MANAGEMENT'S DISCUSSION AND ANALYSIS OF RESULTS OF OPERATIONS AND FINANCIAL CONDITION

RESULTS OF OPERATIONS

Net Sales.... Net sales increased 47% to $33,311,000 in 1999. The increase was a result of growth in the sales of pool products as well as commercial lighting products. Pool lighting sales grew as a result of increases in in-ground pool lighting products and in spa lighting products. Commercial lighting product sales growth was due to increased sales from Europe by companies acquired in 1998, along with increased sales form specialty lighting products from the Company's Seattle operation, also acquired in 1998.

Net sales increased 27% to $22,682,000 in 1998 as compared to 1997. The increase was primarily a result of growth in the commercial lighting products.

International sales accounted for approximately 31% of net sales in 1999 as compared to 17% in 1998 and 17% in 1997. The increase in International sales in 1999 was due to the addition of sales from two European companies acquired in 1998.

Gross Profit.... Gross profit increased to $14,333,000 in 1999, a 68% increase. The increase in gross profit was a result of the increased sales and an increase in the gross profit margin. The gross profit margin was 43% in 1999, an increase of 5 percentage points over the 38% gross margin achieved in 1998. The increase in gross margin was primarily due to savings in 1999 on warranty and repair costs as well as cost reductions achieved on some of the Company's higher volume products.

Gross profit in 1998 was $8,546,000, a 9% increase over 1997. The gross profit margin was 38% in 1998, a decline from the 44% gross margin achieved in 1997. The decrease in gross margin was primarily a result of higher cost of sales for some of the Company's pools products early in the year along with an increase in warranty costs associated with a lamp component. The Company has gained assurances from its lamp supplier that the lamp component involved in the warranty claims has been fixed.

Operating Expenses.... Research and development expenses were $1,484,000 in 1999, a 16% increase over 1998. The increase is largely due to additional personnel and product development expenses associated with releasing new products in 1999 and product development on products to be released in 2000. Research and development expenses were 4.5% of sales in 1999, down from 6% in 1998. Sales and marketing expenses were $8,044,000 in 1999 as compared to $5,381,000 in 1998, an increase of 49%. A portion of the increase was due to $1,908,000 in additional expenses from the acquired companies in 1998 for which there were expenses of $333,400 in 1998. The balance of the increase is largely a result of additional commission expenses paid for sales in Europe in 1999 as compared to those paid in 1998. Sales and marketing expenses were 24% of sales in 1999 compared to 24% in 1998. General and administrative costs were $2,558,000 in 1999, an increase of 53% over 1998 costs. This increase was largely a result of higher goodwill amortization expenses in 1999 which were $492,000 as compared to $63,000 for goodwill amortized in 1998. Other increases in general and administrative expenses were associated with moving the Company's corporate offices to a new location in 1999 and with additional adminstrative costs from the European subsidiaries which were acquired in 1998. Total operating expenses were 36% of sales in 1999 as compared to 37% in 1998 and 39% in 1997.

Research and development expenses were $1,283,000 in 1998, a 10% increase over 1997. The increase was largely due to additional personnel and product development expenses associated with releasing new products in 1998 and preparing products to be released in 1999. Research and development expenses were 6% of sales in 1998, down from 7% in 1997. Sales and marketing expenses were $5,381,000 in 1998 as compared to $4,393,000 in 1997, an increase of 22%. A portion of the increase was due to $333,400 in additional expenses from the acquired companies in 1998 for which there were no expenses in 1997. The balance of the increase was a result of additional personnel and marketing costs associated with supporting existing products as well as introduction costs for new products released during 1998. Sales and marketing expenses were 24% of sales in 1998 compared to 25% in 1997. General and administrative costs were $1,675,000 in 1998, an increase of 18% over 1997 costs. This increase was largely a result of writing down the value of $200,000 in assets which were deemed to have no future value, along with goodwill amortization from acquisitions of $63,000 which was part of general and administrative expense in 1998. Total operating expenses were 37% of sales in 1998 as compared to 39% in 1997 and 38% in 1996.

