

EPLUS INC
Form DEF 14A
July 29, 2008

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

SCHEDULE 14A
Proxy Statement Pursuant to Section 14(a) of
the Securities Exchange Act of 1934 (Amendment No.)

Filed by the Registrant T

Filed by a Party other than the Registrant F

Check the appropriate box:

- Preliminary Proxy Statement
- Confidential, for Use of the Commission Only (as permitted by Rule 14a-6(e)(2))
- Definitive Proxy Statement
- Definitive Additional Materials
- Soliciting Material Pursuant to §240.14a-12

EPLUS INC.
(Name of Registrant as Specified In Its Charter)

(Name of Person(s) Filing Proxy Statement, if other than the Registrant)

Payment of Filing Fee (Check the appropriate box):

- T No fee required.
- F Fee computed on table below per Exchange Act Rules 14a-6(i)(1) and 0-11.

(1) Title of each class of securities to which transaction applies:

(2) Aggregate number of securities to which transaction applies:

(3) Per unit price or other underlying value of transaction computed pursuant to Exchange Act Rule 0-11 (set forth the amount on which the filing fee is calculated and state how it was determined):

(4) Proposed maximum aggregate value of transaction:

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(1) Amount Previously Paid:

(2) Form, Schedule or Registration Statement No.:

(3) Filing Party:

(4) Date Filed:

EPLUS INC.
NOTICE OF ANNUAL MEETING OF STOCKHOLDERS
To be held on Monday, September 15, 2008

To the Stockholders of ePlus inc.:

The Annual Meeting of Stockholders of ePlus inc., a Delaware corporation, will be held on September 15, 2008, at the Hyatt Regency, 1800 Presidents Street, Reston, Virginia, 20190 at 8:00 a.m. local time for the purposes stated below:

1. To elect as directors the two Class III Directors, three Class II Directors, and three Class I Directors named in the attached proxy statement, each to serve a term as described in the proxy statement, and until their successors have been duly elected and qualified;
2. To approve the 2008 Non-Employee Director Long-Term Incentive Plan;
3. To approve the 2008 Employee Long-Term Incentive Plan;
4. To approve our Amended and Restated Certificate of Incorporation;
5. To ratify the appointment of Deloitte & Touche LLP as our independent auditors for our fiscal year ending March 31, 2009;
6. To transact such other business as may properly come before the Annual Meeting and any adjournment or postponement thereof.

Under the provisions of our Bylaws, and in accordance with Delaware law, the Board of Directors has fixed the close of business on July 25, 2008 as the Record Date for stockholders entitled to notice of and to vote at the Annual Meeting.

Whether or not you expect to be present at the Annual Meeting, please date and sign the enclosed Proxy Card and mail it promptly in the enclosed envelope to Proxy Tabulator, P.O. Box 535300, Pittsburgh, PA, 15253-9837. If you submit your proxy and then decide to attend the Annual Meeting to vote your shares in person, you may still do so. Your proxy is revocable in accordance with the procedures set forth in the Proxy Statement.

By Order of the Board of Directors

/s/ Erica S. Stoecker
Erica S. Stoecker
Corporate Secretary

August 12, 2008

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ePlus inc.

www.eplus.com

PROXY STATEMENT
FOR THE 2008 ANNUAL MEETING OF STOCKHOLDERS

QUESTIONS AND ANSWERS ABOUT THIS PROXY MATERIAL AND VOTING

Ø Why am I receiving these materials?

We sent you this proxy statement and the enclosed proxy card because the Board of Directors of ePlus inc. (sometimes referred to as “we”, “us”, “our”, “the Company” and “ePlus”), a Delaware corporation, is soliciting your proxy to vote at the 2008 Annual Meeting of Stockholders and at any adjournment or postponement thereof. The annual meeting will be held on September 15, 2008 at 8:00 a.m. at the Hyatt Regency, 1800 Presidents Street, Reston, Virginia, 20190. You are invited to attend the annual meeting and we request that you vote on the proposals described in this proxy statement. However, you do not need to attend the annual meeting to vote your shares. Instead, you may complete, sign and return the enclosed proxy card.

The Company intends to mail this proxy statement and accompanying proxy card on or about August 12, 2008 to all stockholders of record entitled to vote at the annual meeting.

Ø Who is entitled to vote?

Only stockholders of record at the close of business on July 25, 2008, or “record date,” will be entitled to vote at the annual meeting. On this record date, there were 8,283,541 shares of common stock outstanding and entitled to vote. Each share of common stock is entitled to one vote on each matter properly brought before the annual meeting.

Ø What is the difference between holding shares as a registered stockholder and as a beneficial holder?

If on the record date your shares were registered directly in your name with our transfer agent, National City Bank, then you are a stockholder of record. As a stockholder of record, you may vote in person at the annual meeting or vote by proxy using the enclosed proxy card. Whether or not you plan to attend the annual meeting, we urge you to complete, sign and return the proxy card to ensure your vote is counted.

If on the record date your shares were held in an account at a brokerage firm, bank, dealer, or other similar organization, then you are the beneficial owner of shares held in “street name” and these proxy materials are being forwarded to you by that organization. The organization holding your account is considered the stockholder of record for purposes of voting at the annual meeting. As a beneficial owner you have the right to direct your broker or other agent on how to vote the shares in your account by following the voting instructions included in their mailing. You are also invited to attend the annual meeting. However, since you are not the stockholder of record you may not vote your shares in person at the annual meeting unless you request and obtain a valid proxy from your broker or other agent.

Ø On what am I voting?

There are five matters scheduled for a vote:

- Election of three Class I directors, three Class II directors and two Class III directors.
- Approval of the 2008 Non-Employee Director Long-Term Incentive Plan

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- Approval of the 2008 Employee Long-Term Incentive Plan
- Approval of our Amended and Restated Certificate of Incorporation; and
- Ratification of the appointment of Deloitte & Touche LLP as our independent auditors for our fiscal year ending March 31, 2009.

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Ø Can I change my vote after submitting my proxy?

Yes. You can revoke your proxy at any time before the final vote at the annual meeting. If you are a stockholder of record, you may revoke your proxy in any one of three ways:

- You may submit another properly completed proxy card with a later date.
- You may send a written notice that you are revoking your proxy to the Corporate Secretary, ePlus inc., 13595 Dulles Technology Drive, Herndon, Virginia, 20171.
- You may attend the annual meeting and vote in person. Attending the annual meeting will not, by itself, revoke your proxy.

Please note that to be effective, your new proxy card or written notice of revocation must be received by the Corporate Secretary prior to the annual meeting.

If you are a beneficial owner of shares, you may submit new voting instructions by contacting your broker or other agent. You may also vote in person at the annual meeting if you obtain a legally valid proxy from your broker or other agent as described above.

Ø How are votes counted?

Votes will be counted by the inspector of election appointed for the annual meeting, who will separately count “For” and “Against” votes, abstentions and broker non-votes. A “broker non-vote” occurs when a nominee holding shares for a beneficial owner does not vote on a particular proposal because the nominee does not have discretionary voting power with respect to that proposal and has not received instructions with respect to that proposal from the beneficial owner despite voting on at least one other proposal for which it does have discretionary authority or for which it has received instructions. Discretionary authority is allowed for Proposal 1 and Proposal 5. Discretionary authority is not allowed for Proposals 2, 3 or 4. Broker non-votes will have no effect and will not be counted towards the vote for Proposals 1, 2, 3, and 5. For Proposal 4, broker non-votes will have the same effect as “Against” votes. For Proposal 1, abstentions will have no effect. For Proposals 2, 3, 4 and 5, abstentions will be counted toward the vote total and will have the same effect as “Against” votes.

Ø What are the voting requirements for each proposal?

