COMPUTERIZED THERMAL IMAGING INC
Form 10-Q
May 24, 2004

U.S. SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2004

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

For the transition period from _____ to _____

Commission file number: 001-16253

COMPUTERIZED THERMAL IMAGING, INC.
(Exact name of Registrant as specified in its charter)

| NEVADA | 87-0458721 |
|---|---|
| (State or other jurisdiction of incorporation or organization) | (IRS Employer Identification No.) |
| 1719 West 2800 South Ogden, Utah | 84401 |
| (Address of principal executive offices) | (Zip Code) |

(801) 776-4700
(Registrant's telephone number, including area code)

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

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: Common stock, par value $0.001, of which 113,895,031 shares were issued and outstanding as of May 1, 2004.

COMPUTERIZED THERMAL IMAGING, INC.

FORM 10-Q

QUARTERLY REPORT

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PART I - FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS

COMPUTERIZED THERMAL IMAGING, INC.
(A Development Stage Company)
CONDENSED CONSOLIDATED BALANCE SHEETS

| ASSETS | March 31, 2004 (UNAUDITED) | June 30, 2003 |
|---|---|---|
| CURRENT ASSETS: | | |
| Cash and cash equivalents | $ 125,757 | $ 454,387 |
| Investments available for sale | -- | -- |
| Accounts receivable-trade, net (less allowance for doubtful accounts of $62,471 and $3,199 for March 2004 and June 2003, respectively | 160,133 | 420,395 |
| Accounts receivable-other, net | -- | -- |

| | | |
|---|---|---|
| Inventories | 355,542 | 305,864 |
| Prepaid expenses | 79,083 | 310,248 |
| Deferred Finance Costs | -- | -- |
| Total current assets | 620,515 | 1,490,894 |
| PROPERTY AND EQUIPMENT, Net | 180,154 | 312,719 |
| INTANGIBLE ASSETS: | | |
| Intellectual property rights, net (less accumulated amortization: March - $16,777; June - $14,782) | 16,070 | 18,065 |
| TOTAL ASSETS | $ 816,739 | $ 1,821,678 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| CURRENT LIABILITIES: | | |
| Accounts payable | $ 601,208 | $ 655,075 |
| Accrued liabilities | 396,353 | 406,032 |
| Accrued settlement reserve | -- | 100,000 |
| Convertible Debenture | -- | 157,276 |
| Deferred revenues | 1,171,651 | 786,650 |
| Total current liabilities | 2,169,212 | 2,105,033 |
| STOCKHOLDERS' EQUITY: | | |
| Convertible preferred stock, $5.00 par value, 3,000,000 shares authorized ; issued - none | -- | -- |
| Common stock, $.001 par value, 200,000,000 shares authorized, 113,895,031 and 109,329,098 issued and outstanding on March 31, 2004 and June 30, 2003, respectively | 113,894 | 109,329 |
| Additional paid-in capital | 95,423,816 | 94,041,104 |
| Common stock subscription receivable | -- | -- |
| Other comprehensive income | -- | -- |
| Deficit accumulated during the development stage | (96,890,183) | (94,433,788) |
| Total stockholders' equity | (1,352,473) | (283,355) |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY | $ 816,739 | $ 1,821,678 |

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

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS AND OTHER COMPREHENSIVE INCO
(UNAUDITED)

| | THREE MONTH PERIOD ENDED MARCH 31, | | NINE MONTH PERIOD MARCH 31, | |
|---|---|---|---|---|
| | 2004 | 2003 | 2004 | |
| INCOME: | | | | |
| Revenues | $ 107,233 | $ 390,586 | $ 263,574 | $ |
| Cost of goods sold | (13,444) | (219,952) | (76,375) | ( |
| GROSS MARGIN | 93,789 | 170,634 | 187,199 | |
| OPERATING EXPENSES: | | | | |
| General and administrative | 251,961 | 703,315 | 1,176,775 | |
| Litigation Settlements | 10,000 | -- | 110,000 | |
| Research and development | 264,266 | 851,251 | 927,967 | |
| Marketing | 45,296 | 306,557 | 296,425 | |
| Depreciation and amortization | 36,000 | 48,237 | 131,700 | |
| Impairment loss | -- | -- | -- | |
| Total operating expenses | 607,523 | 1,909,360 | 2,642,867 | |
| OPERATING LOSS | (513,734) | (1,738,726) | (2,455,668) | ( |
| OTHER INCOME (EXPENSE): | | | | |
| Interest income | 313 | 22,012 | 4,498 | |
| Interest expense | (2) | (1,851,868) | (5,426) | ( |
| Other | 200 | -- | 200 | |
| Total other income (expense) | 511 | (1,829,856) | (728) | ( |
| LOSS BEFORE EXTRAORDINARY ITEM | (513,223) | (3,568,582) | (2,456,396) | (1 |
| EXTRAORDINARY GAIN ON EXTINGUISHMENT OF DEBT | -- | -- | -- | |
| NET LOSS | (513,223) | (3,568,582) | (2,456,396) | (1 |
| OTHER COMPREHENSIVE INCOME (LOSS) | | | | |
| Unrealized gain (loss) on investments available for sale | | (8,225) | | |
| TOTAL COMPREHENSIVE (LOSS) | $ (513,223) | $ (3,576,807) | $ (2,456,396) | $ (1 |
| WEIGHTED AVERAGE SHARES OUTSTANDING | 113,430,471 | 94,133,485 | 113,072,213 | 8 |

| | | | | |
|---|---|---|---|---|
| BASIC AND DILUTED LOSS PER COMMON SHARE | $ (0.00) | $ (0.04) | $ (0.02) | $ |

The accompanying condensed notes are an integral part of these consolidated financial st



COMPUTERIZED THERMAL IMAGING, INC.
(A Development Stage Company)
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

| | NINE MONTHS ENDED MARCH 31, 2004 | 2003 |
|---|---|---|
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net loss | $ (2,456,396) | $(10,376,340) |
| Adjustments to reconcile net income (loss) to net cash used in operating activities: | | |
| Depreciation and amortization | 131,700 | 387,815 |
| Impairment loss and loss on disposition of assets | (525) | 774,830 |
| Bond Amortization | -- | 68,157 |
| Amortization Bonds and deferred finance costs and discounts on notes payable | -- | 609,761 |
| Conversion expense of convertible debenture | 1,776,839 | 1,776,839 |
| Common stock, warrants, and options issued as compensation for services | -- | -- |
| Options extended beyond their expiration date | -- | -- |
| Common stock issued for interest expense | -- | -- |
| Stock-based compensation on options marked to market | -- | 7,280 |
| Common stock issued to settle litigation | -- | -- |
| Options issued at discount to market to settle litigation | -- | -- |
| Options issued at discount to market as compensation expense | -- | -- |
| Common stock issued to pay Debenture | -- | 400,430 |
| Common stock issued for failure to complete timely registration | -- | -- |
| | -- | -- |
| Common stock issued to 401(k) plan | -- | 21,883 |
| Extraordinary gain on extinguishment of debt | -- | -- |
| Bad debt expense | 59,272 | (91,502) |
| Interest expense on convertible debenture | 492,406 | |
| Changes in operating assets and liabilities: | | |
| Accounts receivable - trade | 300,990 | 122,510 |
| Accounts receivable - other | -- | 96,004 |
| Inventories | (49,678) | 699,052 |
| Prepaid expenses | 231,165 | 306,195 |
| Accounts payable | (43,867) | (321,706) |
| Accrued liabilities | (109,679) | (925,777) |
| Accrued litigation settlement | -- | (1,300,000) |
| Deferred revenues | 385,001 | 5,338 |
| Net cash used in operating activities | (1,552,017) | (7,739,231) |

| | | |
|---|---|---|
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Proceeds from sale of assets | -- | -- |
| Capital expenditures | 3,386 | (87,318) |
| Acquisition of Thermal Imaging, Inc. common stock | -- | -- |
| Purchase of software license | -- | -- |
| Purchase of investments available for sale | -- | -- |
| Proceeds from redemption of investments available for sale | -- | 7,288,684 |
| Acquisition of Bales Scientific common stock, net of cash acquired | -- | -- |
| Net cash provided by (used in) investing activities | 3,386 | 7,201,366 |

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



COMPUTERIZED THERMAL IMAGING, INC.
(A Development Stage Company)
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

| | NINE MONTHS ENDED MARCH 31, 2004 | 2003 |
|---|---|---|
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Proceeds from issuance of common stock and warrants, net of offering costs | $ 1,220,001 | $ 781,855 |
| Advances to affiliate | -- | -- |
| Advances from stockholders | -- | -- |
| Preferential Dividend | -- | -- |
| Proceeds from borrowing net of finance costs | -- | -- |
| Payments on debt | -- | -- |
| Net cash provided by financing activities | 1,220,001 | 781,855 |
| NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS | (328,630) | 243,990 |
| CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR | 454,387 | 936,796 |
| CASH AND CASH EQUIVALENTS AT END OF YEAR/Quarter | $ 125,757 | $ 1,180,786 |
| SUPPLEMENTAL CASH FLOW INFORMATION | | |
| Cash paid for: | | |
| Interest expense | $ 928 | $ -- |
| Income taxes | -- | -- |
| SUPPLEMENTAL SCHEDULE OF NON-CASH FINANCING AND INVESTING ACTIVITIES | | |
| Common stock issued to reduce debenture, interest and penalty | $ 157,277 | $ 1,653,827 |

| | | |
|---|---|---|
| Warrants issued for financing costs | | |
| Common stock issued to individuals to acquire minority interest of subsidiary | -- | -- |
| Common stock issued in consideration of Bales Scientific | -- | -- |
| Options issued at discount to market in connection with offering | -- | -- |
| Stock offering costs capitalized | -- | -- |
| Common stock issued for advances from shareholders | -- | -- |
| Common stock issued for notes payable, accrued discount and interest | -- | -- |
| Common stock issued for convertible subordinated debentures | -- | -- |
| Common stock issued for liabilities | -- | -- |

The accompanying condensed notes are an integral part of these consolidated financial state



COMPUTERIZED THERMAL IMAGING, INC.
(A Development Stage Company)
Notes to Condensed Consolidated Financial Statements
(UNAUDITED)

NOTE A. UNAUDITED FINANCIAL STATEMENTS AND BASIS OF PRESENTATION

The condensed consolidated financial statements of Computerized Thermal Imaging (the "Company") for the three-month and nine-month periods ended March 31, 2004 and 2003 are unaudited. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation of the Company's results of operation for the periods presented have been included. These interim statements should be read in conjunction with the audited consolidated financial statements and footnotes thereto contained in the Company's most recent Annual Report on Form 10-K for the Year Ended June 30, 2003. The consolidated results of operations for the three-month and nine-month periods ended March 31, 2004 are not necessarily indicative of the results to be expected for the full year.