Other Income and Expense. . . . Other income and expense includes interest income and expense, income (loss) from the Company's joint venture as recognized under the equity method, and income from divestitures. Net interest income was $26,000 in 1999 compared to $223,000 in 1998. The decrease was primarily due to lower cash balances in 1999 as compared to 1998 as a result of cash spent to acquire three companies in the 2nd half of 1998. In addition, there was interest expense in 1999 primarily for a bank loan to the Company's German subsidiary. There was no such expense in 1998. The bank loan was obtained for completion of the German subsidiaries primary offices outside Munich, Germany. The loss from the Company's joint venture was $18,000 in 1999 versus a loss of $22,000 in 1998. In February 2000 the Australian joint venture was sold to the Australian subsidiary of Advanced Technology Lighting, Inc. The divestiture income of $801,000 for 1998 was a result of the Company selling its rights to its phototherapy fiber optic product to Respironics, Inc.

Net interest income in 1998 was $223,000 as compared to $246,000 achieved in 1997. The Company's investment in joint venture activities yielded a loss of $22,000 in 1998 compared to a loss of $12,000 in 1997. The Company had divestiture income of $801,000 in 1998 as described above, as compared to none in 1997.

Income Taxes. . . . The income tax rate in 1999 was 37% compared to 37% in 1998 and 40% in 1997. The lower rates in 1999 and 1998 are due to the recognition of certain tax benefits accumulated over prior years. There is no assurance that the income tax rate in future periods will be maintained at the level experienced in 1998.

Net Income. . . . As a result of the increase in sales and higher gross profit margin in 1999, partially offset by higher expenses, net income for the year was $1,413,000 or 85% above net income achieved in 1998. The Company recorded net income of $762,000 in 1998, a gain of 18% over net income of $644,000 achieved in 1997.

LIQUIDITY AND CAPITAL RESOURCES

For the year ended December 31, 1999, cash and cash equivalents when combined with short-term investments were $1,904,000 as compared to $1,290,000 for the year ended December 31, 1998. Cash in the amount of $1,166,000 was contributed from operating activities in 1999. This was a result of cash provided by earnings before interest, taxes, depreciation and amortization of $3,166,000 partially offset by uses of cash to increase accounts receivable of $1,518,000 and other changes in assets and liabilities. In addition, cash totaling $41,000 came from financing activities which primarily related to sales of common stock under stock option and stock purchase plan. Cash from operating and financing activities was used in the amount of $652,000 for investing activities, primarily for the addition of fixed assets. Cash may decline during the 1st quarter of 2000, but then increase in the 2nd quarter as a result of the seasonal variance in cash needs of the Company.

In August 1999, the Company renewed its $2.5 million unsecured line of credit for working capital purposes and its $500,000 term loan commitment to finance equipment purchases. Both lines expire in August, 2000. As of December 31, 1999 the Company had no borrowings outstanding against either of these lines of credit.

The Company also has a $404,000 bank overdraft agreement with Lloyds Bank Plc through its UK subsidiary. There were no net borrowings against the overdraft agreement as of December 31, 1999. In addition, at year end the Company has a total borrowing of $626,000 against a credit facility which totals $747,00 held by its German subsidiary. This borrowing is largely held in order to finance the building of new offices owned by the Company in Basching, Germany.

The Company believes that existing cash balances, together with the Company's bank lines of credit and funds that may be generated from operations, will be sufficient to finance the Company's currently anticipated working capital requirements and capital expenditure requirements for at least the next twelve months.

