADVANTAGES OVER US.

The market for therapeutic products that address degenerative diseases is large and competition is intense. For example, while we believe that our neural stem cells may have application to Parkinson's disease, we have no clinical program directed toward that disease at this time. More than twenty companies worldwide, including Merck, Roche, Cephalon, Schering AG, Pharmacia Corp., and Genzyme have at least one clinical trial for Parkinson's disease in progress at some phase, and some have more than one. At least seven companies already have products on the market. We expect competition to increase.

In general, we believe that our most significant competitors will be fully integrated pharmaceutical companies and more established biotechnology companies, such as Biogen, Inc. and Genzyme, an Elan Corporation. These companies already produce or are developing treatments for degenerative diseases that are not stem cell-based, and they have significantly greater capital resources and expertise in research and development, manufacturing, testing, obtaining regulatory approvals and marketing than we do. Many of these potential competitors have significant products approved or in development that could be competitive with our potential products, and also operate large, well-funded research and development programs. In addition, we expect to compete with other companies, some of which are

smaller and may be privately owned, including CellFactors, Diacrin, Geron, Layton Bioscience, NeuralStem Biopharmaceuticals, NeuroNova, and ReNeuron, and with universities and other research institutions who are developing treatments for degenerative diseases that are stem cell-based. Our competitors may succeed in developing technologies and products that are more effective than the ones we are developing, or that would render our technology obsolete or non-competitive. The relative speed with which we and our competitors can develop products, complete the clinical testing and approval processes, and supply commercial quantities of a product to market will affect our ability to gather market acceptance and market share. With respect to clinical testing, competition may delay progress by limiting the number of clinical investigators and patients available to test our potential products.

DEVELOPMENT OF OUR TECHNOLOGY IS SUBJECT TO AND RESTRICTED BY EXTENSIVE GOVERNMENT REGULATION, WHICH COULD IMPEDE OUR BUSINESS.

Our research and development efforts, as well as any future clinical trials, and the manufacturing and marketing of any products we may develop, will be subject to and restricted by extensive regulation by governmental authorities in the United States and other countries. The process of obtaining U.S. Food and Drug Administration and other necessary regulatory approvals is lengthy, expensive and uncertain. We or our collaborators may fail to obtain the necessary approvals to commence or continue clinical testing or to manufacture or market our potential products in reasonable time frames, if at all. In addition, the U.S. Congress and other legislative bodies may enact regulatory reforms or restrictions on the development of new therapies that could adversely affect the regulatory environment in which we operate or the development of any products we may develop. We base our research and development on the use of human stem and progenitor cells obtained from fetal tissue. The federal and state governments and other jurisdictions impose restrictions on the use of fetal tissue. These restrictions change from time to time and may become more

onerous. Additionally, we may not be able to identify or develop reliable sources for the cells necessary for our potential products-that is, sources that follow all state and federal guidelines for cell procurement. Further, we may not be able to obtain such cells in the quantity or quality sufficient to satisfy the commercial requirements of our potential products. As a result, we may be unable to develop or produce our products in a profitable manner.

Although we do not use embryonic stem cells, government regulation and threatened regulation of embryonic tissue may lead outstanding researchers to leave the field of stem cell research, or the country, in order to assure that their careers will not be impeded by restrictions on their work. Similarly, these factors may induce the best graduate students to choose other fields less vulnerable to changes in regulatory oversight, thus exacerbating the risk, discussed below, that we may not be able to attract and retain the scientific personnel we need in face of the competition among pharmaceutical, biotechnology and health care companies, universities and research institutions for what may become a shrinking class of qualified individuals. In addition, we cannot assure you that constraints on use of embryonic stem cells will not be extended to use of fetal stem cells. Moreover, it is possible that concerns regarding research using embryonic stem cells will impact our ability to attract collaborators and investors and our stock price.

We may apply for status under the Orphan Drug Act for some of our therapies to gain a seven year period of marketing exclusivity for those therapies. The U.S. Congress in the past has considered, and in the future again may consider, legislation that would restrict the extent and duration of the market exclusivity of an orphan drug. If enacted, such legislation could prevent us from obtaining some or all of the benefits of the existing statute even if we were to apply for and be granted orphan drug status with respect to a potential product.

IF WE LOSE THE SERVICES OF KEY PERSONNEL OR ARE UNABLE TO ATTRACT AND RETAIN ADDITIONAL QUALIFIED PERSONNEL, WE MAY HAVE TO DELAY, REDUCE OR ELIMINATE SOME OR ALL OF OUR RESEARCH AND DEVELOPMENT PROGRAMS.

We are highly dependent on the principal members of our management and scientific staff and some of our outside consultants, including the members of our scientific advisory board, our chief

executive officer, our vice president and the directors of our neural stem cell and liver stem cell programs. Although we have entered into employment agreements with some of these individuals, they may terminate their agreements at any time. In addition, our operations are dependent upon our ability to attract and retain additional qualified scientific and management personnel. We may not be able to attract and retain the personnel we need on acceptable terms given the competition for experienced personnel among pharmaceutical, biotechnology and health care companies, universities and research institutions.

SINCE HEALTH CARE INSURERS AND OTHER ORGANIZATIONS MAY NOT PAY FOR OUR PRODUCTS OR MAY IMPOSE LIMITS ON REIMBURSEMENTS, OUR ABILITY TO BECOME PROFITABLE COULD BE REDUCED.