Certain amounts from the prior period financial statements have been reclassified to conform to current period presentation.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions, including for example, accounts receivable allowances, inventory obsolescence reserves, deferred tax valuation allowances, and reserves for pending or threatened litigation. These assumptions affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from these estimates.

The accompanying condensed consolidated financial statements have been prepared assuming the Company will continue as a going concern. In its Annual Report on Form 10-K for the Year Ended June 30, 2003, the Company reported that its recurring losses from operations, negative cash flows from operations, pending shareholder class-action lawsuits and denial of coverage for any resulting claims by the Company's provider of directors and officers insurance, forced redemption of the Company's convertible debentures, the Company's need for additional working capital, and the possibility that the Company may not

receive FDA approval for its primary product raised substantial doubt about the Company's ability to continue as a going concern.

In order to pursue its existing plan of operations, the Company will have to secure additional financing through the sale of equity, the incurrence of debt or the sale of assets, possibly including the Company's intellectual property. There can be no assurance that capital will be available from any source or, if available, that the terms and conditions associated with such capital will be acceptable to the Company. If the Company raises equity or debt capital, the sale of these securities could dilute existing shareholders, and borrowings from third parties could result in assets being pledged as collateral and could provide loan terms that could adversely affect the Company's operations and the price of its common stock.



The accompanying condensed consolidated financial statements do not include any adjustments relating to the recoverability and classification of recorded asset amounts or the amounts and classification of liabilities that might be necessary if the Company is unable to continue as a going concern.

NOTE B. RECENTLY ISSUED ACCOUNTING STANDARDS

In October 2002, the Financial Accounting Standards Board (the "FASB") issued Statement of Financial Accounting Standards No. 147 ("SFAS 147"), ACQUISITIONS OF CERTAIN FINANCIAL INSTITUTIONS. SFAS 147 provides that the guidance provided by SFAS 141 BUSINESS COMBINATIONS, SFAS 142, GOODWILL AND OTHER INTANGIBLE ASSETS, and SFAS 144, ACCOUNTING FOR THE IMPAIRMENT OR DISPOSAL OF LONG-LIVED ASSETS will apply to acquisitions of financial institutions (previously covered under special industry guidance). The transition provisions of SFAS 147 became effective on October 1, 2002. At this time the Company does not believe the adoption of SFAS 147 will have any impact on its condensed consolidated financial statements.

In December 2002, the FASB issued Statement of Financial Accounting Standards No. 148 ("SFAS 148"), ACCOUNTING FOR STOCK-BASED COMPENSATION - TRANSITION AND DISCLOSURE, which amends Statement of Financial Accounting Standards No. 123, ACCOUNTING FOR STOCK-BASED COMPENSATION. SFAS 148 provides alternative methods of transition for a voluntary change to the fair value-based method of accounting for stock-based employee compensation and requires more prominent and more frequent disclosures in the financial statements of the effects of stock-based compensation. The provisions of SFAS 148 are effective for fiscal years ending after December 15, 2002 and the interim disclosure provisions are effective for interim periods beginning after December 15, 2002. The Company began providing the required interim and annual disclosures beginning in the quarter ended March 31, 2003.

In February 2003, the FASB issued Statement of Financial Accounting Standards No. 149 ("SFAS 149"), ACCOUNTING FOR CERTAIN FINANCIAL INSTRUMENTS WITH CHARACTERISTICS OF LIABILITIES AND EQUITY, which became effective at the beginning of the first interim period beginning after March 15, 2003. SFAS 149 establishes standards for the Company's classification of liabilities in the financial statements that have characteristics of both liabilities and equity. The Company does not believe the adoption of SFAS 149 will have a material effect on the Company's consolidated financial position or results of operations.

In May 2003, the FASB issued Statement of Financial Accounting Standards No. 150 ("SFAS 150") ACCOUNTING FOR CERTAIN FINANCIAL INSTRUMENTS WITH CHARACTERISTICS OF BOTH LIABILITIES AND EQUITY, which is effective the first interim period beginning after June 15, 2003. SFAS 150 establishes standards for

how the Company classifies and measures in its statement of financial position certain financial instruments with characteristics of both liabilities and equity. The Company does not believe the adoption of SFAS 150 will have a material effect on the Company's consolidated financial position or results of operations.



NOTE C. CONVERTIBLE DEBENTURE

Financing Agreement with Beach Boulevard, LLC.

On December 31, 2001, the Company entered into a financing agreement (the "Agreement") with Beach Boulevard, LLC (the "Investor"), pursuant to which the Company issued a 7% convertible debenture (the "Convertible Debenture") in the amount of $2.5 million (the "Debenture Offering") and secured an equity line of credit (the "Equity Line") for $20 million that allowed the Company to sell up to $20 million of common stock to the Investor at 94% of the market price, as defined by the Agreement. The Convertible Debenture was originally due on December 31, 2004. The terms of the Agreement permitted the Investor to convert the Convertible Debenture into 2,100,694 shares of common stock at a conversion price of $1.44 per share at any time during the term of the Agreement. Interest on the Convertible Debenture was due on the conversion date and was payable, at the option of the Company, in cash or common stock.

In connection with the Agreement, the Company issued to the Investor warrants for the purchase of 260,417 shares of common stock at $2.03 a share and 641,026 shares of common stock at $1.95 a share. The proceeds from the Debenture Offering were allocated between the Convertible Debenture, the beneficial conversion feature and the warrants issued to the Investor. The Company also issued separate warrants to an investment banking firm for the purchase of 100,000 shares of common stock at $1.87 per share. The fair market value of these warrants and other related financing costs were recorded as deferred financing costs and were originally being amortized over the three-year term of the Agreement. However, because of the occurrence of the redemption of the Convertible Debenture discussed below, the deferred financing costs and beneficial conversion feature associated with the Convertible Debenture were amortized over the nine-month period ended January 25, 2003.

On July 25, 2002, the Investor notified the Company that a "Trigger Event" had occurred, which obligated the Company to redeem the Convertible Debenture. On the date of the Trigger Event, the Company's redemption obligation was equal to approximately $2.9 million, which included principal of $2.5 million, $111 thousand of accrued interest and $287 thousand of penalties. The Company elected to satisfy its redemption obligation through a series of put notices based on the terms of the Equity Line. During the period from July 1, 2002 through January 29, 2003, the Company issued 5,009,083 shares of common stock pursuant to a series of mandatory put notices. The proceeds were applied to redeem approximately $685,000 of the Convertible Debenture and to pay accrued interest and penalties totaling $176,000 and $95,000, respectively.

On February 5, 2003, the Company received approximately $210,000 from the issuance of 2,234,043 shares of common stock pursuant to the terms of the Equity Line. The proceeds were used to redeem approximately $183,000 of the Convertible Debenture and to pay accrued interest and penalties totaling $6,000 and $21,000, respectively.

On or about February 21, 2003, the Company entered into an agreement with the Investor which was formalized on March 19, 2003 (the "Amendment"), whereby the Company agreed to reduce the conversion price in the Convertible Debenture from $1.44 per share to an amount equal to the lower of (a) $1.44 (the

"Fixed Conversion Price") or (b) ninety-four percent (94%) of the average of the lowest closing bid prices (not necessarily consecutive) for any three trading days during the ten trading day period immediately preceding the conversion



date. The Company also agreed to reduce the exercise price of the warrants that were issued to the Investor in connection with the Agreement to $0.087733 per share, which was the average of the lowest closing bid price for any of the three trading days during the ten trading day period immediately preceding the Amendment. Pursuant to the Amendment, the Investor exercised warrants to purchase 260,417 shares of common stock at an agreed-upon exercise price of $0.087733 per share and (2) converted approximately $86,000 in principal of the Convertible Debenture into 977,244 shares of common stock at the agreed-upon conversion price of $0.087733 per share. The proceeds from the exercise of the warrants totaling approximately $23,000 were applied to redeem approximately $20,000 of the Convertible Debenture and to pay accrued interest of approximately $2,000. In connection with the modification of the conversion terms of the Convertible Debenture, which was considered to be an inducement to convert the Convertible Debenture, and the reduction of the exercise price of the Investor's warrants, the Company recorded an interest expense totaling approximately $1,770,000 during the quarter ended March 31, 2003.

The Company issued 1,212,956 shares of common stock to the Investor pursuant to a mandatory put notice on February 21, 2003. The proceeds were applied to redeem approximately $91,000 of the Convertible Debenture and to pay accrued interest and penalties totaling $5,000 and $11,000, respectively. On March 19, 2003, the Company entered into an agreement with the Investor (the "Amendment Agreement") that formalized the terms reached in the Amendment. In connection with the Amendment Agreement, the Investor also agreed to defer its demand for immediate payment of the full amount due under the Convertible Debenture for at least 90 days and agreed to not file suit against CTI, its officers, employees, partners or agents for a period of 90 days. Upon execution of the Amendment Agreement, the Investor converted $272,000 in principal of the Convertible Debenture, including $7,000 of interest, into 3,224,146 shares of common stock.