SUBSEQUENT EVENT

On February 1, 2000 the Company completed the acquistion of selected assets of Unison Fiber Optic Systems, LLC, a joint venture between Advanced Lighting Technologies, Inc. ("ADLT") and Rohm & Haas Company. The Company acquired key personnel, technologies, fixed assets totaling $600,000 and, subject to achievement of development milestones, up to $2 million in development funds from Unison. In exchange for this the Company issued warrants to ADLT for the purchase of up to 1 million shares of the Company's common stock at $0.01 per share. These warrants may not be exercised until the price of the Company's stock reaches certain trading levels on the Nasdaq National Market, as follows: 250,000 will be exercisable when the the Company's stock price reaches $6.00; 250,000 when the price reaches $8.00; 250,000 when the price reaches $10.00; and 250,000 when the price reaches $12.00. These prices must be maintained as an average over at least 30 days. In addition, at each price level, certain sales milestones must be reached on products of Unison technology before the warrants can be exercised. At ADLT's option, the warrants may be exchanged by ADLT, regardless of their exercisability, for up to 445,000 newly issued Fiberstars shares.

Other Factors.... This Annual Report contains forward-looking statements. Such statements generally concern future operating results, capital expenditures, product development and enhancements, liquidity and strategy. Specific forward-looking statements in this report include, without limitation, our remarks concerning the evolution of the fiber optic lighting market, the future size of the fiber optic lighting market, our expectations concerning the future performance of our recently completed acquisitions, our expectations regarding future performance of certain lamp components of our products that have recently experienced problems, the rate of adoption of fiber optic lighting in Europe and in the United States, trends in the price and performance of fiber optic lighting products, the future performance of our lighting products, our relationship with ADLT and future technologies expected to result from our relationship with ADLT. We may not update these forward looking statements, and the occurrence of the events predicted in these statements is subject to a number of risks and uncertainties, including those discussed in this report. These risks and uncertainties could cause our actual results to differ materially from the results predicted in our forward looking statements. You are encouraged to consider all the information in this report, and in our Annual

Report on Form 10-K filed with the Securities and Exchange Commission ("SEC"), along with our other periodic reports on file with the SEC, prior to investing in our stock.

BUSINESS RISKS AND UNCERTAINTIES

Our quarterly operating results can vary significantly depending upon a number of factors. It is difficult to predict the lighting market's acceptance of our products on a quarterly basis, and the level and timing of orders received can fluctuate substantially. Our sales volumes also fluctuate. Historically we have shipped a substantial portion of our quarterly sales in the last month of each of the second and fourth quarters of the year. Significant portions of our expenses are relatively fixed in advance based upon our forecasts of future sales. If sales fall below our expectations in any given quarter, we will not be able to make any significant adjustment in our operating expenses and our operating results will be adversely affected. In addition, our product development and marketing expenditures may vary significantly from quarter to quarter and are made well in advance of potential resulting revenue.

Sales of our pool and spa lighting products, which currently are available only with newly constructed pools and spas, depend substantially upon the level of new construction. Sales of commercial lighting products also depend significantly upon the level of new building construction. Construction levels are affected by housing market trends, interest rates, and the weather. Because of the seasonality of construction, our sales of swimming pool and commercial lighting products, and thus our overall revenues and income, have tended to be significantly lower in the first quarter of each year. Various economic and other trends may alter these seasonal trends from year to year, and we cannot predict the extent to which these seasonal trends will continue. We believe our business has been favorably impacted by recent strength in the overall U.S. economy. If the U.S. economy softens, our operating results will probably suffer.

In the first quarter of 2000, we introduced three major new products. Our Pool & Spa products called FS1/2 and Sarah are expected to provide measurable sales. The Model 701S illuminator for the Commercial Lighting market will replace and is expected to outperform our current brightest illuminator Model 601. We could have difficulties manufacturing these new products as a result of our inexperience with them. Also, it is difficult to predict whether the market will accept either of these new products. If either of these new products fails to meet expectations, our operating results will be adversely affected.