- For Proposal 1, election of directors, nominees who receive a plurality of the votes cast will be elected director. Abstentions and broker non-votes will have no effect.
 - To be approved, Proposal 2, approval of the 2008 Non-Employee Director Long-Term Incentive Plan, must receive a “For” vote from the majority of shares present and entitled to vote either in person or by proxy. If you “Abstain” from voting, it will have the same effect as an “Against” vote. Broker non-votes will have no effect.
- To be approved, Proposal 3, approval of the 2008 Employee Long-Term Incentive Plan, must receive a “For” vote from the majority of shares present and entitled to vote either in person or by proxy. If you “Abstain” from voting, it will have the same effect as an “Against” vote. Broker non-votes will have no effect.
- To be approved, Proposal 4, approval of our Amended and Restated Certificate of Incorporation, must receive a “For” vote from the majority of the outstanding shares entitled to vote. Abstentions and broker non-votes will have the same effect as an “Against” vote.

- To be approved, Proposal 5, ratification of appointment of independent auditors, must receive a “For” vote from the majority of shares present and entitled to vote either in person or by proxy. If you “Abstain” from voting, it will have the same effect as an “Against” vote. Broker non-votes will have no effect.

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Ø What is a quorum?

A quorum of stockholders is necessary to hold a valid annual meeting. A quorum will be present if at least a majority of the outstanding shares are represented by proxy or by stockholders present and entitled to vote at the annual meeting. On the record date, there were 8,283,541 shares outstanding and entitled to vote. Thus, at least 4,141,771 shares must be represented by proxy or by stockholders present and entitled to vote at the annual meeting to have a quorum.

Your shares will be counted towards the quorum only if you submit a valid proxy (or one is submitted on your behalf by your broker or bank) or if you vote in person at the annual meeting. We will count abstentions and broker non-votes for purposes of determining a quorum. If there is no quorum, the chairman of the annual meeting or holders of a majority of the votes present at the annual meeting may adjourn the annual meeting to another time or date.

Ø Who pays for the cost of this proxy solicitation?

We will pay for the entire cost of soliciting proxies. In addition to these mailed proxy materials, our directors and employees may also solicit proxies in person, by telephone, or by other means of communication. Directors and employees will not be paid any additional compensation for soliciting proxies. We may retain the services of Georgeson Inc. in connection with soliciting proxies for the Annual Meeting of Stockholders for an estimated fee of \$1,200 to \$1,600, plus appropriate out-of-pocket expenses. We may also reimburse brokerage firms, banks and other agents for the cost of forwarding proxy materials to beneficial owners.

Ø How do I submit a proposal for the Annual Meeting of Stockholders in 2009?

To be considered for inclusion in the Company's proxy statement and form of proxy for next year's annual meeting, your stockholder proposal must be submitted in writing by April 14, 2009 to the Corporate Secretary, ePlus inc., 13595 Dulles Technology Drive, Herndon, Virginia 20171. Proposals must be received by that date and satisfy the requirements under applicable SEC Rules (including SEC Rule 14a-8) to be included in the proxy statement and on the proxy card that will be used for solicitation of proxies by the Board for the 2009 Annual Meeting.

On June 25, 2008, our Board of Directors approved the Amended and Restated Bylaws, which amended, among other things, the procedures for stockholders to submit proposals or nominate directors. In accordance with our current Bylaws, if you wish to submit a proposal for consideration at next year's annual meeting that is not to be included in next year's proxy materials, or wish to nominate a candidate for election to the Board of Directors at next year's annual meeting, your proposal or nomination must be submitted in writing and received by the Corporate Secretary not less than 60 days before the date of the first anniversary of this 2008 annual meeting if the 2009 annual meeting is held within 30 days of the anniversary of this 2008 annual meeting, otherwise, within seven days after the first public announcement of the date of the 2009 annual meeting.

A submission by an ePlus stockholder must contain the specific information required in ePlus' Bylaws. If you would like a copy of ePlus' current Bylaws, please write to the Corporate Secretary, ePlus inc., 13595 Dulles Technology Drive, Herndon, Virginia 20171. ePlus' current Bylaws may also be found on the Company's website at <http://www.eplus.com/bylaws.htm>.

Ø Can I find additional information on the Company's website?

Yes. Although the information contained on our website is not part of this proxy statement, you will find information about ePlus and our corporate governance practices at http://www.eplus.com/about_us.htm. Our website contains information about our Board, Board Committees and their charters, a copy of our Bylaws, and Standard of Conduct

and Ethics. Stockholders may obtain, without charge, hard copies of the above documents by writing to: Corporate Secretary, ePlus inc., 13595 Dulles Technology Drive, Herndon, Virginia 20171.

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CORPORATE GOVERNANCE

Role of the Board of Directors

Our Board plays an active role in overseeing management and representing the interests of stockholders. Directors are expected to attend Board meetings and the meetings of committees on which they serve. Directors are also frequently in communication with management between formal meetings. During the fiscal year ended March 31, 2008, the Board met a total of seven times. All directors attended at least 75% of the total Board and committee meetings to which they were assigned in the fiscal year ended March 31, 2008. All members of the Board, who were members of the Board on such date, attended the last meeting of our stockholders.

Standard of Conduct and Ethics

We are committed to ethical behavior in all that we do. Our Standard of Conduct and Ethics applies to all of our directors, officers and employees. It sets forth our policies and expectations on a number of topics, including our commitment to promoting a fair workplace, avoiding conflicts of interest, compliance with laws (including insider trading laws), appropriate relations with government officials and employees, and compliance with accounting principles.

We also maintain a toll-free hotline through which employees may raise concerns regarding accounting or financial reporting matters. The hotline is available to all employees, 7 days a week, 24 hours a day, in English and in Spanish. Employees using the hotline may choose to remain anonymous. All hotline inquiries are forwarded to a member of our Audit Committee.

Our Standard of Conduct and Ethics is posted on our website at www.eplus.com/ethics.htm. Printed copies of the Standard of Conduct and Ethics may be obtained by stockholders, without can" SIZE="1">

2001 Nanophase Technologies Corporation Equity Compensation Plan, incorporated by reference to Exhibit 4.3 to the Company's Registration Statement on Form S-8 (File No. 333-74170).

10.1

The Nanophase Technologies Corporation Amended and Restated 1992 Stock Option Plan, as amended (the "Stock Option Plan"), incorporated by reference to Exhibit 10.1 to the IPO S-1.

10.2

Form of Indemnification Agreement between the Company and each of its directors and executive officers, incorporated by reference to Exhibit 10.2 to the IPO S-1.

10.3

Amended and Restated Registration Rights Agreements dated as of March 16, 1994, as amended, incorporated by reference to Exhibit 10.2 to the IPO S-1.

10.4

License Agreement dated June 1, 1990 between the Company and ARCH Development Corporation, as amended, incorporated by reference to Exhibit 10.7 to the IPO S-1.

10.5

License Agreement dated October 12, 1994 between the Company and Hitachi, incorporated by reference to Exhibit 10.8 to the IPO S-1.

10.6

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License Agreement dated May 31, 1996 between the Company and Research Development Corporation of Japan, incorporated by reference to Exhibit 10.9 to the IPO S-1.	10.7
License Agreement dated April 1, 1996 between the Company and Cornell Research Foundation, incorporated by reference to Exhibit 10.10 to the IPO S-1.	10.8
*	
Consulting and Stock Purchase Agreement between Richard W. Siegel and the Company dated as of May 9, 1990, as amended February 13, 1991, November 21, 1991 and January 1, 1992, incorporated by reference to Exhibit 10.11 to the IPO S-1.	10.9
Lease Agreement between the Village of Burr Ridge and the Company, dated September 15, 1994, incorporated by reference to Exhibit 10.12 to the IPO S-1.	10.10
Distribution Agreement between the Company and C.I. Kasei, Ltd., (a subsidiary of Itochu Corporation) dated as of October 30, 1996, incorporated by reference to Exhibit 10.15 to the IPO S-1.	