During the period from March 20, 2003 through May 19, 2003, the Investor converted approximately $1,181,000 of the remaining redeemable balance of the Convertible Debenture, including interest of $11,000, into 9,805,161 shares of common stock. As of June 30, 2003, the Company owed the Investor approximately $157,000 under the Convertible Debenture, which consisted of the unpaid portion of the penalty. In July 2003, the Company issued approximately 200,000 shares of common stock to redeem the remaining balance of the Convertible Debenture. The July 2003 transaction represented the final issuance of shares of common stock under the Equity Line, and the Company does not anticipate issuing additional shares of common stock thereunder.

PRIVATE OFFERING - THERFIELD HOLDINGS LTD

On July 10, 2003 the Company closed a private placement under Regulation S of the Securities Act of 1933, as amended, and sold 3,344,482 shares of common stock to Therfield Holdings LTD ("Therfield"), for $1 million. The Company entered into negotiations with Therfield in early June 2003 and offered a 15% discount off the then prevailing market price. The transaction process took over 30 days to conclude and the Company received the funds from the private placement on July 10, 2003.

In order to pursue its existing plan of operations, the Company will have to secure additional financing through the sale of equity, the incurrence

of debt or the sale of assets, possibly including the Company's intellectual property. There can be no assurance that capital will be available from any source or, if available, that the terms and conditions associated with such



capital will be acceptable to the Company. If the Company raises equity or debt capital, the sale of these securities could dilute existing shareholders, and borrowings from third parties could result in assets being pledged as collateral and could provide loan terms that could adversely affect the Company's operations and the price of the Company's common stock.

The accompanying consolidated financial statements do not include any adjustments relating to the recoverability and classification of recorded asset amounts or the amounts and classification of liabilities that might be necessary if the Company is unable to continue as a going concern.

STOCK ISSUANCE TO SETTLE DEBT

On January 22, 2004 the Company issued 25,000 shares of stock in connection with the settlement reached with Garvey Schubert Barer. The settlement satisfied a payable of $110,751 with cash payments of $80,000 over five (5) months and the issuance of 25,000 shares.

PRIVATE OFFERING - CHARLES DAI

On May 18, 2004 the company issued 1,000,000 shares of restricted stock in a private placement to Charles Dai in exchange for $220,000 in cash. The agreement was for up to $1,000,000 cash for a total 4,545,454 shares. As of May 1, 2004 Charles Dai has not exercised the rights to purchase the remaining 3,545,454 shares.

NOTE D. REVENUE RECOGNITION

The Company generates revenues from sales of its products and from services provided to its customers. The Company sells its products to independent distributors and to end customers. With the exception of sales transactions in which a customer may return defective products, the Company does not provide its customers with other rights to return products.

The Company recognizes revenue from its product sales to end customers upon shipment of products when persuasive evidence of an agreement exists, delivery of the product has occurred, no significant Company obligations remain, the fee is fixed or determinable, and collectibility is probable. If these conditions are not met, revenue is deferred until such obligations and conditions are fulfilled. If the Company retains an ongoing obligation under a sales arrangement, revenue is deferred until all of the Company's obligations are fulfilled.

Effective July 1, 2001, the Company adopted the practice of deferring revenue on shipments to distributors until cash payment from the distributor is received by the Company, which is generally when the product is sold by the distributor to the end customer. Prior to that date, revenue on shipments to distributors was recognized upon shipment to the distributor if all of the criteria for revenue recognition were satisfied. The Company believes that deferral of revenue on shipments to distributors until cash payment is received is a more meaningful measurement of results of the Company's operations.

Certain of the Company's products contain software that is not

considered incidental to the product. Sales of those products are subject to the provisions of AICPA Statement of Position No. 97-2, SOFTWARE REVENUE RECOGNITION, as amended, which requires the deferral of revenue from certain multiple-element arrangements. The Company defers revenue from multiple-element arrangements until all elements have been delivered.



Service revenue is derived from non-destructive testing of turbine blades and other items. Service revenue is recognized upon the completion of the services provided. The Company offers extended warranties on certain of its products. Warranty revenue is recognized ratably over the period of the agreement as services are provided.

Beginning in the next quarter ending June 30, 2004 the Company will begin to lease products using Associated International Leasing. Cash will flow from Associated to the Company at the time of acceptance with approximately 80% of the revenue recognized. The Company will provide a three (3) to five (5) year warranty and service agreement over the life of the lease insuring product integrity. The remaining 20% will be recognized on a straight-line basis as permitted by generally excepted accounting principles, GAAP.

NOTE E. DEFERRED REVENUE

At March 31, 2004 the Company's deferred revenues were approximately $1,172 thousand, and consisted of $3,000 of deferred medical revenues, $660,000 of deferred revenues associated with a Manufacturing/licensing and manufacturing agreement (the "Nanda Agreement"), executed between the Company and NanDa thermal Medical Technologiy, Inc. ("NanDa"), $13,000 of deferred warranty revenues and $496,000 of deferred industrial revenues and deposits relating to the Turbine Blade Inspection System ("TBIS") the Company shipped to Pratt & Whitney. At June 30, 2003 the Company's deferred revenues were approximately $787,000, and consisted of $10,000 of deferred medical revenues, $300,000 of deferred revenues associated with the Nanda Agreement, $28,000 of deferred warranty revenues and $449,000 of deferred industrial revenues and deposits relating to TBIS the Company shipped to Pratt & Whitney.

DEFERRED REVENUES

DEFERRED REVENUES

| | March 31, 2004 | June 30, 2003 |
|---|---|---|
| Medical Products | $ 3,000 | $ 10,000 |
| Nanda Licensing | 660,000 | 300,000 |
| Industrial Products | 496,000 | 449,000 |
| Warranty Revenue | 13,000 | 28,000 |
| Total Deferred Revnue | $1,172,000 | $ 787,000 |

Medical product deferred revenues consist one half month's rental on six Thermal Imaging Processors ("TIP") cameras the Company has placed with Boothroyd, a Canadian customer.

The Nanda Agreement is billed in stages. Upon the execution of the Nanda Agreement in June 2003, the Company billed Nanda $300,000; however, the amount of the initial billing remained unpaid as of June 30, 2003 and was collected in the quarter ended March 31, 2004. In addition, the Company billed and collected an additional $360,000 under the Nanda Agreement during the

quarter ended March 31, 2004. The Nanda Agreement obligates the Company to provide training services in the United States and in China. Although the training was completed in the United States, the Company will not recognize any revenue from the Nanda Agreement until its obligations are performed and the Company has completed its training in China.

Industrial product deferred revenue consist of non-destructive testing devices shipped to Pratt & Whitney. The Company will recognize these sales when it has completed its obligations under the purchase agreements with Pratt & Whitney. The Pratt& Whitney deferral increased in the quarter ended March 31, 2004 due the Company invoicing Pratt & Whitney an additional $42,000 as per the contract being deferred due to the total contract revenue being deferred because the completion of the contract requires a final on site calibration to gain complete acceptance by Pratt & Whitney.

NOTE F. INVENTORIES

Inventories are stated at the lower-of-cost or market with cost determined using the first-in first-out method of accounting. As of the dates set forth below, the Company's inventories consisted of the following:

INVENTORY

| | March 31, 2004 | June 30, 2003 |
|---|---|---|
| Raw materials | $ 626,303 | $ 673,833 |
| Inventory reserve | (605,996) | (594,674) |
| Work-in process | 123,066 | 19,286 |
| Finished goods | 212,169 | 207,419 |
| Total | $ 355,542 | $ 305,864 |

Finished goods inventory at March 31, 2004 and June 30, 2003 consisted of approximately $212,000 and $207,000, respectively, of finished goods ready for sale, a 2% increase, due, primarily, to completion of the manufacturing of photonic stimulators anticipating sales, $123,000 and $19,000 respectively in the manufacturing process, a 538% increase which consisted primarily of four TIP cameras in the process to sell to Nanda, and $626,000 and $674,000 of raw materials, an 7% decrease, due primarily to the attempt to reduce inventory to preserve cash. In their report on the Company's condensed consolidated financial statements for the year ended June 30, 2003, the Company's auditors expressed concern regarding the Company's ability to continue its operations as a going concern. As a result of that concern, coupled with the U.S. food and Drug Administration's ("FDA") decision to not approve the BCS 2100, the Company has treated its inventories as impaired assets on its condensed consolidated financial statements for the quarter ended March 31, 2004. The impairment is held in a reserve account in the amount of $606,000 and represents about 63% of all inventories.



The Company reserves for excess and obsolete inventory by comparing inventory on hand to estimated consumption during the next twelve months.

Consumption is estimated by annualizing trailing three or nine -month sales volumes, adjusting those volumes for known activities and trends, then comparing forecast consumption to quantity on hand. Any difference between inventory on hand and greater than estimated consumption is recorded to cost of revenues and an excess and obsolete reserve, which is included as an element of net inventory reported on the Company's condensed consolidated balance sheet. Amounts charged to the inventory reserves are not reversed to income until the reserved inventory is sold or otherwise disposed. The Company felt no need to impair additional inventory in the quarter ended March 31, 2004

NOTE G. INCOME TAXES

The Company accounts for income taxes using the liability method. Under this method, the Company records deferred income taxes to reflect future year tax consequences of temporary differences between the tax basis of assets and liabilities and their financial statement amounts. The Company has reviewed its net deferred tax assets, together with net operating loss carry-forwards, and has provided a valuation allowance to reduce its net deferred tax assets to their net realizable value.