Competition is increasing in a number of our markets. A number of companies offer directly competitive products, including fiber optic lighting products for downlighting, display case and water lighting, and neon and other lighted signs. Our competitors include some very large and well established companies such as Philips, Schott, 3M, Bridgestone, Mitsubishi and Osram/ Siemens. All of these companies have substantially greater financial, technical and marketing resources than we do. We anticipate that any future growth in fiber optic lighting will be accompanied by continuing increases in competition, which could accelerate growth in the market for fiber optic lighting, but which could also adversely affect our operating results to the extent we do not compete effectively.

We were awarded our tenth patent in the fourth quarter of 1999. However, we believe the success of our business depends primarily on our continued technical innovation, marketing abilities and responsiveness to customer requirements, rather than on patents, trade secrets, trademarks, copyrights and other intellectual property rights. Nevertheless, we have a policy of seeking to protect our intellectual property through, among other things, the prosecution of patents with respect to certain of our technologies. There are many issued patents and pending patent applications in the field of fiber optic technology, and certain of our competitors hold and have applied for patents related to fiber optic lighting. Although to date we have not been involved in litigation challenging our intellectual property rights or asserting intellectual property rights of others, we have in the past received communications from third parties asserting rights in our patents or that our technology infringes intellectual property rights held by such third parties. Based on information currently available to us we do not believe that any such claims involving our technology or patents are meritorious. However, we may be required to engage in litigation to protect our patent rights or to defend against the claims of others. In the event of litigation to determine the validity of any third party claims or claims by us against such third party, such litigation, whether or not determined in our favor, could result in significant expense.

Our business is subject to additional risks that could materially and adversely affect our future business, including:

..... manufacturing risks, including the risks of shortages in materials or components necessary to our manufacturing and assembly operations, and the risks of increases in the prices of raw materials and components;

..... sales and distribution risks, such as risks of changes in product mix or distribution channels that result in lower margins;

..... risks of the loss of a significant distributor or sales representative;

..... risks of the loss of a significant customer or swimming pool builder;

..... risks of the effects of volume discounts that we grant from time to time to our larger customers, including reduced profit margins;

..... risks of product returns and exchanges; in this regard, as noted above, in 1998 we increased our warranty reserve inresponse to evidence of defective lamps in certain of our products. We cannot be assured that we will not experience similar component problems in the future that could also require increased warranty reserves and manufacturing costs;

..... risks associated with product development and introduction problems, such as increased research, development and marketing expenses associated with new product introductions; and

..... risks associated with delays in the introduction of new products and technologies, including lost sales and loss of market share.

Consolidated Balance Sheets

(Amounts in thousands, except share and per share amounts)	*December 31,* 1999	1998
ASSETS		
Current assets:		
Cash and cash equivalents	$ 1,904	$ 1,290
Accounts receivable, net of allowances for doubtful accounts of $428 in 1999 and $370 in 1998	6,533	5,210
Notes and other receivables	250	771
Inventories, net	4,269	4,179
Prepaids and other current assets	428	369
Deferred income taxes	662	507
Total current assets	14,046	12,326
Fixed assets, net	2,242	1,522
Goodwill, net	3,800	4,403
Investment in joint venture		18
Other assets	218	566
Deferred income taxes	86	89
Total assets	$20,392	$18,924
LIABILITIES		
Current liabilities:		
Accounts payable	$ 2,572	$ 2,598
Accrued liabilities	2,518	2,198
Current portion of long-term debt	8	107
Total current liabilities	5,098	4,903
Long-term debt, less current portion	626	667
Total liabilities	5,724	5,570
Commitments and contingencies (Note 9).		
Shareholders' Equity		
Preferred stock, par value $0.0001 per share:		
Authorized: 2,000,000 shares in 1999 and 1998		
Issued and outstanding: no shares in 1999 and 1998		
Common stock, par value $0.0001 per share:		
Authorized: 30,000,000 shares in 1999 and 1998		
Issued and outstanding: 4,003,514 shares in 1999 and 3,982,601 shares in 1998		
Additional paid-in capital	13,973	13,930
Notes receivable from shareholders	(75)	(86)
Cumulative translation adjustments	(153)	
Retained earnings (accumulated deficit)	923	(490)
Total shareholders' equity	14,668	13,354
Total liabilities and shareholders' equity	$20,392	$18,924