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- 10.11 Supply Agreement between the Company and Schering-Plough HealthCare Products, Inc. dated as of March 15, 1997, incorporated by reference to Exhibit 10.17 to the IPO S-1.
 - 10.12 License Agreement between the Company and C.I. Kasei Co., Ltd. (a subsidiary of Itochu Corporation) dated as of December 30, 1997, incorporated by reference to Exhibit 10.17 to the 1997 10-K.
 - 10.13* Employment Agreement dated as of November 9, 1999 between the Company and Joseph Cross, incorporated by reference to Exhibit 10.15 to the 1999 10-K.
 - 10.14* Employment Agreement dated as of February 15, 1999 between the Company and Gina Kritchevsky, incorporated by reference to Exhibit 10.18 to the 1998 10-K.
 - 10.15* Employment Agreement dated as of March 15, 1999 between the Company and Daniel S. Bilicki, incorporated by reference to Exhibit 10.19 to the 1998 10-K.
 - 10.16* Employment Agreement dated as of June 1, 1999 between the Company and Donald Freed incorporated by reference to Exhibit 10.19 to the 1999 10-K.
 - 10.17* Form of Options Agreement under the Stock Option Plan, incorporated by reference to Exhibit 4.5 to the Company's Registration Statement on Form S-8 (File No. 333-53445).
 - 10.18** Zinc Oxide Supply Agreement dated as of September 16, 1999 between the Company and BASF Corporation, as assignee, incorporated by reference to Exhibit 10.22 to the 1999 10-K.
 - 10.19* Employment Agreement dated as of November 2, 2000 between the Company and Robert Haines, incorporated by reference to Exhibit 10.22 to the Company's Annual Report on Form 10-K for the year ended December 31, 2000 (the 2000 10-K).
 - 10.20 Lease Agreement between Centerpointe Properties Trust and the Company, dated June 15, 2000, incorporated by reference to Exhibit 10.23 to the 2000 10-K.
 - 10.21*** Amendment No. 1 to Zinc Oxide Supply Agreement dated as of January, 2001 between the Company and BASF Corporation, incorporated by reference to Exhibit 10.24 to the 2000 10-K.
 - 10.22 Promissory Note dated as of September 14, 2000 between the Company and BASF Corporation, incorporated by reference to Exhibit 10.25 to the 2000 10-K.
 - 11 Statement regarding computation of loss per share.
 - 23.1 Consent of McGladrey & Pullen, LLP.
 - 23.2 Consent of Ernst & Young, LLP.
-

* Management contract or compensatory plan or arrangement.

** Confidentiality previously requested for portions of this agreement. The Company has disclosed that such agreement is with BASF Corporation, as assignee.

*** Confidentially requested, confidential portions have been omitted and filed separately with the Commission as required by Rule 24b-2.

(b) Reports on Form 8-K:

On December 3, 2001, the Company filed a Form 8-K disclosing a change in its certifying accountant under Item 4.

NANOPHASE TECHNOLOGIES CORPORATION

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Report of Independent Auditors

The Board of Directors and Stockholders
Nanophase Technologies Corporation

We have audited the accompanying balance sheet of Nanophase Technologies Corporation as of December 31, 2001, and the related statements of operations, stockholders' equity, and cash flows for the year then ended. Our audit also included the 2001 data in the financial statement schedule, Schedule II - Valuation and Qualifying Accounts, listed in the index at Item 14(a). These financial statements and the schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedule based on our audit.

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

In our opinion, the 2001 financial statements referred to above present fairly, in all material respects, the financial position of Nanophase Technologies Corporation at December 31, 2001, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, the 2001 data in the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the information set therein.

/s/ McGLADREY & PULLEN, LLP
McGladrey
&
Pullen,
LLP

Schaumburg, Illinois
January 31, 2002, except for the
last paragraph of Note 18, for
which the date is March 8, 2001

Report of Independent Auditors

The Board of Directors and Stockholders
Nanophase Technologies Corporation

We have audited the accompanying balance sheets of Nanophase Technologies Corporation as of December 31, 2000, and the related statements of operations, stockholders' equity, and cash flows for each of the two years in the period ended December 31, 2000. Our audit also included the financial statement schedule for the two years in the period ended December 31, 2000, listed in the index at Item 14 (a). These financial statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedule 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 audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Nanophase Technologies Corporation at December 31, 2000, and the results of its operations and its cash flows for each of the two years in the period ended December 31, 2000, in conformity with accounting principles generally accepted in the United States. Also in our opinion, the related financial statement schedule for the two years in the period ended December 31, 2000, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

/s/ ERNST & YOUNG LLP
Ernst &
Young
LLP

Chicago, Illinois
February 2, 2001

NANOPHASE TECHNOLOGIES CORPORATION

BALANCE SHEETS

	As of December 31,	
	2001	2000
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 582,579	\$ 473,036
Investments	6,842,956	16,831,721
Trade accounts receivable, less allowance for doubtful accounts of \$25,000 in 2001 and \$81,450 in 2000	1,112,952	1,238,334
Other receivable, net	67,449	144,818
Inventories, net	956,268	892,674
Prepaid expenses and other current assets	381,696	770,200
Total current assets	9,943,900	20,350,783
Equipment and leasehold improvements, net	8,914,745	3,266,245
Other assets, net	325,743	213,135
	\$ 19,184,388	\$ 23,830,163
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Current portion of long-term debts	\$ 714,135	\$ 285,316
Current portion of capital lease obligations	48,352	
Accounts payable	1,233,466	824,338
Accrued expenses	732,427	884,780
Total current liabilities	2,728,380	1,994,434
Long-term debt, less current maturities	758,490	827,984
Long-term portion of capital lease obligations, less current maturities	53,900	
	812,390	827,984
Contingent liabilities:		
Stockholders equity:		
Preferred stock, \$.01 par value; 24,088 authorized and no shares issued and outstanding		
Common stock, \$.01 par value; 25,000,000 shares authorized; 13,705,931 and 13,593,914 shares issued and outstanding at December 31, 2001 and December 31, 2000, respectively	137,059	135,939
Additional paid-in capital	50,260,747	49,885,751
Accumulated deficit	(34,754,188)	(29,013,945)
Total stockholders equity	15,643,618	21,007,745
	\$ 19,184,388	\$ 23,830,163

(See accompanying Notes to Financial Statements)

NANOPHASE TECHNOLOGIES CORPORATION

STATEMENTS OF OPERATIONS

	Years ended December 31,		
	2001	2000	1999
Revenue:			
Product revenue	\$ 3,650,914	\$ 3,824,159	\$ 1,128,861
Other revenue	388,555	449,194	295,986
Total revenue	4,039,469	4,273,353	1,424,847
Operating expense:			
Cost of revenue	4,890,697	4,754,485	2,610,667
Research and development expense	1,601,671	1,837,036	1,456,126
Selling, general and administrative expense	3,798,543	3,388,758	3,641,736
Total operating expenses	10,290,911	9,980,279	7,708,529
Loss from operations	(6,251,442)	(5,706,926)	(6,283,682)
Interest income	585,782	1,234,054	1,213,448
Interest expense	(33,485)	(3,455)	
Other, net	(11,098)	(42,000)	(46,833)
Loss before provision for income taxes	(5,710,243)	(4,518,327)	(5,117,067)
Provision for income taxes	(30,000)		
Net loss	\$ (5,740,243)	\$ (4,518,327)	\$ (5,117,067)
Net loss net per share-basic and diluted	\$ (0.42)	\$ (0.34)	\$ (0.40)
Weighted average number of common shares outstanding	13,667,062	13,390,741	12,690,483

(See accompanying Notes to Financial Statements)

NANOPHASE TECHNOLOGIES CORPORATION

STATEMENTS OF STOCKHOLDERS EQUITY

Description	Preferred Stock		Common Stock		Additional Paid-in Capital	Accumulated Deficit	Total
	Shares	Amount	Shares	Amount			
Balance as of January 1, 1999		\$	12,568,691	\$ 125,687	\$ 48,360,454	\$ (19,378,551)	\$ 29,107,590
Exercise of stock options			170,867	1,709	44,766		46,475
Stock Compensation			24,500	245	124,080		124,325
Net loss for the year ended December 31, 1999						(5,117,067)	(5,117,067)
Balance as of December 31, 1999			12,764,058	127,641	48,529,300	(24,495,618)	24,161,323
Exercise of stock options			444,569	4,445	1,147,431		1,151,876
Exercise of warrants			372,579	3,726	146,274		150,000
Stock compensation			12,708	127	62,746		62,873
Net loss for the year ended December 31, 2000						(4,518,327)	(4,518,327)
Balance as of December 31, 2000			13,593,914	135,939	49,885,751	(29,013,945)	21,007,745
Exercise of stock options			105,212	1,052	302,761		303,813
Stock compensation			6,805	68	72,235		72,303
Net loss for the year ended December 31, 2001						(5,740,243)	(5,740,243)
Balance as of December 31, 2001		\$	13,705,931	\$ 137,059	\$ 50,260,747	\$ (34,754,188)	\$ 15,643,618