NOTE H. CONTINGENCIES

AL-HASAWI LITIGATION -- On March 29, 2000, Salah Al-Hasawi, a citizen and resident of Kuwait, filed an action in the United States District Court for the Southern District of New York, against the Company and its former Chief Executive Officer, alleging violations under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder, for commissions allegedly due to the plaintiff in connection with the private placement of the Company's securities. Shortly thereafter, the lawsuit was dismissed without prejudice and on April 12, 2000 the plaintiff filed a similar complaint in the United States District Court for the District of Utah. The plaintiff's complaint sought specified damages of $15.5 million, attorney fees and unspecified damages pursuant to five separate causes of action including breach of contract, fraud and unjust enrichment.

In December 2003, the Company reached a settlement with the plaintiff, pursuant to which the Company agreed to pay the aggregate amount of $100,000 in three installments ($50,000 paid in December, 2003, $25,000 paid in January 2004 and $25,000 paid in February 2004) and the plaintiff agreed to dismiss the litigation with prejudice. The settlement is set forth in a Settlement Agreement and Mutual Release, which provides for the filing with the court of dismissal pleadings when the company paid the final installment in February 2004.

CLASS ACTIONS -- In 2002, five different lawsuits were filed against the Company in the United States District Court in Oregon. The lawsuits, which were consolidated into a single class action, allege in substance that the Company violated Section 10(b) of the Securities Exchange Act of 1934, as amended, and accompanying regulations by misleading shareholders regarding such things as FDA approval and other matters, which the plaintiffs allege caused significant damage to the holders of our common stock at the time of these alleged misrepresentations and omissions.



On April 17, 2003, the consolidated litigation was dismissed without prejudice by the United States District Court. In a written opinion, the U.S. District Court Judge concluded that the alleged misstatements were either not material, not misleading, or not pled by plaintiffs with sufficient particularity to constitute a claim. The Court gave the plaintiffs until May 8, 2003 to replead three of the nine claims. Plaintiffs did not replead, so the judge dismissed the case with prejudice on May 13, 2003, On May 22, 2003, the

plaintiffs filed for appeal, and on September 3, 2003 the plaintiffs filed their memorandum in support of their appeal. On October 20, 2003, we filed our response in support of the District Court's opinion. We do not expect to receive a decision from the appellate court for at least one year. The likelihood of an unfavorable outcome or the extent of any potential loss is not presently determinable.

SEC INVESTIGATION -- In December 2002, the Company was requested to provide certain documents to the U.S. Securities and Exchange Commission and the U.S. Attorney for the Southern District of New York in connection with their investigation of possible violations by the Company's Chairman of the Board and Chief Executive Officer of the insider trading prohibitions found in the federal securities laws. During the year ended June 30, 2003 the Company incurred approximately $658 thousand in legal costs in complying with these requests. During the period between June 30, 2003 and March 31, 2004, the Company incurred approximately $168 thousand in additional legal costs associated with these investigations. The Company also may be required to indemnify its officers and directors for fees incurred for these investigations. For the year ended June 30, 2003, such indemnification obligations totaled approximately $36 thousand, and during the period between June 30, 2003 and March 31, 2004 the Company incurred approximately $12 thousand in additional indemnification obligations which are included in the previous figures.

ST. PAUL PROPERTIES -- On April 11, 2003, St. Paul Properties, Inc. (the "Landlord") filed suit against the Company in the Circuit Court for Clackamas County. The Landlord alleges that the Company breached its prior corporate office lease by failing to pay the rent specified under the lease. The Landlord seeks damages of approximately $667,000 plus interest and attorneys' and other fees. The Company has filed an answer and affirmative defenses alleging that the Landlord failed to use reasonable efforts to mitigate its damages. In addition, the Company is aware that much of the vacant space has been relet to a third party tenant, substantially reducing the damage claim. The Company has settled with the Landlord for the sum of $110,000 and which includes a $50,000 payment with 5 monthly payments of $12,000. Although this settlement has been completed and the law firms are holding as of May 15, 2004, $74,000 (initial payment and two monthly payments), the final documents have not yet been signed by the Landlord however, we expect to receive the fully executed documents soon.

INDEMNIFICATION -- Under the Company's bylaws and contractual agreements the Company may be required to indemnify its current and former officers and directors who are parties to litigation or other proceedings by providing legal defense through the Company's attorneys (or reimbursing the parties for their own attorneys) and covering all damages the parties may suffer if the plaintiffs are successful.

The Company is involved in certain other litigation matters in the normal course of business that management currently believes are not likely to result in any material adverse effects on the financial position, results of operations, or net cash flows of the Company.



NOTE I. FDA DEVELOPMENTS

The Company's medical imaging and treatment products are subject to regulation by the U.S. Food and Drug Administration ("FDA"). Over the past few years, the Company has sought approval for its breast cancer detection system through the FDA's Pre-Market Approval process ("PMA"), which requires rigorous clinical efficacy testing, manufacturing and other data. The Company utilized the FDA's modular submission method and submitted its application for approval

on five modules for review.

On December 10, 2002, the Company presented the Breast Cancer System 2100TM ("BCS") to the FDA's Radiological Devices Panel ("Panel"), which recommended by a vote of 4 to 3 against recommending approval of the BCS to the FDA. On January 23, 2003, the FDA sent the Company a letter concurring with the panel's recommendation. The letter provided specific actions the Company could take in an effort to obtain FDA approval in the future including: (a) performing a new pre-market clinical study, (b) modifying the indication for use, (c) performing a reproducibility study to take into account variations encountered in clinical practice, and (d) providing a validated daily quality assurance procedure.

The main issues cited by the FDA were the Panel's conclusion that 1) the proposed indications for use were revised on the basis of a retrospective analysis of the results in the original PMA, 2) the additional clinical data in the "post-PMA" ("PPMA") was insufficient to constitute an adequate study, 3) enrollment in the Company's studies was not limited to mammographically visible masses, and 4) the number of exclusions of enrolled subjects was excessive.

Representatives of the Company met with the FDA Deputy Commissioner and the FDA Chief Counsel on July 9, 2003. The Company was asked to provide to the Commissioner's staff a scientific document addressing the FDA's reasons for non-approval of the Company's application. The scientific document was sent on July 29, 2003. Another follow-up meeting reviewing the process was held with the FDA on January 15, 2004. The Company received a response from the FDA's commissioners office provided again three actions the Company could take in an effort to obtain FDA approval. The Company continues to consider the actions suggested each of which would require new capital investments in the Company.

Note J - OTHER REGULATORY MATTERS

The Company's TIP camera is a thermal imaging device that reads temperature (such as an external thermometer) and is noninvasive. In connection with SARS screening activities, Canada and China have used the cameras in-airport terminals as a first-line defense measure for identifying travelers with elevated facial temperatures. Due to the noninvasive nature of the camera, as well as the fact that the Company has not marketed or promoted the TIP camera as an SARS screening device, both Canada and China have required minimal governmental regulation. The Company believes that all regulatory matters associated with the sale and shipment of these TIP cameras were met according to the Canadian and Chinese governments.

Most recently the Company has obtained a Canadian license for the Photonic Stimulator, TIP System and the BCS2100. This allows the Company to sell all three products into the Canadian market.



Note K - SEGMENTS

The Company's operations have historically been reported in two segments: medical products and industrial products. Results of the Company's operations for the two segments during the three-month and nine-month periods ended March 31, 2004 are as follows:

THREE MONTH PERIOD ENDED
March 31,
2004

| | Medical | Industrial | Total |
|---|---|---|---|
| Revenue | $ 60,303 | $ 46,930 | $ 107,233 |
| Cost of Revenues | (13,184) | (260) | (13,444) |
| Gross Margin | 47,119 | 46,670 | 93,789 |
| General & Administration | 261,961 | -- | 261,961 |
| Research & Development | 264,266 | -- | 264,266 |
| Marketing | 45,296 | -- | 45,296 |
| Depreciation and amortization | 36,000 | -- | 36,000 |
| Impairments | -- | -- | -- |
| Total Operating Expense | 607,523 | -- | 607,523 |
| Operating Loss | $ (560,404) | $ 46,670 | $ (513,734) |

NINE MONTH PERIOD ENDED
March 31,
2004

| | Medical | Industrial | Total |
|---|---|---|---|
| Revenue | $ 152,471 | $ 111,103 | $ 263,574 |
| Cost of Revenues | (53,433) | (22,942) | (76,375) |
| Gross Margin | 99,038 | 88,161 | 187,199 |
| General & Administration | 1,286,775 | -- | 1,286,775 |
| Research & Development | 927,967 | -- | 927,967 |
| Marketing | 296,425 | -- | 296,425 |
| Depreciation and amortization | 45,560 | -- | 131,700 |
| Impairments | -- | -- | -- |
| Total Operating Expense | 2,556,727 | -- | 2,642,867 |
| Operating Loss | $(2,457,689) | $ 88,161 | $(2,455,668) |

Because the Company's principal efforts during the three-month and nine-month periods identified above have been focused on obtaining FDA approval of the Company's BCS application, as well as resolution of pending litigation and the SEC investigation regarding the Company's Chairman of the Board and Chief Executive Officer, no overhead cost allocations to the industrial segment are reflected in the tables set forth above.



ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

GENERAL

Computerized Thermal Imaging, Inc. ("we", "us", "CTI" or the "Company") designs, manufactures and markets thermal imaging devices and services used for clinical diagnosis, pain management and industrial testing. We market our products through an internal sales force and a network of independent distributors.

We have developed thermal imaging technology and equipment and methods for applying our proprietary technology. We believe our thermal imaging systems generate data, difficult to obtain or not available using other imaging methods,

which is useful to health care providers in the detection of certain diseases and disorders and useful to the health industry for product quality testing.