Consolidated Income Statements

(Amounts in thousands except per share amounts)	*For the years ended December 31,* 1999	1998	1997
Net sales	$33,311	$22,682	$17,871
Cost of sales	18,978	14,136	10,047
Gross profit	14,333	8,546	7,824
Operating expenses:			
Research and development	1,484	1,283	1,165
Sales and marketing	8,044	5,381	4,393
General and administrative	2,558	1,675	1,419
Total operating expenses	12,086	8,339	6,977
Income from operations	2,247	207	847
Other income (expense):			
Equity in joint ventures' loss	(18)	(22)	(12)
Divestiture		801	
Interest and other income	71	224	248
Interest expense	(45)	(1)	(2)
Income before provision for income taxes	2,255	1,209	1,081
Provision for income taxes	(842)	(447)	(437)
Net income	$ 1,413	$ 762	$ 644
Net income per share - basic	$ 0.35	$ 0.21	$ 0.19
Shares used in per share calculation - basic	3,986	3,623	3,446
Net income per share - diluted	$ 0.35	$ 0.21	$ 0.18
Shares used in per share calculation - diluted	4,080	3,695	3,597

Consolidated Statements of Comprehensive Income

(Amounts in thousands)	*For the years ended December 31,* 1999	1998	1997
Net income	$ 1,413	$ 762	$ 644
Other comprehensive loss:			
Foreign currency translation adjustments	(239)		
Income tax benefit	86		
Comprehensive income	$ 1,260	$ 762	$ 644

CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

For the years ended December 31, 1998, 1997 and 1996

(Amounts in thousands)	*Common Stock* Shares	*Common Stock* Amount	*Additional Paid-in Capital*	*Notes Receivable from Shareholders*	*Accumulated Other Comprehensive Loss*	*Accumulated Deficit Retained Earnings*	*Total*
Balances, January 1, 1997	3,413	$ —	$11,903	$ (75)		$ (1,896)	$ 9,932
Exercise of common stock options	88		97				97
Issuance of common stock under employee stock purchase plan	9		35				35
Net income						644	644
Balances, December 31, 1997	3,510	—	12,035	(75)		(1,252)	10,708
Exercise of common stock options	46		164				164
Issuance of common stock under employee stock purchase plan	10		35				35
Issuance of common stock pursuant to exercise of warrants	12		11	(11)			-
Issuance of common stock for acquisitions	405		1,685				1,685
Net income						762	762
Balances, December 31, 1998	3,983	—	13,930	(86)		(490)	13,354
Exercise of common stock options	13		11				11
Issuance of common stock under employee stock purchase plan	8		32				32
Issuance of common stock pursuant to exercise of warrants				11			11
Foreign exchange rate translation					$ (153)		(153)
Net income						1,413	1,413
Balances, December 31, 1999	4,004	$ —	$13,973	$ (75)	$ (153)	$ 923	$14,668