(See accompanying Notes to Financial Statements)

NANOPHASE TECHNOLOGIES CORPORATION

STATEMENTS OF CASH FLOWS

	Years ended December 31,		
	2001	2000	1999
Operating activities:			
Net loss	\$ (5,740,243)	\$ (4,518,327)	\$ (5,117,067)
Adjustments to reconcile net loss to cash used in operating activities:			
Depreciation and amortization	714,276	722,877	678,749
Stock compensation expense	72,303	62,873	124,325
Allowance for excess inventory quantities	539,415	(168,627)	69,581
Loss on disposition of equipment	84,388		61,011
Changes in assets and liabilities related to operations:			
Trade accounts receivable	125,382	(836,508)	(85,498)
Other receivable	77,369	103,023	(247,841)
Inventories	(603,009)	42,731	2,466
Prepaid expenses and other assets	266,690	(728,417)	8,807
Accounts payable	(424,696)	208,520	202,440
Accrued expenses	(152,353)	(15,618)	(32,621)
Net cash used in operating activities	(5,040,478)	(5,127,473)	(4,335,648)
Investing activities:			
Acquisition of equipment and leasehold improvements	(5,465,697)	(1,823,623)	(504,061)
Purchases of held-to-maturity investments	(84,880,519)	(132,457,935)	(126,819,265)
Maturities of held-to-maturity investments	94,869,284	136,842,382	131,873,614
Net cash provided by investing activities	4,523,068	2,560,824	4,550,288
Financing activities:			
Principal payment on debt obligations, including capital leases	(320,755)	(22,700)	
Proceeds from borrowings	643,895	1,136,000	
Proceeds from sale of common stock	303,813	1,301,876	46,475
Net cash provided by financing activities	626,953	2,415,176	46,475
Increase (decrease) in cash and cash equivalents	109,543	(151,473)	261,115
Cash and cash equivalents at beginning of period	473,036	624,509	363,394
Cash and cash equivalents at end of period	\$ 582,579	\$ 473,036	\$ 624,509
Supplemental cash flow information:			
Interest paid	\$ 33,485	\$ 3,455	\$
Income taxes paid	\$ 30,000	\$	\$
Supplemental non-cash investing and financing activities:			
Capital lease obligations incurred for use of equipment	\$ 138,437	\$	\$
Accounts payable incurred for the purchase of equipment and leasehold improvements	\$ 833,824	\$	\$



(See accompanying Notes to Financial Statements)

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NANOPHASE TECHNOLOGIES CORPORATION

NOTES TO FINANCIAL STATEMENTS

(1) Description of Business

The Company was incorporated on November 30, 1989, for the purpose of developing nanocrystalline materials for commercial production and sale in domestic and international markets.

In the course of its corporate development, the Company has experienced net losses and negative cash flows from operations. Historically, the Company has funded its operations primarily through the issuance of equity securities.

Revenue from international sources approximated \$530,625, \$587,500, and \$573,300, for the years ended December 31, 2001, 2000, and 1999, respectively.

(2) Summary of Significant Accounting Policies

Cash and Cash Equivalents

Cash and cash equivalents primarily consist of demand deposits.

Investments

Investments are classified by the Company at the time of purchase for appropriate designation and such designation is reevaluated as of each balance sheet date. The Company's policy is to classify money market funds and certificates of deposit as investments. Investments are classified as held-to maturity when the Company has the positive intent and ability to hold the securities to maturity. Held-to maturity securities are stated at amortized cost and are adjusted to maturity for the amortization of premiums and accretion of discounts. Such adjustments for amortization and accretion are included in interest income.

Accounts Receivable

Credit evaluations of customers are ongoing and collateral or other security is generally not required on accounts receivable. An allowance for doubtful accounts is maintained at a level management believes is sufficient to cover potential credit losses.

Inventory

Inventory is stated at the lower of cost, maintained on a first in, first out basis, or market. The Company has recorded allowances to reduce inventory relating to excess quantities of certain materials. Although materials subject to this allowance remain in good condition, the quantities on hand exceed the Company's short-term needs.

Equipment and Leasehold Improvements

Equipment is stated at cost and is being depreciated over its estimated useful life (3-10 years) using the straight-line method. Leasehold improvements are stated at cost and are being amortized using the straight-line method over the shorter of the useful life of the asset or the term of the lease (1-16 years). Depreciation expense for leased assets is included with depreciation expense for owned assets.

NANOPHASE TECHNOLOGIES CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

Patent Costs

Patent costs are included in other assets and are being amortized over the life of the respective patent using the straight-line method.

Use of Estimates

The preparation of financial statements requires the Company to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

Product Revenue

Product revenue consists of sales of product that are recognized when realized and earned. This generally occurs when persuasive evidence of an arrangement exists, delivery has occurred, the price is fixed or determinable, and collectibility is reasonably assured. At times, the Company may recognize revenue prior to delivery, in arrangements requested by the Company's customers and meeting the requirements of Staff Accounting Bulletin No. 101, that, including other requirements, requires that the Company has fully completed the production of the product such that no specific performance obligations excluding shipment remain and that the risks of ownership have passed to the buyer.

Other Revenue

Other revenue consists of revenue from research and development arrangements with non-governmental entities, fees from the transfer of technology and related royalties. Research and development arrangements include both cost-plus and fixed fee agreements and such revenue is recognized when specific milestones are met under the arrangements. Fees related to the transfer of technology are recognized when the transfer of technology to the acquiring party is completed and the Company has no further significant obligation. Royalties are recognized when earned pursuant to the contractual arrangement.

Income Taxes

The Company accounts for income taxes using the liability method. As such, deferred income taxes reflect the 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. Deferred tax assets and liabilities are calculated using the enacted tax rates and laws that are expected to be in effect when the anticipated reversal of these differences is scheduled to occur. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or all of the deferred tax assets will not be realized.

Employee Stock Options

As permitted by Statement of Financial Accounting Standards No. 123 Accounting for Stock-Based Compensation (FASB 123), the Company accounts for stock options granted to employees in accordance with APB Opinion No. 25, Accounting for Stock Issued to Employees (APB No. 25). As long as the exercise price of the options granted equals the estimated fair value of the underlying stock on the measurement date, no compensation expense is recognized by the Company for these options. FASB 123, established an alternative fair value method of accounting for stock-based compensation plans. As required by FASB 123 for companies using APB No. 25 for financial reporting purposes, the

NANOPHASE TECHNOLOGIES CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

Company makes pro forma disclosures regarding the impact on net loss of using the fair value method of FASB Statement No. 123.

Fair Value of Financial Instruments

The Company's financial instruments include investments, accounts receivable, accounts payable, accrued liabilities, and long-term debt. The fair values of all financial instruments were not materially different from their carrying values.

Net Loss Per Share

Net loss per common share is computed based upon the weighted average number of common shares outstanding. Common equivalent shares of 596,140 for 2001, 961,207 for 2000, and 483,927 for 1999 are not included in the per share calculations because the effect of their inclusion would be anti-dilutive.

New Accounting Pronouncements

In July 2001, the Financial Accounting Standards Board issued SFAS 141, Business Combinations, and SFAS 142, Goodwill and Other Intangible Assets. SFAS 141 addresses financial accounting and reporting for business combinations and is effective for all business combinations initiated after June 30, 2001. SFAS 142 addresses financial accounting and reporting for acquired goodwill and other intangible assets and is effective for fiscal years beginning after December 15, 2001. Management does not anticipate that the adoption of these Statements will have a significant effect on the Company's financial statements.