Our research indicates that our equipment and technology is useful in studying and diagnosing breast cancer, which is the second most common cancer in women. Our research and development efforts led to the creation of our breast imaging system, known as the "BCS 2100." We are seeking FDA pre-market approval for the BCS 2100 as an adjunct to mammography and clinical examinations for use as a painless and non-invasive technique for acquiring clinical information. To receive pre-market approval ("PMA") from the FDA, we must establish the BCS 2100's ability to consistently distinguish between malignant and benign tissue and thereby reduce the number of breast biopsies performed on benign tissue. We have received acceptance on four of the five modules required for PMA approval. We submitted the fifth module, which includes clinical trial results and efficacy claims, during June 2001.

We presented the BCS 2100 to the FDA's Radiological Devices Panel (the "Panel") on December 10, 2002 and the Panel voted against approval of the BCS 2100. On January 23, 2003, the FDA concurred with the recommendation made by the Panel and issued to the Company a non-approval letter with respect to the BCS 2100. We believe the FDA's decision was based on technical and statistical issues regarding the clinical trial and analysis of the clinical trial data. The main issues cited by the FDA were 1) the Panel concluded that the proposed indications for use were revised on the basis of a retrospective analysis of the results in the original PMA, 2) the additional "post-PMA" clinical data was deemed insufficient to constitute an adequate study, 3) enrollment in the Company's studies was not limited to mammographically visible masses, and 4) the Panel concluded that the number of exclusions of enrolled subjects was excessive. The FDA's letter states specific actions we could take in an effort to put the PMA into an approvable form including: a) performing a new pre-market clinical study, (b) modifying the indication for use, (c) performing a reproducibility study to take into account variations encountered in clinical practice, and (d) providing a validated daily quality assurance procedure.

Our management met with the FDA Deputy Commissioner and the FDA Chief Counsel on July 9, 2003. We were asked to provide to the Deputy Commissioner's staff a scientific document addressing the FDA's reasons for non-approval. The scientific document was sent on July 29, 2003, and we are currently waiting for a response. Another follow-up meeting was held with the FDA on January 15, 2004 for the purpose of reviewing the process. On March 19, 2004 the Company received a letter from the staff of the U.S. Food and Drug Administration (the "FDA") addressing CTI's application for premarket approval of CTI's BCS 2100 breast



cancer screening device. In its letter, the FDA staff identified three alternative approaches, including CTI's current approach, to achieve premarket approval of the BCS2100. CTI management believes the FDA response is, in part, attributable to intervention by the Office of the FDA Commissioner. CTI management and staff are now reviewing and evaluating each of the three alternatives. All three alternatives involve different concepts in statistical methodology; however, the FDA staff has indicated that the two alternative approaches to CTI's existing approach would require new studies, but would involve considerably fewer subjects than CTI's current approach. Mr. Secord commented, "We are very appreciative of the FDA staff's willingness to help resolve the longstanding statistical issue regarding premarket approval of the CTI breast cancer system."

The Company announced in a press release dated March 25, 2004 that, through discussions with staff of the American Stock Exchange ("AMEX"), it

agreed to remove its common stock from listing on AMEX, and will seek to have its common stock quoted on the OTC Bulletin Board ("OTCBB"). The Company had requested a hearing before an AMEX Listing Qualifications Panel in an effort to appeal the AMEX staff's determination to delist the CTI common stock from AMEX, the Company ultimately determined that the best interests of the Company and its shareholders would be served by ensuring an orderly transition to the OTCBB. The last trading day of the CTI common stock on AMEX was Friday, March 26, 2004. CTI originally anticipated that the OTCBB would commence quotation of the CTI common stock on Monday, March 29, 2004. However, although application has been made by market makers, the stock is currently trading on "the pink sheets" as COIBB.PK.

The Company has entered into a letter of commitment with Associated Leasing International Corp., pursuant to which Associated Leasing proposes to help market CTI's medical and industrial equipment and provide a credit facility of up to $500 million to facilitate sales of CTI's products. Associated Leasing provides lease financing for a broad range of capital equipment, including medical, heavy industrial, electronics, aerospace, transportation, and to equip entire hospitals.

We use our capital to pay general corporate expenses, including salaries, manufacturing costs, professional fees, clinical study and technical support costs, and general and administrative expenses. We are a development stage company and, to date, we have funded our business activities with funds raised through the private placement of common stock, debt and warrants, and the exercise of warrants and options.

This report contains forward-looking statements within the meaning of the Securities Act of 1933, as amended, and Securities Exchange Act of 1934, as amended. Forward-looking statements involve known and unknown risks, uncertainties and other factors which may cause our actual results, performance or achievements to be materially different from any expected results, performance or achievements. When used in this document the words "expects", "anticipates," "intends," "plans," "may," "believes," "seeks," "estimates," and similar expressions generally identify forward-looking statements. All forward-looking statements included in this report are based on information available to us on the date hereof, and we assume no obligation to update any forward-looking statements except to the extent required under applicable securities laws.

The following discussion and analysis of our consolidated financial condition and results of operations should be read in conjunction with our audited condensed consolidated financial statements and notes thereto contained in our Annual Report on Form 10-K for the fiscal year ended June 30, 2003.



CRITICAL ACCOUNTING POLICIES

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

We believe the following are our critical accounting policies. That is, they are both important to the portrayal of our financial condition and results, and they require management to make judgments and estimates about matters that are inherently uncertain.

CASH AND CASH EQUIVALENTS-- Cash and cash equivalents include cash in checking accounts and short-term highly liquid investments with an original maturity of one year or less.

REVENUE RECOGNITION -- Although we believe revenues recognized to date have been immaterial to our financial statements, we also believe revenue recognition is a significant business process that requires management to make estimates and assumptions. We recognize revenue from product sales after shipment when persuasive evidence of an agreement exists, delivery of the product has occurred, no significant obligations remain, the price or fee is fixed or determinable, and collection is probable. If these conditions are not met, revenue is deferred until such obligations and conditions are fulfilled.

Our standard domestic terms for sales of our medical products to end-user customers are "net 30 days," and our standard international terms for sales of our medical products require payment in cash or placement of a letter of credit before shipment. On occasion, we offer extended payment terms beyond our normal business practices, usually in connection with providing an initial order of demonstration equipment to a new domestic distributor. We consider fees on these extended terms agreements not fixed and collectibility less than probable and defer the revenue until receipt of payment. Our sales prices have declined over time and we credit price decreases to any balance due from a distributor. We sell separate extended warranty contracts for our Thermal Image Processor ("TIP") and Photonic Stimulator and recognize revenue from those arrangements ratably over the contract life. We do not offer rights or return privileges in sales agreements.



Industrial sales are made pursuant to individually negotiated commercial contracts which specify payment terms that have ranged from 60 to 90 days from shipment or service completion. With industrial products, even if delivery and payment have occurred, we may retain a significant ongoing obligation under a sales arrangement for the delivery of components or customized software and customer testing, and we defer recognizing revenue until all the multiple elements of the sale are completed.

RESEARCH AND DEVELOPMENT EXPENSES -- We expense as incurred the direct, indirect and purchased research and development costs associated with our products. We believe this method is conservative given the product and market acceptance risk inherent to our products and reduces administrative burden and cost.

IMPAIRMENT OF LONG-LIVED ASSETS -- We follow the provisions of Financial Accounting Standards Board ("FASB") SFAS No. 141, ACCOUNTING FOR THE IMPAIRMENT OF LONG-LIVED ASSETS AND FOR LONG-LIVED ASSETS TO BE DISPOSED OF, which requires that if the sum of the future cash flows expected to result from the assets, undiscounted and without interest charges, is less than a company's reported value of the assets, the asset is not recoverable and the company must recognize an impairment. The amount of impairment to be recognized is the excess of the reported value of the assets over the fair value of those assets and is recorded as impairment expense on our statement of operations. In estimating impairments, management makes assumptions about future cash flows and fair value that are inherently uncertain, can significantly affect the results and may differ from actual future results.

INVENTORY RESERVES -- We establish reserves for excess and obsolete inventory by comparing inventory on hand to estimated consumption during the subsequent twelve-month period. Consumption is estimated by annualizing trailing three- or nine-month sales volumes, adjusting those volumes for known activities

and trends, and comparing forecast consumption to quantity on hand. Any difference between inventory greater than estimated consumption is recorded to cost of revenues and an excess and obsolete inventory reserve, which is included as an element of net inventory reported on our balance sheet. Amounts charged to the inventory reserves are not reversed to income until the reserved inventory is sold or otherwise disposed.

EMPLOYEE INCENTIVE PLANS -- We have terminated our discretionary 401(k) plan. All CTI common stock formerly held in our 401(k) plan was sold and the proceeds were placed in funds as selected by each individual employee. We have issued lump sum distributions and qualified plan rollovers for each participant.

TRENDS/UNCERTAINTIES AFFECTING CONTINUING OPERATIONS

We are exposed to the opportunities and risks usually associated with marketing and manufacturing novel products, including staff retention and recruiting, market acceptance of our products, product warranty, bad debts and inventory obsolescence. We expect to earn revenues from the sale of our products, but there is no guarantee that these revenues will recover all the costs of marketing, selling and manufacturing our products.

Our marketing efforts rely upon building relationships with manufacturers, medical equipment dealers, physicians and clinical investigators. We have communicated with our target markets by attending trade shows and conferences, making direct sales calls, and sponsoring clinics where we introduce and demonstrate our products. Although most recently all marketing efforts have been placed on hold due to lack of funds. We believe marketing



medical products through trade shows, conference presentations, direct mail and inside sales augmented with dealers provides a low-cost, high-leverage approach to diagnostic imaging and pain management practitioners. To the extent possible, which is extremely limited at present, we plan to continue investing resources in these programs, although there can be no assurance they will lead to market acceptance of our products.

We organize clinical studies with institutions and practitioners to obtain user feedback and to secure technical papers for training and marketing purposes. These strategies represent a significant investment of time and resources and have provided useful information; however, there can be no guarantee that these strategies will lead to market acceptance of our products. At the time of filing this report, our only existing clinical study with Massachusetts General Hospital has been placed on hold due to lack of funding.