Consolidated Statements of Cash Flows

(Amounts in thousands)	*1999*	*1998*	*1997*
	For the years ended December 31,		
Cash flows from operating activities:			
Net income	$ 1,413	$ 762	$ 644
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	937	647	453
Provision for doubtful accounts receivable	97	77	76
Deferred income taxes	(154)	135	407
Equity in joint venture	18	22	12
Changes in assets and liabilities:			
Accounts receivable, trade	(1,518)	(1,072)	2
Inventories	(152)	(275)	(900)
Prepaid and other current assets	(60)	36	(192)
Other assets	177	(463)	19
Accounts payable	58	240	101
Accrued liabilities	350	671	196
Total adjustments	(247)	18	174
Net cash provided by operating activities	1,166	780	818
Cash flows from investing activities:			
Sale of short-term investments		4,597	
Purchase of short-term investments			(1,282)
Acquisition of business, net of cash acquired		(3,232)	
Loans made under notes receivable		(610)	(30)
Repayment of loans made under notes receivable	656		
Acquisition of fixed assets	(1,308)	(479)	(624)
Net cash provided by (used in) investing activities	(652)	276	(1,936)
Cash flows frxom financing activities:			
Proceeds from issuances of common stock	54	199	132
Repayment of long-term debt	(270)	(488)	(11)
Proceeds from issuance of long-term debt	257		
Net cash provided by (used in) financing activities	41	(289)	121
Effect of exchange rate changes on cash	59		
Net increase in cash and cash equivalents	614	767	(997)
Cash and cash equivalents, beginning of period	1,290	523	1,520
Cash and cash equivalents, end of period	$ 1,904	$ 1,290	$ 523
Supplemental information:			
Interest paid	$ 45	$ 1	$ 2
Income taxes paid	$ 669	$ 66	$ 24

The Company purchased certain business during 1998. In conjunction with the acquisitions, liabilities were assumed as follows:

Fair value of assets acquired	$ 7,649
Cash paid for capital stock	(3,232)
Capital stock issued	(1,685)
Liabilities assumed	$ 2,732

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. NATURE OF OPERATIONS:

Fiberstars, Inc. (the Company) develops and assembles lighting products using fiber optic technology for commercial lighting and swimming pool and spa lighting applications. The Company markets its products for worldwide distribution primarily through independent sales representatives, distributors and swimming pool builders.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES:

Basis of Consolidation.... The consolidated financial statements include the accounts of Fiberstars, Inc. and its subsidiaries. All significant intercompany balances and transactions have been eliminated.

Use of Estimates.... The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amount 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 reported period. Actual results could differ from those estimates.

Cash Equivalents.... The Company considers all highly liquid investments purchased with a remaining maturity of three months or less to be cash equivalents.

Inventories.... Inventories are stated at the lower of cost (determined on a first-in, first-out basis) or market.

Investments in Joint Ventures.... The Company records its investments in joint ventures under the equity method of accounting.

Fair Value of Financial Instruments.... Carrying amounts of certain of the Company's financial instruments including cash and cash equivalents, short-term investments, accounts receivable, accounts payable and other accrued liabilities approximate fair value due to their short maturities. Based on borrowing rates currently available to the Company for loans with similar terms, the carrying value of long-term debt obligations also approximates fair value.

Revenue Recognition.... The Company recognizes sales upon shipment.

Depreciation and Amortization.... Fixed assets are stated at cost and depreciated by the straight-line method over the estimated useful lives of the related assets (two to five years). Leasehold improvements are amortized on a straight-line basis over their estimated useful lives or the lease term, whichever is less.

Certain Risks and Concentrations.... The Company invests its excess cash in deposits and high-grade short-term securities with two major banks.

The Company sells its products primarily to commercial lighting distributors and residential pool distributors and pool installation contractors in North America, Europe and the Far East. The Company performs ongoing credit evaluations of its customers and generally does not require collateral. Although the Company maintains allowances for potential credit losses that it believes to be adequate, a payment default on a significant sale could materially and adversely affect its operating results and financial condition. At December 31, 1999, one customer accounted for 20% of accounts receivable and at December 31, 1998, one customer accounted for more than 22% accounts receivable.

One customer accounted for 7%, 13% and 13% of net sales in 1999, 1998 and 1997, respectively.
The Company currently buys all of its fiber, the main component of its products, from one supplier. Although there is a limited number of fiber suppliers, management believes that other suppliers could provide fiber on comparable terms. A change in suppliers, however, could cause delays in manufacturing and a possible loss of sales which would adversely affect operating results.

Research and Development.... Research and development costs are charged to operations as incurred.

Income Taxes .... The Company accounts for income taxes using the liability method under which deferred tax assets or liabilities are calculated at the balance sheet date using current tax laws and rates in effect.