In both domestic and foreign markets, sales of potential products are likely to depend in part upon the availability and amounts of reimbursement from third party health care payor organizations, including government agencies, private health care insurers and other health care payors, such as health maintenance organizations and self-insured employee plans. There is considerable pressure to reduce the cost of therapeutic products, and government and other third party payors are increasingly attempting to contain health care costs by limiting both coverage and the level of reimbursement for new therapeutic products, and by refusing, in some cases, to provide any coverage for uses of approved products for disease indications for which the U.S. Food and Drug Administration has not granted marketing approval. Significant uncertainty exists as to the reimbursement status of newly approved health care products. We can give no assurance that reimbursement will be provided by such payors at all or without substantial delay, or, if such reimbursement is provided, that the approved reimbursement amounts will be sufficient to enable us to sell products we develop on a profitable basis. Changes in reimbursement policy could also adversely affect the willingness of pharmaceutical companies to collaborate with us on the development of our stem cell technology. In certain foreign markets, pricing or profitability of prescription pharmaceuticals is subject to government control. We also expect that there will continue to be a number of federal and state proposals to implement government control over health care costs. Efforts at health care reform are likely to continue in future legislative sessions. We do not know what legislative proposals federal or state governments will adopt or what actions federal, state or private payers for health care goods and services may take in response to health care reform proposals or legislation. We cannot predict the effect government control and other health care reforms may have on our business.

WE HAVE LIMITED LIQUIDITY AND CAPITAL RESOURCES AND MAY NOT OBTAIN THE SIGNIFICANT CAPITAL RESOURCES WE WILL NEED TO SUSTAIN OUR RESEARCH AND DEVELOPMENT EFFORTS.

We have limited liquidity and capital resources and must obtain substantial additional capital to support our research and development programs, for acquisition of technology and intellectual property rights, and, to the extent we decide to undertake these activities ourselves, for pre-clinical and clinical testing of our anticipated products, pursuit of regulatory approvals, establishment of production capabilities, establishment of marketing and sales capabilities and distribution channels, and general administrative expenses. If we do not obtain the necessary capital resources, we may have to delay, reduce or eliminate some or all of our research and development programs or license our technology or any potential products to third parties rather than commercializing them ourselves. If we are unable to draw down on our existing equity line or choose not to do so, we intend to pursue our needed capital resources through equity and debt financings, corporate alliances, grants and collaborative research arrangements. We may fail to obtain the necessary capital resources from any such sources when needed or on terms acceptable to us. Our ability to complete any such arrangements successfully will depend upon market conditions and, more specifically, on continued progress in our research and development efforts. We are prohibited from entering into other stand-by equity based credit facilities during the term of the common stock purchase agreement that governs our existing equity line.

IF OUR COMMON STOCK PRICE DROPS SIGNIFICANTLY, WE MAY BE DELISTED FROM THE NASDAQ NATIONAL MARKET, WHICH COULD ELIMINATE THE TRADING MARKET FOR OUR COMMON STOCK.

Our common stock is quoted on the Nasdaq National Market. In order to continue to be included in the Nasdaq National Market, a company must meet Nasdaq's maintenance criteria. The maintenance criteria most applicable to us requires a minimum bid price of \$1.00 per share and \$5,000,000 market value of publicly held shares. Additionally, we must maintain either \$10 million in stockholders' equity or \$4 million in net tangible assets. After November 1, 2002, the net tangible asset maintenance criterion will no longer apply and we must satisfy the stockholders' equity maintenance criterion. Stockholders' equity is composed of three fundamental sources: capital stock, additional paid-in-capital, and retained earnings. Capital stock represents ownership interest in the corporation. Additional paid-in-capital represents additional monies paid into the corporation by investors above the par value of shares issued. Retained earnings represents income (loss) that the corporation has accumulated as a result of its day-to-day operating activities. Our stockholders' equity at the end of 2001 was \$13,207,807. Failure to meet these maintenance criteria may result in the delisting of our common stock from the Nasdaq National Market. If our common stock were delisted, in order to have our common stock relisted on the Nasdaq National Market we would be required to meet the criteria for initial listing, which are more stringent than the maintenance criteria. Accordingly, we cannot assure you that if we were delisted we would be able to have our common stock relisted on the Nasdaq National Market. If our common stock were delisted from the Nasdaq National Market, we would not be able to draw down any additional funds on our existing equity line, and we also may be required to pay damages to holders of our common stock under agreements we previously entered into with them in connection with equity financings. Finally, if our common stock were removed from listing on the Nasdaq National Market, it might become more difficult for us to raise funds through the sale of our common stock or securities convertible into our common stock.

THE SALE AND ISSUANCE OF THE 3% AND THE 6% CUMULATIVE CONVERTIBLE REDEEMABLE PREFERRED STOCK WILL HAVE AN IMPACT TO EARNINGS AVAILABLE TO COMMON STOCKHOLDERS.

Of the proceeds from our sale of the 3% and the 6% cumulative convertible redeemable preferred stock, approximately \$3.1 million will be allocated to the common stock warrants and the conversion feature included with the subscription agreements, and will be reflected as an increase to additional paid-in capital and a decrease to the 3% and the 6% cumulative convertible redeemable preferred stock. This \$3.1 million will be accreted to the preferred stock over the term of the redemption period. This accretion, along with the preferred stock dividends, will increase the net loss (reduce the net income) available to common stockholders. The conversion price for the 6% cumulative convertible preferred stock is subject to adjustment based on certain equity transactions.