To date, we have had limited operating revenues from the sale of our products and services ($3.7 million in total revenues since inception). We cannot provide any assurance that we will achieve profitability in the future. Our immediate priorities are to sell existing FDA 510k approved products and to sell the BCS 2100 into Canada where we have recently obtained a license for sale. Furthermore, we continue to reconcile issues presented to us by the Panel on December 10, 2002 and FDA administrators in subsequent meetings, most recently January 15, 2004, and the to pursue additional funding. At this time, we are unsure how much time and additional financing we will require to resolve these issues with the FDA. We are also unsure about our ability to raise additional financing that will be required to continue our business operations. These uncertainties, among others, raise doubts about our ability to continue as a going concern. Furthermore, based on our expected cash flow from operations and our limited current assets, our auditors have expressed their view, in their report on our financial statements for the year ended June 30, 2003, that they

did not believe we would be able to continue our operations as a going concern through the end of our 2004 fiscal year.

FACTORS THAT MAY AFFECT FUTURE RESULTS

Our operating results and financial condition are subject to substantial risks and uncertainties. These risks and uncertainties include, but are not limited to, the following:

For the years ended June 30, 2003 and 2002, our auditors issued their audit report with a going concern qualification. This means, based on our expected cash flow from operations and our existing current assets, our auditors did not believe that we would be able to continue our operations in their then-existing form through the end of our 2004 fiscal year. We can provide no assurance that we will ever generate sufficient revenues to continue our operations.

Our failure to raise additional capital could cause us to severely curtail operations, which would adversely affect shareholder value, or cease operations entirely, which would likely eliminate any value in our common stock.

Our failure to obtain FDA approval of our BCS 2100 would have a material adverse impact on our results of operation and financial condition, and may result in cessation of our operations entirely.



The Company announced in a press release dated March 25, 2004 that, through discussions with staff of the American Stock Exchange ("AMEX"), it agreed to remove its common stock from listing on AMEX, and will seek to have its common stock quoted on the OTC Bulletin Board ("OTCBB"). The Company had requested a hearing before an AMEX Listing Qualifications Panel in an effort to appeal the AMEX staff's determination to delist the CTI common stock from AMEX, the Company ultimately determined that the best interests of the Company and its shareholders would be served by ensuring an orderly transition to the OTCBB. The last trading day of the CTI common stock on AMEX was Friday, March 26, 2004. CTI originally anticipated that the OTCBB would commence quotation of the CTI common stock on Monday, March 29, 2004. Although application has been made by market makers the stock is currently trading on "the pink sheets" as COIBB.PK.

We are involved in substantial shareholder litigation, which may have an adverse impact on us and our shareholders.

We have limited revenues from operations and may never have substantial revenue from operations.

Failure to obtain insurance reimbursement codes for our BCS 2100 may make the BCS 2100 unmarketable, thereby adversely affecting shareholder value.

We expect to continue to incur losses, deficits, and deficiencies in liquidity for the foreseeable future. Unless we are able to reverse those trends, we will likely be unable to continue our operations.

We may sell assets or reduce activities to fund operations, which could adversely affect shareholder value.

The recent volatility in the market price of our common stock could continue and adversely affect shareholder value.

We could issue preferred stock or sell other securities or other financing instruments, including convertible debt, which could result in

significant dilution to existing shareholders.

We rely on third parties in the development and manufacture of key components for our products. If they fail to perform, product development, and/or production could be substantially delayed.

If we are unsuccessful in preventing others from using our intellectual property, we could lose a competitive advantage.

We do not have product liability insurance; if we are made subject to a products liability claim, whether or not the claim is meritorious, our results of operation and financial condition may be adversely affected.

OTHER FACTORS THAT MAY AFFECT FUTURE RESULTS.



The foregoing factors should be read in conjunction with our audited consolidated financial statements, notes thereto and risk factors set forth in our Annual Report on Form 10-K for the fiscal year ended June 30, 2003 (the "Form 10-K"). Many of the risks identified above are discussed in greater detail in the Form 10-K.

RESULTS OF OPERATIONS

QUARTER ENDED MARCH 31, 2004, COMPARED TO QUARTER ENDED MARCH 31, 2003.

REVENUES

Revenues for the three and nine months ended March 31, 2004 decreased $283 and $986 thousand, or 73% and 79%, respectively, from the same period last year to $107 and $264 thousand; $55 thousand (three months) and $137 thousand (nine months) of our revenues resulted from the sale of pain management products and rental of our TIP camera to a Boothroyd, a Canadian customer using the camera for monitoring the skin surface temperatures of passengers as they pass through airport security screening areas; $5 thousand (three months) and $15 thousand (nine months) was recognition of warranty revenue; the remaining $47 thousand (three months) and $111 thousand (nine months) was other and industrial services including a industrial camera repair for SPAWAR. The decrease in revenue was due primarily to a decrease in pain management products sales that partly can be attributed to the reduction in sales force.

During the three and nine months ended March 31, 2004, medical segment revenues were $60 thousand (three months) and $152 thousand (nine months), compared to $68 thousand (three months) and $715 thousand (nine months) from the same periods last year, resulting in an decrease of $8 thousand (three months) and $563 thousand (nine months), or 11% decrease (three months) and 85% decrease (nine months). This decrease reflected decreased sales of our pain management products, due to a reduced sales force and decreased marketing efforts. The sale of Photonic Stimulator units was the same in the three months and decreased approximately 56% in the nine months ended March 31, 2004, compared to the same period of 2003, and sales of the TIP Camera decreased over 32% in the three months and 86% in the nine months ended March 31, 2004, compared to the same two periods in 2003.

During the three and nine months ended March 31, 2004, industrial segment revenues were $47 thousand (three months) and $111 thousand (nine months), compared to $323 thousand (three months) and $535 thousand (nine months) for the same periods of last year, resulting in a decrease of $276 thousand (three months) and $424 thousand (nine months), a 85% (three months) and 79% (nine months) decrease. There was two primary sales of a TIP camera made

to Dresser-Rand and to Alstom Power in the nine-month period ended March 31, 2003, and no comparable sale in the nine-month period ended March 31, 2004 (Alstom in the three month period).

During the three and nine months ended March 31, 2004, no overhead expenses were allocated to the industrial segment of our operations, due to our reduction in sales staff and decreased development in the segment and the shift in focus of management to obtaining FDA approval of our BCS 2100, as well as resolution of ongoing litigation and governmental investigations.



We recognized $18 thousand, or 17% of total revenue, in foreign sales, consisting primarily of fees generated from the rental of a TIP camera to a Canadian customer, during the quarter ended March 31, 2004, compared to approximately $318 thousand, primarily revenues generated from product sales to Alstom Power, a UK company, or 81% of total revenues, for the quarter ended March 31, 2003.

COSTS AND EXPENSES

Gross margins for the three and nine months ended March 31, 2004 were $93 thousand (three months) and $187 thousand (nine months), compared to gross margins of $170 thousand (three months) and $77 thousand (nine months) for the same periods of the prior year. Total cost of goods sold for the three and nine months ended March 31, 2004 was $13 thousand (three months) and $76 thousand (nine months), compared to $220 thousand (three months) and $1,172 thousand (nine months) for the same periods last year, which included an allowance for obsolete inventory of approximately $350 thousand.

We expect that unit prices for our TIP System and Photonic Stimulator will continue to decline as a prerequisite to increasing market penetration. We also expect prices to decline faster than we will be able to reduce manufacturing costs; therefore, we anticipate our gross margins as a percentage of sales for our pain management products will also decline. Declining demand for our pain management products and the resulting revenues and gross margins are dependant upon a number of factors, including general economic conditions, insurance reimbursements, insurance coverage offered by medical plans and our ability to market and promote our products.

General and administrative expenses for the three and nine months ended March 31, 2004 were $252 thousand (three months) and $1,177 thousand (nine months), compared to $703 thousand (three months) and $2,182 thousand (nine months) for the same period last year, a decrease of $451 thousand (three months) and $1,006 thousand (nine months), or 64% (three months) and 46% (nine months). The decrease reflects our effort to reduce costs and preserve cash. The decrease consisted of declines in salary expense ($109 thousand for three months; $357 thousand for nine months), professional services ($9 thousand for three months; $79 thousand for nine months), equipment supplies ($20 thousand for three months; $76 thousand for nine months), shareholder service costs(ie board meetings and shareholders meetings and stock transfers) ($25 thousand for three months and $119 thousand for nine months), office expenses ($45 thousand decrease for three months; $160 thousand increase for nine months), insurance expense ($30 thousand decrease for three months; $47 thousand increase for nine months), and other expenses ($9 thousand decrease for three months; $16 thousand increase for nine months) with bad debt expense increasing ($28 thousand decrease for three months; $91 thousand increase for nine months).

Marketing expenses for the three and nine months ended March 31, 2004 were $45 thousand (three months) and $296 thousand (nine months), compared to $307 thousand (three months) and $1,302 thousand (nine months) for the same

periods last year, a decrease of $262 thousand (three months) and $1,006 thousand (nine months), or 85% (three months) and 77% (nine months), from the same periods last year. Reduction in salaries accounted for $130 thousand (three months) and $555 thousand (nine months) of the decrease. The decrease also reflected decreased Legal expenses ($2 thousand for three months; $4 thousand for nine months), advertising expense ($6 thousand for three months; $40 thousand for nine months), a reduced general marketing expense ($56 thousand for



three months; $154 thousand for nine months), reduced office expense ($16 thousand for three months; $11 thousand for nine months), reduced rent expense ($8 thousand for three months; $51 thousand for nine months), reduced insurance expense ($26 thousand for three months; $71 thousand for nine months), reduced travel expense ($16 thousand for three months; $114 thousand for nine months), and other expenses ($2 thousand for three months; $3 thousand for nine months). The decrease reflected management's efforts to preserve our cash position.