Earnings Per Share.... Basic EPS is computed by dividing income available to common shareholders by the weighted average number of common shares outstanding for the period. Diluted EPS is computed giving effect to all dilutive potential common shares that were outstanding during the period. Dilutive potential common shares consist of incremental shares upon exercise of stock options.

A reconciliation of the numerator and denominator of basic and diluted EPS is provided as follows (in thousands, except per share amounts):

	Years Ended December 31,		
	1999	*1998*	*1997*
Numerator - Basic and Diluted EPS			
Net income	$ 1,413	$ 762	$ 644
Denominator - Basic EPS			
Weighted average shares outstanding	3,986	3,623	3,446
Basic earnings per share	$ 0.35	$ 0.21	$ 0.19
Denominator - Diluted EPS			
Denominator - Basic EPS	3,986	3,623	3,446
Effect of dilutive securities:			
Stock options and warrants	94	72	151
	4,080	3,695	3,597
Diluted earnings per share	$ 0.35	$ 0.21	$ 0.18

Options and warrants to purchase 985,335 shares, 584,626 shares and 371,705 shares of common stock were outstanding at December 31, 1999, 1998 and 1997, respectively, but were not included in the calculations of diluted EPS because their exercise prices were greater than the average fair market price of the common shares.

Foreign Currency Translation.... The Company's international subsidiaries use their local currency as their functional currency. For those subsidiaries, assets and liabilities are translated at exchange rates in effect at the balance sheet dateand income and expense accounts at average exchange rates during the year. Resulting translation adjustments are recorded directly to a separate component of shareholders' equity.

Recent Pronouncements.... In June 1998, the FASB issued Statement of Financial Accounting Standards No. 133, or SFAS 133, "Accounting for Derivative Instruments and Hedging Activities". SFAS 133 establishes new standards of accounting and reporting for derivative instruments and hedging activities. SFAS 133 requires that all derivatives be recognized at fair value in the statement of financial position, and that the corresponding gains or losses be reported either in the statement of operations or as a component of comprehensive income, depending on the type of hedging relationship that exists. SFAS 133 as amended, will be effective for fiscal years beginning after June 15, 2000. The Company does not currently hold derivative instruments or engage in hedging activities.

In November 1999, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin (SAB) No. 1000, Restructuring and Impairment Charges. In December 1999, the SEC issued SAB No. 101, Revenue Recognition in Financial Statements. SAB No. 100 expresses not commonly reported in connection with exit activities and business combinations. This includes the accrual of exit and employee termination costs and the recognition of impairment charges. SAB No. 101 expresses the views of the SEC staff in applying generally accepted accounting principles to certain revenue recognition issues. The Company does not anticipate that these SABs will have a material impact on its financial position, results of operations, or cash flow.

3. Inventories (in thousands):

	December 31, 1999	1998
Raw materials	$ 2,736	$ 2,780
Finished goods	1,533	1,399
	$ 4,269	$ 4,179

4. Fixed assets (in thousands):

	December 31, 1999	1998
Equipment	$ 3,888	$ 2,823
Furniture and fixtures	341	250
Computer software	414	452
Leasehold improvements	629	541
	5,272	4,066
Less accumulated depreciation and amortization	(3,030)	(2,544)
	$ 2,242	$ 1,522

5. Acquisitions:

In August 1998, the Company completed the acquisition of the net assets of Fibre Optics International, Inc. (FOI) for $865,000 consisting of $315,000 in cash and 122,350 shares of Fiberstars stock. FOI is a manufacturer and marketer of fiber optic-lighted signs, based in Seattle, Washington.

In November 1998, the Company acquired the net assets of Lichberatung Mann (LBM), fiber optic lighting manufacturers and distributor headquartered near Munich, Germany. Also in November 1998, the Company purchased the net assets of Crescent Lighting, Ltd. (Crescent), which is a fiber optic lighting manufacturer and distributor based in Newbury, England. The consideration given for both the European acquisitions was $2,875,000 in cash and 282,386 shares of Fiberstars stock, or an aggregate of $4,013,000.