In October 2001, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards (SFAS) No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. This Statement addresses the financial accounting and reporting for the impairment or disposal of long-lived assets and supersedes FASB Statement No. 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-Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently occurring Events and Transactions, for the disposal of a segment of a business (as previously defined in that Opinion). SFAS 144 also amends ARB No. 51, Consolidated Financial Statements, to eliminate the exception to consolidation for a subsidiary for which control is likely to be temporary. The provisions of this Statement are effective for financial statements issued for fiscal years beginning after December 15, 2001. Management does not anticipate that the adoption of this Statement will have a significant effect on the Company's financial statements.

Reclassifications

Certain items in the 2000 and 1999 Statements of Operations have been reclassified to conform to the 2001 presentation with no effect on net loss.

(3) Investments

Investments at December 31, 2001 were comprised of variable rate demand notes, certificates of deposit and a money market fund. Investments at December 31, 2000 were comprised of government bonds, commercial paper and a money market fund. These investments had an approximate fair value of \$6,800,000 and \$16,838,000 at December 31, 2001 and 2000, respectively. All investments have been classified as held-to-maturity and mature in the subsequent year. Included in investments is \$554,822 at

NANOPHASE TECHNOLOGIES CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

December 31, 2001 and 2000 in the form of certificates of deposit which are pledged as collateral and restricted as to withdrawal or usage.

(4) Inventories

Inventories consist of the following:

	As of December 31,	
	2001	2000
Raw materials	\$ 429,393	\$ 328,786
Finished goods	1,157,877	655,475
	<u>1,587,270</u>	<u>984,261</u>
Allowance for excess quantities	(631,002)	(91,587)
	<u>\$ 956,268</u>	<u>\$ 892,674</u>

(5) Equipment and Leasehold Improvements

Equipment and leasehold improvements consist of the following:

	As of December 31,	
	2001	2000
Machinery and equipment	\$ 4,239,038	\$ 3,137,182
Office equipment	306,751	292,202
Office furniture	75,871	69,230
Leasehold improvements	1,407,342	873,317
Construction in progress	5,710,743	1,524,515
	<u>11,739,745</u>	<u>5,896,446</u>
Less: Accumulated depreciation and amortization	(2,825,000)	(2,630,201)
	<u>\$ 8,914,745</u>	<u>\$ 3,266,245</u>

Depreciation expense was \$705,070, \$709,792, and \$673,728 for the years ended December 31, 2001, 2000, and 1999, respectively.

(6) Pledged Assets and Long-Term Debt

In November 2000, the Company executed a three-year promissory note, held by the Company's largest customer, in the amount of \$1,293,895 for the construction of additional production capabilities at the Company's Romeoville, Illinois facility. At December 31, 2001 and 2000, borrowings against this note amounted to \$1,293,895 and \$650,000, respectively. The note bears interest at 8.45% per annum, with interest accruing beginning January 1, 2002, and the first payment commencing in February of 2002. The note is collateralized by certain powder coating, packaging, lab and related equipment, not yet placed in service, to be used in the manufacture of product for this customer, with a cost at December 31, 2001 approximating the outstanding balance of the note. Contractually, the Company has twenty-nine months to pay back this note, based on a rate per kilogram of product shipped, with any remaining outstanding balance at June 1, 2004 becoming payable on demand. An estimated twelve months worth of payments are included in the current portion of the Company's long-term debts.

NANOPHASE TECHNOLOGIES CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

In December 2000, the Company financed \$486,000 in insurance premiums. The balance due on the note was \$463,300 at December 31, 2000. The interest on the note was accrued at 8.53% per annum through September 2001. In September 2001, the interest rate was adjusted to the 30 Day LIBOR rate plus 1.84%. At December 31, 2001, the rate of interest on this note was 5.42%. At December 31, 2001, the balance due is \$178,730 and expected monthly payments will be approximately \$26,000 through July 2002. The note is collateralized by a declining letter of credit to be reduced over the life of the loan.

(7) Lease Commitments

The Company leases its operating facilities under operating leases. These leases are renewable at current market rates. Future minimum rental payments required under these leases having an initial or non-cancelable term in excess of one year as of December 31, 2001 are as follows:

The following is a schedule of future minimum lease payments as required under the above operating leases:

Year ending December 31:

2002	\$ 403,428
2003	305,815
2004	301,601
2005	310,651
2006	184,345
	<hr/>
Total minimum payments required:	\$ 1,505,840
	<hr/>

Rent expense, including real estate taxes, under these leases amounted to \$523,615, \$303,416, and \$190,832, for the years ended December 31, 2001, 2000, and 1999, respectively.

During the year ended December 31, 2001, the Company entered into capital leases for equipment costing \$138,437 which are included in property and equipment on the balance sheet. Depreciation expense for these assets was \$13,129 for the year ended December 31, 2001.

The following is a schedule of future minimum lease payments as required under the above capital leases:

Year ending December 31:

2002	\$ 55,988
2003	46,574
2004	10,859
	<hr/>
	113,421
Less: Amount representing interest	(11,169)
	<hr/>
Present value of net future minimum lease payments	102,252
Less: Current Portion	(48,352)
	<hr/>
	\$ 53,900
	<hr/>

NANOPHASE TECHNOLOGIES CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

(8) Accrued Expenses

Accrued expenses consist of the following:

	As of December 31,	
	2001	2000
Accrued payroll and related expenses	\$ 359,708	\$ 534,994
Accrued professional services	119,245	122,768
Other	253,474	227,018
	<u>\$ 732,427</u>	<u>\$ 884,780</u>

(9) Research and Development Arrangements

The Company is party to a number of research and development arrangements with commercial entities. These arrangements are generally short-term in nature and provided \$47,450, \$10,500, and \$197,500 of revenues for the years ended December 31, 2001, 2000, and 1999, respectively.

(10) License Agreements

The Company was granted a non-exclusive license by a third party to make, use, and sell products of the type claimed in two U.S. patents. In consideration for this license, the Company agreed to pay royalties of 1% of net sales, as defined, and made an advance royalty payment of \$17,500. Royalties under this agreement amounted to approximately \$35,200, \$24,200, and \$12,900 for the years ended December 31, 2001, 2000, and 1999, respectively.

The Company was granted a non-exclusive license by a third party to produce and sell ultrafine powders of metal and ceramics claimed in four U.S. patents. In consideration for this license, the Company agreed to pay \$14,000 as an initial payment, and pay royalties of 3% of net proceeds of sales of the product, as defined. There were no royalties under this agreement in the years ending December 31, 2001 and 2000, and \$37,900 was paid in the year ending December 31, 1999.

In December 1997, the Company entered into a license agreement whereby the Company granted a royalty-bearing exclusive right and license, as defined, to purchase, make, use and sell nanocrystalline materials to C. I. Kasei, a division of Itochu Corporation (CIK). Under this agreement, the Company also will earn royalties on net sales of manufactured products containing nanocrystalline materials. The agreement also provided for minimum sales targets and minimum royalty payments to maintain exclusivity. The agreement expires on March 31, 2013 unless earlier terminated as provided therein. The Company recorded royalty revenues, classified as Other Revenue on the Statements of Operations, under this agreement of \$300,000, \$300,000, and \$4,417, for the years ended December 31, 2001, 2000, and 1999, respectively. In 1999, the Company allowed CIK to purchase additional product as a substitute for its minimum royalty requirements.

(11) Income Taxes

The Company has net operating loss carryforwards for tax purposes of approximately \$39,800,000 at December 31, 2001, which expire between 2005 and 2021.