Research and development expenses for the three and nine months ended March 31, 2004 were $264 thousand (three months) and $928 thousand (nine months), compared to $851 thousand (three months) and $3,253 thousand (nine months) for the same periods last year, a decrease of $586 thousand (three months) and $ 2,325 thousand (nine months), or 69% (three months) and 71% (nine months). The reduction in research and development expense reflects our efforts to preserve cash. Reductions in salary expense accounted for $276 thousand (three months) and $1,178 thousand (nine months), legal expense for $32 thousand (three months) and $33 thousand (nine months), medical R&D expense for $59 thousand (three months) and $283 thousand (nine months), engineering expense for $51 thousand (three months) and $195 thousand (nine months), clinical trial expense for $34 thousand (three months) and $45 thousand (nine months), regulatory expense for $34 thousand (three months) and $126 thousand (nine months), office expense for $17 thousand (three months) and $33 thousand (nine months), rent expense for $34 thousand (three months) and $154 thousand (nine months), insurance expense for $30 thousand (three months) and $90 thousand (nine months), travel expense for $16 thousand (three months) and $84 thousand (nine months), temporary labor expense for $25 thousand (three months) and $96 thousand (nine months), with miscellaneous other expenses making the difference.

We believe securing a favorable recommendation from the FDA is critical to obtaining additional funding. Due, however, to the delay in the FDA's response, we have been forced to conserve cash by reducing expenses throughout the Company. We feel it is not wise to continue development of a product that has not yet been approved by the FDA.

When funding permits, we plan to continue conducting clinical studies at a much reduced level in the near future, utilizing the BCS 2100, with institutions and practitioners to obtain user feedback, test product enhancements as they become available, secure technical papers and for training and educational marketing purposes. The only study we currently are conducting at Massachusetts General Hospital was placed on hold in January 2004. Clinical studies are not the same as clinical trials, which we conducted for FDA PMA approval purposes.

Litigation settlement expense was an additional $10 thousand for the quarter ending March 31, 2004 totaling $110 thousand for the nine month period ending March 31, 2004. $100 thousand was expensed in estimation of settlement for the breached office lease contract for the Portland office. An agreement was reached in April 2004 and an additional $10 thousand was expensed in the quarter ending March 31, 2004.

Depreciation and amortization expense for the quarter ended March 31, 2004 decreased $12 thousand and $256 thousand to $36 thousand and $132 thousand, or 25% and 66%, respectively, compared to the same periods of the prior year. During fiscal 2003, we impaired all assets to reflect possible recovery values due to the concern expressed by our auditors that we may not be able to continue as a going concern. There was no additional impairment in the three and nine-month periods ended March 31, 2004.



OPERATING INCOME / LOSS

Principally as a result of the foregoing, we recorded operating losses of $514 thousand and $2,456 thousand for the three and nine-month periods ended March 31, 2004, respectively, compared to operating losses of $1.7 million and 7.8 million, respectively, for the three and nine-month periods ended March 31, 2003. Sales in the medical segment accounted for over half of our revenue in the three and nine months ended March 31, 2004. Our activities in the industrial segment during the three and nine months resulted primarily in service and repair revenues and related labor costs. By reducing expenses we have been able to reduce our losses; however, revenue growth has suffered consequently.

OTHER INCOME

Net interest expense for the three- and nine-month periods ended March 31, 2004 decreased $1.8 million and $2.6 million, respectively, from the same periods of 2003, to an income of less than $1 thousand for the three months ended March 31, 2004 and expense of less than $1 thousand for the nine months ended March 31, 2004. These decreases resulted primarily from the retirement of a convertible debenture in 2003.

NET INCOME/(LOSS)

We recorded a net loss of $513 thousand and $2,457 thousand for the three and nine months ended March 31, 2004, compared to a net loss of 3.6 million and $10.4 million for the same periods in 2003. For the three and nine months ended March 31, 2004, the loss attributable to common shareholders was $513 thousand, or less than ($0.01) per share, and $2,457 thousand or ($0.02) per share, compared to a loss attributable to common shareholders of $3.6 million, or ($0.04) per share, and $10.4 million or ($0.12) per share for the same periods in 2003. The decreased loss per share is in part due to the retirement of the Beach Boulevard debenture and equity line, diluting shareholder ownership by increasing shares from 87 million shares to 113 million shares and to the reduction in costs.

LIQUIDITY AND CAPITAL RESOURCES

SOURCES AND USES OF LIQUIDITY

Our sources of funds used for operations have historically come from selling common stock, as well as the issuance and exercise of options and warrants, revenues generated from operations, sales of marketable securities, interest earned from marketable securities available for sale and debt assumption.

Our cash requirements include, but are not limited to, general corporate expenses including employee salaries and benefits, defense of shareholder lawsuits and response to regulatory investigations, indemnification of employees, lease payments on office space, legal and accounting fees for litigation, compliance with securities registration and reporting requirements, costs of clinical trials and studies and technical support, FDA consulting

expenses, procurement of inventory and supply expenses associated with our efforts to develop, manufacture and market our medical and industrial applications. We have reduced many of these costs in an effort to preserve cash; however, a significant amount of these costs are attributable to activities that are necessary to continue our operations and obligations.

Net cash used in operating activities for the nine months ended March 31, 2004 was $1.55 million, compared to $7.7 million for the nine months ended March 31, 2003. The decrease in cash used in operating activities was primarily a result of our efforts to decrease our expenses and cash outlays, as well as the collection of cash for invoices where the revenue has been deferred due to outstanding obligations (primarily the Nanda Agreement see below) and is affected by fluctuations in accounts receivable, accounts payable and accrued expense balances.

Excluding an allowance for doubtful accounts of $62 thousand for the nine months ended March 31, 2004, accounts receivable decreased approximately $301 thousand from $420 thousand to $60 thousand at March 31, 2004, compared to June 30, 2003. This decrease in receivables relate primarily to one invoice to NanDa Thermal Technology, Inc. ("NanDa") for $300 thousand associated with a prepayment required by the contract. We have deferred our recognition of revenue under the NanDa agreement until we have satisfied our obligations under the agreement.

Net cash provided by investing activities for the nine months ended March 31, 2004 was $3 thousand, compared to net cash used in investing activities of $7.2 million in the nine months ended March 31, 2003. Net cash provided by and used in investing activities was provided by the sale of fixed assets in connection with our office consolidation process for fiscal 2004, whereas net cash in 2003 was from the sale of securities.

Net cash provided by financing activities was $1.22 million for the nine months ended March 31, 2004, compared to $782 thousand during the nine months ended March 31, 2003. On July 9, 2003 we closed a private placement pursuant to Regulation S of the Securities Act, and sold 3,344,482 shares of our common stock to Therfield Holdings LTD., a limited liability company formed under the laws of the British Virgin Islands, for $1 million. Also in February 2004 we closed a second private placement pursuant to Regulation S of the Securities Act, and sold 1,000,000 shares of our common stock to Charles Dai for $220,000. Net cash provided by financing activities for the nine months ended March 31, 2004 was from net cash provided from selling shares of common stock pursuant to an equity line of credit.

As a result of the foregoing, our net cash decreased by $329 thousand during the nine months ended March 31, 2004, compared to a $244 thousand decrease in the nine months ended March 31, 2003.

Cash and cash equivalents at March 31, 2004 were $126 thousand, compared to $454 thousand at June 30, 2003.

As of May 1, 2004, our current monthly expense rate is under $150 thousand; our monthly expense rate at our former full operational level was approximately $1,100 thousand. As of May 1, 2004 , we had cash, accounts receivable and pre-paid expenses of approximately $187 thousand and current liabilities (excluding the debenture and deferred revenue) of approximately $993 thousand. These current liabilities consisted of approximately $598 thousand of accounts payable, $338 thousand of accrued liabilities, and $62 thousand of

accrued employee costs. Accordingly, unless we are able to secure additional funding from a third party, we do not currently have sufficient working capital to sustain our operations at current levels, which are already substantially reduced, beyond June or July 2004. Our failure to secure additional funding may result in further severe reductions in our operations or the discontinuance of our operations altogether.

The following table summarizes our contractual obligations and commitments to make future payments as of March 31, 2004:

| | Payments due by period | | | |
|---|---|---|---|---|
| | Total | less than 1 year | 1-2 years | after 3 years |
| Oswego operating lease | $110,000 | $110,000 | $0 | $0 |

CAPITAL REQUIREMENTS/PLAN OF OPERATION

Our capital requirements may vary from our estimates and will depend upon numerous factors including, but not limited to: a) FDA approval process; b) results of pre-clinical and clinical testing; c) costs of technology; d) time and costs involved in obtaining other regulatory approvals; e) costs of filing, defending and enforcing any patent claims and other intellectual property rights; f) the economic impact of developments in competing technology and our markets; g) competing technological and market developments; h) the terms of any new collaborative, licensing and other arrangements that we may establish; i) litigation costs; and j) costs we incur in responding to inquiries and investigations conducted by the SEC and other governmental entities.

Since inception, we have generated significant losses from operations ($96.6 million) and, although we have generated some revenues ($3.7 million), we are still a development stage enterprise. We have taken actions to reduce our expenses and cash consumption; however, we expect to incur additional operating losses for the indefinite future. Our working capital requirements in the foreseeable future will depend on a variety of factors and assumptions. In particular, we will need to obtain additional financing through additional equity and/or debt financings or through the sale of assets (including our intellectual property) during fiscal year 2004. If we raise additional funds through the issuance of equity securities or other financing instruments which are convertible to equity securities, our shareholders may experience significant dilution that aversely affect the price of our common stock. If we raise debt capital, the lenders may require us to pledge our assets as collateral and could insist on loan terms that could adversely affect our operations and the price of our common stock. Furthermore, there can be no assurance that additional financing will be available when needed or at all, or that if available, such financing will be on terms favorable to us or our shareholders. If financing is not available when required or is not available on acceptable terms, we may be required to curtail our operating plan and will likely not be able to continue operations as a going concern.

We do not have sufficient capital to cover: 1) the expected costs of additional clinical studies if required by the FDA; 2) the potential damages from pending shareholder litigation; or 3) the anticipated expense of funding our business plan over the next year. We will have to obtain

additional capital within the fiscal year through the issuance of securities, assumption of loans and sale of assets (including our intellectual property). Furthermore, these factors have made it difficult, if not impossible, to raise the required capital needed to continue operations. If we are not successful, we will have to scale back our business plans and may have to discontinue operations.

As of March 31, 2004, we believed that we had sufficient liquidity to sustain current operations for next two months. Our monthly expense rate at that time averaged $200 thousand, we had cash, marketable securities, accounts receivable and pre-paid expenses of approximately $266 thousand and current liabilities (excluding the debenture and deferred revenue) of approximately $998 thousand. On a short-term basis, we believed we would be able to fund our operations with cash on hand and the proceeds of our receivables and current sales activities; however, to fund our operations over the long term (more than 2 months) we believed we would need to raise additional capital or curtail our operation.

As of May 1, 2004, we have reduced operating expenses and curtailed operating activities. Overall, we have reduced our monthly cash consumption to under $150 thousand, which we currently believe will be adequate to sustain our operations at current levels only through May or June 2004. We have selectively reduced expenses by eliminating expenditures for certain regional trade shows and conferences; reducing or eliminating administrative staff, reducing purchased services and the level of certain employee benefit programs, reducing salaries by 50%, eliminating insurance and consolidating operations. If we are unable to secure additional capital, we may need to further reduce our operations or discontinue operations entirely. On February 4, 2004, we received $220 thousand in connection with an agreement with a private investor, Charles Dai. We are currently pursuing other investors.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We are a development stage enterprise. We believe we are not subject to market risks beyond ordinary economic risks, such as interest rate fluctuations and inflation.

ITEM 4. CONTROLS AND PROCEDURES

An evaluation was performed under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer, or CEO, and the Company's Director of Finance, of the effectiveness of the Company's disclosure controls and procedures as of March 31, 2004. Based on that evaluation, the Company's management, including its CEO and Director of Finance, concluded that the Company's disclosure controls and procedures are effective to ensure that information required to be disclosed by the Company in reports filed or submitted by the Company under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported as specified in the SEC's rules and forms. There have been no significant changes in the Company's internal controls or in other factors that could significantly affect internal controls subsequent to the evaluation.

PART II-- OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

SALAH AL-HASAWI ADVISORY SERVICES CLAIM

On March 29, 2000, Salah Al-Hasawi, a citizen and resident of Kuwait, filed an action in the United States District Court for the Southern District of New York, against us and our former Chief Executive Officer, alleging violations under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder, for commissions allegedly due to the plaintiff in connection with the private placement of our securities. Shortly thereafter, the lawsuit was dismissed without prejudice and on April 12, 2000 the plaintiff filed a similar complaint in the United States District Court for the District of Utah. The plaintiff's complaint sought specified damages of $15.5 million, attorney fees and unspecified damages pursuant to five separate causes of action including breach of contract, fraud and unjust enrichment.

In December 2003, we reached a settlement with the plaintiff, pursuant to which we agreed to pay the aggregate amount of $100,000 in three installments ($50,000 paid on December 17, 2003, $25,000 paid in January 2004 and $25,000 paid in February 2004) and the plaintiff agreed to dismiss the litigation with prejudice. The settlement is set forth in a Settlement Agreement and Mutual Release, which provided for the filing with the court of dismissal pleadings with the final installment payment in February 2004.

SHAREHOLDER CLASS ACTION

In 2002 five different lawsuits were filed against us in the United States District Court of Oregon. The lawsuits, which were consolidated into a single class action, allege in substance that CTI violated Section 10(b) of the Securities Exchange Act of 1934, as amended, and accompanying regulations by misleading shareholders regarding such things as FDA approval and other matters, which the plaintiffs allege caused significant damage to the holders of our common stock at the time of these alleged misrepresentations and omissions. The plaintiffs have not specified their damages. On April 17, 2003, the consolidated litigation was dismissed without prejudice by the United States District Court. In a written opinion, the U.S. District Court Judge concluded that the alleged misstatements were either not material, not misleading, or not plead by plaintiffs with sufficient particularity to constitute a claim. The Court gave the plaintiffs until May 8, 2003 to replead three of the nine claims. Plaintiffs did not replead, so the judge dismissed the case with prejudice on May 13, 2003. On May 22, 2003, the plaintiffs filed for appeal, and on September 3, 2003 the plaintiffs filed their memorandum in support of their appeal. On October 20, 2003, we filed our response in support of the District Court's opinion. We do not expect to receive a decision from the appellate court for at least one year.

We believe the plaintiffs' allegations are without merit and intend to defend them vigorously. Defending these lawsuits will require additional legal expenses, may make fundraising more difficult if not impossible and will distract members of management from day-to-day operations. Moreover, our insurance carrier has previously denied coverage for the plaintiffs' claims and, accordingly, has indicated it will not cover the costs of defending the claims and will not pay any resulting damages we may suffer if the plaintiffs are successful. We have retained insurance counsel to advise us in this matter, which is in its early stages. In addition, under our bylaws and contractual agreements we are required to indemnify our current and former officers and directors who are parties to the litigation by providing legal defense through our attorneys (or reimbursing them for their own attorneys) and covering all damages they may suffer if the plaintiffs are successful.

SEC AND DEPARTMENT OF JUSTICE INVESTIGATIONS

In December 2002, we were requested to provide certain documents to the U.S. Securities and Exchange Commission and the U.S. Attorney for the Southern District of New York in connection with their investigation of possible violations by our Chairman of the Board and Chief Executive Officer of the insider trading prohibitions found in the federal securities laws. During the year ended June 30, 2003, we incurred approximately $658 thousand in legal costs in complying with these requests. During the period between June 30, 2003 and March 31, 2004, we incurred approximately $168 thousand in additional legal costs associated with these investigations. We also may be required to indemnify our officers and directors for fees incurred for these investigations. For the year ended June 30, 2003, such indemnification obligations totaled approximately $36 thousand, and during the period between June 30, 2003 and March 31, 2004 we incurred approximately $12 thousand in additional indemnification obligations which are included in the previous figures. It is difficult to place a dollar value on the time spent by executives, board members, and employees in dealing with this issue. However, considerable time has been spent in testifying, interviews, and document location and preparation by many of our staff, executives and board members.

ST. PAUL PROPERTIES

On April 11, 2003, the Landlord filed suit against the Company in the Circuit Court for Clackamas County. The Landlord alleges that the Company breached its prior corporate office lease by failing to pay the rent specified under the lease. The Landlord seeks damages of approximately $667,000 plus interest and attorneys and other fees. The Company has filed an answer and affirmative defenses alleging that the Landlord failed to use reasonable efforts to mitigate its damages. In addition, the Company is aware that much of the vacant space has been relet to a third party tenant, substantially reducing the damage claim. The Company has settled with the Landlord for the sum of $110,000 and which includes a $50,000 payment with 5 monthly payments of $12,000. Although this settlement has been completed and the law firms are holding as of May 15, 2004, $74,000 (uncial payment and two monthly payments), the final documents have not yet been signed by the Landlord however, we expect to receive the fully executed documents soon.

INDEMNIFICATION

Under our bylaws and contractual agreements, we may be required to indemnify our current and former officers and directors who are parties to litigation or other proceedings by providing legal defense through our attorneys (or reimbursing the parties for their own attorneys) and covering all damages the parties may suffer if the plaintiffs are successful.

OTHER LEGAL PROCEEDINGS

We are involved in certain other litigation matters in the normal course of business which management currently believes are not likely to result in any material adverse effects on our financial position, results of operations, or net cash flows.



ITEM 2. CHANGES IN SECURITIES

On January 22, 2004, in connection with an October 17, 2003 settlement with a law firm the Company issued 25,000 shares of stock in exchange for a reduction of approximately $30 thousand in a payable to the law firm. The

settlement was for an outstanding amount of approximately $110 thousand for cash of $80 thousand (40 thousand in October 2003 and $10 thousand a month for 4 months) plus the $25,000 shares of common stock. The obligation was fully satisfied in January 2004.

On May 18, 2004 the Company issued 1,000,000 shares of restricted stock in a private placement to Charles Dai in exchange for $220,000 in cash. The agreement was for up to $1,000,000 cash for a total 4,545,454 shares. As of May 1, 2004 Charles Dai has not exercised the rights to purchase the remaining 3,545,454 shares.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) EXHIBITS

31.1 Certification of Chief Executive Officer
31.2 Section 302 Certification of Chief Financial Officer
32.1 Section 906 Certification of Chief Executive Officer
32.2 Section 906 Certification of Chief Financial Officer

(b) REPORTS ON FORM 8-K (AND PRESS RELEASE)

Current Report on Form 8-K filed February 9, 2004 (reporting the Company's appeal to American Stock Exchange notice to delist and private placement as the first step to restore compliance).

Current Report on Form 8-K filed March 26, 2004 (reporting the Company's delistment from the American Stock Exchange, a leasing commitment and a letter received from FDA ).

Press Release April 21, 2004 (reporting the licensing of the Company's BSC 2100 Breast Cancer Thermal Imaging System in Canada ).

SIGNATURES

Pursuant to the requirements 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.

COMPUTERIZED THERMAL IMAGING, INC.
(Registrant)

/s/Richard V. Secord
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Dated May 24, 2004
Richard V. Secord
Chairman & Chief Executive Officer