NANOPHASE TECHNOLOGIES CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

Deferred income taxes reflect the 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 income taxes consist of the following:

	As of December 31,	
	2001	2000
Deferred tax assets:		
Net operating loss carryforwards	\$ 15,501,000	\$ 12,498,000
Foreign tax credit carryforward	186,000	156,000
Inventory and other allowances	256,000	67,000
Excess book depreciation	35,000	179,000
Other accrued costs	131,000	189,000
	<u>16,109,000</u>	<u>13,089,000</u>
Total deferred tax assets	16,109,000	13,089,000
Less: Valuation allowance	(16,109,000)	(13,089,000)
	<u>\$</u>	<u>\$</u>
Deferred income taxes		

The valuation allowance increased \$3,020,000 for the year ended December 31, 2001 due principally to the increase in the net operating loss carryforward and uncertainty as to whether future taxable income will be generated prior to the expiration of the carryforward period. Under the Internal Revenue Code, certain ownership changes, including the prior issuance of preferred stock and the Company's public offering of common stock, may subject the Company to annual limitations on the utilization of its net operating loss carryforward.

As a result of certain transactions with third parties operating in foreign countries, the Company may be subject to the withholding and payment of foreign income taxes as transactions are completed. Under the Internal Revenue Code, foreign tax payments may be used to offset federal income tax liabilities when incurred, subject to certain limitations. At December 31, 2001, the Company has a foreign tax credit carryforward of \$186,000.

(12) Capital Stock

In October 1998, the Company declared a dividend of one Preferred Stock Purchase Right (a "Right") for each outstanding share of Company common stock on November 10, 1998. The Rights are not presently exercisable. Each Right entitles the holder, upon the occurrence of certain specified events, to purchase from the Company one ten-thousandth of a share of the Company's Series A Junior Participating Preferred Stock at a purchase price of \$25 per one-ten thousandth of a share (the "Purchase Price"). The Rights further provide that each Right will entitle the holder, upon the occurrence of certain specified events, to purchase from the Company, common stock having a value of twice the Purchase Price and, upon the occurrence of certain other specified events, to purchase from another entity into which the Company is merged or which acquires 50% or more of the Company's assets or earnings power, common stock of such other entity having a value of twice the Purchase Price. In general, the Rights may be redeemed by the Company at a price of \$0.01 per Right. The Rights expire on October 28, 2008.

NANOPHASE TECHNOLOGIES CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

At December 31, 2001, 2,500 shares of authorized but unissued Preferred Stock have been reserved for future issuance regarding the Rights. In addition, authorized but unissued shares of common stock have been reserved for future issuance as follows:

Warrants	28,949
Options	2,697,226
	<u>2,726,175</u>

(13) Stock Options, Warrants, and Stock Grants

The Company has entered into stock option agreements with certain officers, employees, directors and three Advisory Board members. At December 31, 2001, the Company had outstanding options to purchase 1,815,226 shares of common stock. The stock options generally expire ten years from the date of grant. Of the total number of options granted 810,891 of the outstanding options vest over a five-year period, 948,701 vest over a three-year period from their respective grant dates and 55,634 vest on the eighth anniversary following their grant date.

Exercise prices are determined by the Board of Directors and equal the estimated fair values of the Company's common stock at the grant date. The table below summarizes all option activity through December 31, 2001:

	<u>Number of Options</u>	<u>Exercise Price</u>	<u>Weighted Average Exercise Price</u>
Outstanding at January 1, 1999	1,781,385	.112-5.750	2.916
Options granted during 1999	417,000	1.750-5.000	2.115
Options exercised during 1999	(170,867)	.112-1.727	.272
Options canceled during 1999	(174,274)	.432-5.250	3.641
	<u>1,853,244</u>		
Outstanding at December 31, 1999	1,853,244	.112-5.750	2.911
Options granted during 2000	335,675	6.312-11.625	7.777
Options exercised during 2000	(444,569)	.432-5.750	2.591
Options canceled during 2000	(292,669)	1.727-7.687	3.732
	<u>1,451,681</u>		
Outstanding at December 31, 2000	1,451,681	.112-11.625	3.876
Options granted during 2001	482,200	7.062-12.250	9.075
Options exercised during 2001	(105,212)	.432-7.625	2.888
Options canceled during 2001	(13,443)	1.727-10.875	6.749
	<u>1,815,226</u>		
Outstanding at December 31, 2001	1,815,226	.112-12.250	5.293

NANOPHASE TECHNOLOGIES CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

Information with respect to stock options outstanding and stock options exercisable at December 31, 2001 follows:

	Options Outstanding		
	Number Outstanding at December 31, 2001	Weighted-Average Remaining Contractual Life (Years)	Weighted-Average Exercise Price
Range of Exercise Prices			
\$0.112-0.432	69,563	2.803	\$ 0.352
\$1.727-2.375	373,144	6.750	1.911
\$2.813-3.886	562,154	5.919	3.558
\$5.000-7.062	239,640	8.904	6.889
\$7.625-11.063	558,725	8.721	9.092
\$11.625-12.250	12,000	8.925	\$ 11.729
	1,815,226		

	Options Exercisable	
	Number Exercisable at December 31, 2001	Weighted-Average Exercise Price
Range of Exercise Prices		
\$0.112-0.432	69,563	\$ 0.352
\$1.727-2.375	233,477	1.845
\$2.813-3.886	364,095	3.638
\$5.000-7.063	19,073	5.469
\$7.625-11.063	99,002	7.693
\$11.625-12.250	2,000	11.625
	787,210	3.390

Option shares exercisable at December 31, 2000 and 1999, were 549,533 and 666,582 and had a weighted average exercise price of \$2.765 and \$2.907, respectively.

The Company has elected to follow APB No. 25 and related interpretations in accounting for its employee stock options because, as discussed below, the alternative fair value accounting provided for under FASB No. 123 requires use of option valuation models that were not developed for the use in valuing employee stock options. Pro forma information regarding net income is required by FASB No. 123, which also requires that the information be determined as if the Company had accounted for the employee stock options granted subsequent to December 31, 1994 under the fair value method of that Statement. The fair value for these options was estimated at the date of grant using a Black-Scholes option pricing model with the following assumptions for the years ended December 31, 2001, 2000, and 1999: U.S. government zero coupon 7-year bond interest rates ranging from 5.11% to 5.95%, depending upon the specific grant date of the options; a dividend yield of zero percent; and a weighted-average expected life of the option of

NANOPHASE TECHNOLOGIES CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

7 years. The volatility factors used range from 25.0% to 92.3%. The weighted average fair value of the options granted during 2001, 2000, and 1999 was \$7.392, \$ 3.263, and \$ 0.885 per share, respectively.

For purposes of the pro forma disclosures, the estimated fair value of the options is amortized to expense over the vesting period of the respective option. Because FASB No. 123 is applicable only to options granted subsequent to December 31, 1994, its pro forma impact will not be fully reflected until 2002. The Company's pro forma net loss would be \$7,285,713, \$4,789,332, and \$5,456,516 and the pro forma net loss per share, basic and diluted, would be \$0.53, \$0.36, and \$0.43 for the years ended December 31, 2001, 2000, and 1999, respectively.

In connection with the issuance of Series C convertible preferred stock in 1993, the Company issued common stock purchase warrants for 662,287 shares at no additional cost to the Series C convertible preferred stockholders. At the Company's initial public offering on November 26, 1997, all preferred stock shares were converted to common stock shares. These warrants have an exercise price of \$1.123 per share and expire upon the tenth anniversary of issuance. No warrants were converted in 1999. For the year ended December 31, 2000, 400,847 warrants were converted to common stock, of which 267,231 warrants were converted, via a cashless exchange into 238,963 shares of common stock, and 133,616 warrants were exercised for \$150,000. No warrants were converted in 2001. At December 31, 2001, 28,949 warrants remain outstanding and exercisable.

For the year ended December 31, 2001, the Company recognized \$72,303 in stock compensation expense related to the grant of 6,805 shares of stock to five directors. For the year ended December 31, 2000, the Company recognized \$62,873 in stock compensation expense related to the grant of 12,708 shares of stock to four directors. For the year ended December 31, 1999, the Company recognized \$124,325 in stock compensation expense related to the grant of 24,500 shares of stock to an officer and to the extension of stock option vesting periods for three former officers.

(14) 401(k) Profit-Sharing Plan

The Company has a 401(k) profit-sharing plan covering substantially all employees who meet defined service requirements. The plan provides for deferred salary contributions by the plan participants and a maximum contribution by the Company not to exceed 3% of the participant's salary. The Company contributions under this plan were \$81,579, \$42,026, and \$0 for the years ended December 31, 2001, 2000, and 1999, respectively.

(15) Related Party Transactions

The Company has an ongoing consulting agreement with a director/stockholder. Payments under this agreement amount to \$2,000 per month.

(16) Significant Customers and Contingencies

Revenue from two customers constituted approximately 75.5% and 9.4%, respectively, of the Company's 2001 revenue. Amounts included in accounts receivable relating to these two customers were approximately \$719,000 and \$307,000, respectively. Revenue from two customers constituted approximately 68.5% and 10.0%, respectively, of the Company's 2000 revenue. Amounts included in accounts receivable relating to these two customers were approximately \$805,000 and \$309,000, respectively. Revenue from three customers constituted approximately 33.8%, 9.9%, and 9.7%, respectively, of the Company's 1999 revenue. Amounts included in accounts receivable relating to these

NANOPHASE TECHNOLOGIES CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

three customers were approximately \$94,000, \$70,000, and \$80,000, respectively. The Company currently has supply agreements with the aforementioned customers that have contingencies outlined in them which could potentially result in the license of technology and/or, as provided for in the supply agreement with the Company's largest customer, the sale of production equipment, providing capacity sufficient to meet the customer's production needs, from the Company to the customer, if triggered by the Company's failure to meet certain performance requirements and/or certain financial condition covenants. The financial condition covenants included in the Company's supply agreement with its largest customer triggers a technology transfer (license or, optionally, an equipment sale) in the event (a) that earnings of the Company for a twelve month period ending with its most recently published quarterly financial statements are less than zero and its cash, cash equivalents and liquid investments are less than \$4,000,000, (b) of an acceleration of any debt maturity having a principal amount of more than \$10,000,000 or (c) the Company's insolvency, as further defined within the agreement. In the event of an equipment sale, upon incurring a triggering event, the equipment would be sold to the customer at 115% of the equipment's depreciated cost. The Company believes that it has complied with all contractual requirements and that it has not had a triggering event.

(17) QUARTERLY FINANCIAL DATA (UNAUDITED)

	<u>First Quarter</u>	<u>Second Quarter</u>	<u>Third Quarter</u>	<u>Fourth Quarter</u>
2001				
Total revenue	\$ 1,071,924	\$ 1,049,379	\$ 679,545	\$ 1,238,621
Loss from operations	(1,352,072)	(1,410,884)	(1,541,340)	(1,947,146)
Net loss	(1,119,283)	(1,286,720)	(1,437,712)	(1,896,528)
Basic and diluted loss per share	(0.08)	(0.09)	(0.10)	(0.14)
2000				
Total revenue	\$ 618,921	\$ 1,105,336	\$ 1,354,951	\$ 1,194,145
Loss from operations	(1,717,784)	(1,552,282)	(1,024,466)	(1,412,394)
Net loss	(1,434,559)	(1,252,767)	(715,241)	(1,115,760)
Basic and diluted loss per share	(0.11)	(0.09)	(0.05)	(0.08)

(18) Contingent Liabilities

Five separate complaints were filed in the United States District Court for the Northern District of Illinois, each alleging that the Company, certain of its officers and directors, and the underwriters of the Company's initial public offering of the Company's Common Stock (the "Offering") were liable under the federal Securities Act of 1933 for making supposedly negligent or reckless material misstatements or omissions of fact in the Registration Statement and Prospectus relating to the Offering. A consolidated complaint was filed in those cases in October 1998, alleging that the action should be maintained as (i) a plaintiff class action on behalf of certain persons who purchased the Common Stock from November 26, 1997 through January 8, 1998, and (ii) a defendant class action against the underwriters who participated in the Offering. The consolidated complaint sought relief including unquantified damages, interest, and attorneys' fees. In October 1999, the Court granted in part and denied in part defendants' motions to dismiss the consolidated complaint, finding in part that plaintiffs who did not purchase their Common

NANOPHASE TECHNOLOGIES CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

Stock during the Offering could not sue under Section 12(a)(2) of the Securities Act of 1933. Each defendant's respective answer to the remaining claims in the consolidated complaint was filed in November 1999. Following certain discovery, the Company agreed to settle all claims against all defendants in the consolidated complaint for \$4,025,000. The settlement did not admit liability by any party. Because the settlement was funded by the Company's directors and officers liability insurance, the settlement payment did not have a material adverse effect on the Company's financial condition or results of operations. In March 2001, the Court ordered final approval of the settlement and dismissed the consolidated complaint with prejudice.

The above-described settlement did not resolve a separate complaint filed in the Northern District of Illinois in November 1998, alleging that the Company, certain of its officers and directors, and the underwriters of the Company's Offering were liable under the federal Securities Exchange Act of 1934 for making supposedly fraudulent material misstatements and omissions of fact in connection with the solicitation of consents to proceed with the Offering from certain of the Company's preferred stockholders. The complaint alleged that the action should be maintained as a plaintiff class action on behalf of certain former preferred stockholders whose shares of preferred stock were converted into Common Stock on or about the date of the Offering. The complaint sought relief including unquantified damages, interest, and attorneys' fees. Each defendant's respective answer to the preferred stockholders' complaint was filed in September 2000. Following certain discovery, the Company agreed to settle all claims against all defendants in the preferred stockholders' complaint for \$800,000, plus up to an additional \$50,000 for the cost of settlement notices and administration. The settlement did not admit liability by any party. Because the settlement was funded by the Company's directors and officers liability insurance, the settlement payment did not have a material adverse effect on the Company's financial position or results of operations. On January 10, 2002, the Court ordered final approval of the settlement and dismissed the preferred stockholders' complaint with prejudice.

In early November 2001, a separate complaint was filed in the United States District Court for the Northern District of Illinois, alleging that the Company and one of its officers are liable under the federal Securities Exchange Act of 1934. The recent complaint asserts that defendants made supposedly fraudulent material misstatements of fact and omitted to state material facts necessary to make other statements of fact not misleading in connection with the Company's public disclosures, including certain press releases, concerning the Company's dealings with a certain British customer. The complaint alleges that the action should be maintained as a plaintiff class action on behalf of certain persons who purchased shares of the Company's Common Stock from April 5, 2001 through October 24, 2001. The complaint seeks relief including unquantified compensatory damages, and attorneys' and expert witness' fees. Defendants filed a motion to dismiss the complaint in December 2001. Rather than respond to that motion, plaintiff filed an amended complaint on March 8, 2002. The amended complaint alleges that the Company and four of its officers are liable under the federal Securities Exchange Act of 1934 for making supposedly fraudulent material misstatements and omissions of fact in connection with the Company's press releases, publicly-filed reports and other public disclosures concerning the Company's dealings with the British customer and the revenue reported under a purchase order with that customer. The amended complaint alleges the same putative class, and seeks the same relief, as in plaintiff's initial complaint. Defendants anticipate filing a motion to dismiss the amended complaint by April 12, 2002. Although the Company believes that the allegations of the amended complaint are without merit, it is not feasible for the Company to predict at this time the outcome of this litigation or whether its resolution could have a material adverse effect on the Company's results of operations or financial condition.

Valuation and Qualifying Accounts

Description	Balance Beginning of Period	Additions		Deductions	Balance at End of Period
		Costs and Expenses	Other Accounts		
Year ended December 31, 1999:					
Allowance for doubtful accounts	\$ 85,000	\$ 54,068	\$	\$ 19,068(1)	\$ 120,000
Allowance for excess inventory quantities accounts	\$ 190,633	\$ 69,581	\$	\$	\$ 260,214
Deferred tax asset valuation account	\$ 7,663,000	\$ 1,930,000	\$	\$	\$ 9,593,000
Year ended December 31, 2000:					
Allowance for doubtful accounts	\$ 120,000	\$	\$	\$ 38,550(1)	\$ 81,450
Allowance for excess inventory quantities accounts	\$ 260,214	\$	\$	\$ 168,627(2)	\$ 91,587
Deferred tax asset valuation account	\$ 9,593,000	\$ 3,496,000	\$	\$	\$ 13,089,000
Year ended December 31, 2001:					
Allowance for doubtful accounts	\$ 81,450	\$	\$	\$ 56,450	\$ 25,000
Allowance for excess inventory quantities accounts	\$ 91,587	\$ 631,002	\$	\$ 91,587(2)	\$ 631,002
Deferred tax asset valuation account	\$ 13,089,000	\$ 3,020,000	\$	\$	\$ 16,109,000

(1) Uncollectible accounts written off.

(2) Reduction in inventory allowance as a result of the sale of inventories for which an allowance had previously been provided.

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, on the 28th day of March, 2002.

NANOPHASE TECHNOLOGIES
CORPORATION

By: /s/ JOSEPH CROSS

**Joseph
Cross
President and
Chief Executive Officer**

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 indicated on the 28th day of March, 2002.

<u>Signature</u>	<u>Title</u>
<u> /s/ JOSEPH CROSS </u> Joseph Cross	President, Chief Executive Officer (Principal Executive Officer) and a Director
<u> /s/ JESS JANKOWSKI </u> Jess Jankowski	Acting Chief Financial Officer, Corporate Controller, Treasurer and Secretary (Principal Financial and Accounting Officer)
<u> /s/ DONALD S. PERKINS </u> Donald S. Perkins	Chairman of the Board and Director
<u> /s/ JAMES A. HENDERSON </u> James A. Henderson	Director
<u> /s/ JAMES A. McCLUNG </u> James A. McClung	Director
<u> /s/ JERRY PEARLMAN </u> Jerry Pearlman	Director
<u> /s/ RICHARD W. SIEGEL </u> Richard W. Siegel	Director

EXHIBIT INDEX

**Exhibit
Number**

- 2 Plan and Agreement of Merger dated as of November 25, 1997 by and between the Company and its Illinois predecessor, incorporated by reference to Exhibit 2 to the Company's Annual Report on Form 10-K for the year ended December 31, 1997 (the 1997 10-K).
- 3.1 Certificate of Incorporation of the Company, incorporated by reference to Exhibit 3.1 to the 1997 10-K.
- 3.2 Bylaws of the Company, incorporated by reference to Exhibit 3.2 to the 1997 10-K.
- 4.1 Specimen stock certificate representing Common Stock, incorporated by reference to Exhibit 4.1 to the Company's Registration Statement on Form S-1 (File No. 333-36937) (the IPO S-1).
- 4.2 Form of Warrants, incorporated by reference to Exhibit 4.2 to the IPO S-1.
- 4.3 Rights Agreement dated as of October 28, 1998 by and between the Company and LaSalle National Bank, incorporated by reference to Exhibit 1 to the Company's Registration Statement on Form 8-A, filed October 28, 1998.
- 4.7 Certificate of Designation of Series A Junior Participating Preferred Stock incorporated by reference to Exhibit 4.4 to the Company's Annual Report on Form 10-K for the year ended December 31, 1998 (the 1998 10-K).
- 4.8 Amendment to Rights Agreement dated August 1, 2001 between the Company and LaSalle National Association, as Rights Agent, incorporated by reference to Exhibit 4.5 to the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2001.
- 4.9 2001 Nanophase Technologies Corporation Equity Compensation Plan, incorporated by reference to Exhibit 4.3 to the Company's Registration Statement on Form S-8 (File No. 333-74170).
- 10.1 The Nanophase Technologies Corporation Amended and Restated 1992 Stock Option Plan, as amended (the Stock Option Plan), incorporated by reference to Exhibit 10.1 to the IPO S-1.
- 10.2 Form of Indemnification Agreement between the Company and each of its directors and executive officers, incorporated by reference to Exhibit 10.2 to the IPO S-1.
- 10.3 Amended and Restated Registration Rights Agreements dated as of March 16, 1994, as amended, incorporated by reference to Exhibit 10.2 to the IPO S-1.
- 10.4 License Agreement dated June 1, 1990 between the Company and ARCH Development Corporation, as amended, incorporated by reference to Exhibit 10.7 to the IPO S-1.
- 10.5 License Agreement dated October 12, 1994 between the Company and Hitachi, incorporated by reference to Exhibit 10.8 to the IPO S-1.

- 10.6 License Agreement dated May 31, 1996 between the Company and Research Development Corporation of Japan, incorporated by reference to Exhibit 10.9 to the IPO S-1.
- 10.7 License Agreement dated April 1, 1996 between the Company and Cornell Research Foundation, incorporated by reference to Exhibit 10.10 to the IPO S-1.
- 10.8* Consulting and Stock Purchase Agreement between Richard W. Siegel and the Company dated as of May 9, 1990, as amended February 13, 1991, November 21, 1991 and January 1, 1992, incorporated by reference to Exhibit 10.11 to the IPO S-1.
- 10.9 Lease Agreement between the Village of Burr Ridge and the Company, dated September 15, 1994, incorporated by reference to Exhibit 10.12 to the IPO S-1.
- 10.10 Distribution Agreement between the Company and C.I. Kasei, Ltd., (a subsidiary of Itochu Corporation) dated as of October 30, 1996, incorporated by reference to Exhibit 10.15 to the IPO S-1.
- 10.11 Supply Agreement between the Company and Schering-Plough HealthCare Products, Inc. dated as of March 15, 1997, incorporated by reference to Exhibit 10.17 to the IPO S-1.
- 10.12 License Agreement between the Company and C.I. Kasei Co., Ltd. (a subsidiary of Itochu Corporation) dated as of December 30, 1997, incorporated by reference to Exhibit 10.17 to the 1997 10-K.
- 10.13* Employment Agreement dated as of November 9, 1999 between the Company and Joseph Cross, incorporated by reference to Exhibit 10.15 to the 1999 10-K.
- 10.14* Employment Agreement dated as of February 15, 1999 between the Company and Gina Kritchevsky, incorporated by reference to Exhibit 10.18 to the 1998 10-K.
- 10.15* Employment Agreement dated as of March 15, 1999 between the Company and Daniel S. Bilicki, incorporated by reference to Exhibit 10.19 to the 1998 10-K.
- 10.16* Employment Agreement dated as of June 1, 1999 between the Company and Donald Freed incorporated by reference to Exhibit 10.19 to the 1999 10-K.
- 10.17* Form of Options Agreement under the Stock Option Plan, incorporated by reference to Exhibit 4.5 to the Company's Registration Statement on Form S-8 (File No. 333-53445).
- 10.18** Zinc Oxide Supply Agreement dated as of September 16, 1999 between the Company and BASF Corporation, as assignee, incorporated by reference to Exhibit 10.22 to the 1999 10-K.
- 10.19* Employment Agreement dated as of November 2, 2000 between the Company and Robert Haines, incorporated by reference to Exhibit 10.22 to the Company's Annual Report on Form 10-K for the year ended December 31, 2000 (the 2000 10-K).
- 10.20 Lease Agreement between Centerpointe Properties Trust and the Company, dated June 15, 2000, incorporated by reference to Exhibit 10.23 to the 2000 10-K.

- 10.21*** Amendment No. 1 to Zinc Oxide Supply Agreement dated as of January, 2001 between the Company and BASF Corporation, incorporated by reference to Exhibit 10.24 to the 2000 10-K.
- 10.22 Promissory Note dated as of September 14, 2000 between the Company and BASF Corporation, incorporated by reference to Exhibit 10.25 to the 2000 10-K.
- 11 Statement regarding computation of loss per share.
- 23.1 Consent of McGladrey & Pullen, LLP.
- 23.2 Consent of Ernst & Young, LLP.
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* Management contract or compensatory plan or arrangement.

** Confidentiality previously requested for portions of this agreement. The Company has disclosed that such agreement is with BASF Corporation, as assignee.

*** Confidentially Requested, confidential portions have been omitted and filed separately with the Commission as required by Rule 24b-2.