All three acquisitions were accounted for as purchases. Accordingly, the purchase price was allocated to the net assets acquired based on their estimated fair market values. In connection with the acquisitions, the Company recorded goodwill of $4,466,000 which is being amortized on a straight line basis over ten years.

6. Joint Venture:

Fiberstars Australasia Pty. Ltd.... The Company participates in a joint venture with Fiberstars Australasia Pty. Ltd., to market lighting products using fiberoptic technology in Australia and New Zealand. The Company maintains a 46.5% interest in Fiberstars Australasia.

The Company recorded sales to Fiberstars Australasia totaling $253,912, $137,000, and $259,000 for the years ended December 31, 1999, 1998 and 1997, respectively. Accounts receivable from Fiberstars Australasia Pty. Ltd. as of December 31, 1999 and 1998 were $216,021 and $130,887 respectively.

The following represents condensed financial information (unaudited) of Fiberstars Australasia as of December 31, 1999 and 1998 and for the years then ended. (in thousands):

	December 31, 1999	December 31, 1998
Current assets	$ 288	$ 193
Property and other assets	61	64
	$ 349	$ 257
Current liabilities	$ 348	$ 227
Issued capital	108	108
Accumulated deficit	(107)	(78)
	$ 349	$ 257

	December 31, 1999	December 31, 1998	December 31, 1997
Revenue	$ 580	$ 569	$ 589
Expenses	625	620	626
Net loss	$ (45)	$ (51)	$ (37)

7. Accrued Liabilities (in thousands):

	December 31, 1999	December 31, 1998
Sales commissions and incentives	$ 1,213	$ 1,003
Accrued warranty expense	305	325
Accrued legal and accounting fees	123	372
Accrued employee benefits	209	161
Others	450	337
	$ 2,300	$ 2,198

8. Lines of Credit and Long-Term Debt:

The Company entered into the following borrowing arrangements with its banks:

a) A $2,500,000 revolving line of credit expiring August 1, 2000, bearing interest at prime plus 0.125% (8.625% at December 31, 1999). Borrowings under this line are uncollateralized, and the Company must maintain a zero balance for at least 30 consecutive days during each fiscal year. There were no borrowings against this facility at December 31, 1999.

b) A $500,000 term loan commitment to finance equipment purchases, expiring August 1, 2000. Borrowings bear interest at prime plus 0.50% (9% at December 31, 1999). Under this note, the Company may finance up to 80% of the cost of new equipment and 75% of the cost of used equipment. The note is collateralized by a security interest in all equipment financed with the proceeds. Interest only is payable monthly until August 15, 2000, after which the principal plus interest is repayable in 36 monthly installments. There were no amounts outstanding at December 31, 1999. The Company is required to maintain certain financial ratios on a quarterly basis, including specified levels of working capital and tangible net worth.

c) A $404,000 (in UK pound sterling) bank overdraft agreement with Lloyds Bank Plc. There were no borrowings against this facility at December 31, 1999.

d) A $592,000 (in German Deutsche Mark) bank borrowing facility in Germany with Sparkasse Neumarkt Bank for the German office facility. There was $555,000 and $528,000 in borrowings against this facility as of December 31, 1999 and 1998, respectively. $232,000 of this facility terminates in 2003 and $360,000 terminates in 2008. In addition, there is a revolvingline of credit of $155,000 (in German Deutsche Mark) with Sparkasse Neumarkt Bank. As of December 31, 1999, there was $71,000 in borrowings against this facility.

9. Commitments and Contingencies:

The Company occupies manufacturing and office facilities under operating leases expiring in 2006 under which it is responsible for related maintenance, taxes and insurance. Minimum lease commitments under the leases are as follows (in thousands):

	Minimum lease commitments
2000	$ 824
2001	846
2002	873
2003	858
2004	883
2005	919
2006	719
Total minimum lease payments	$ 5,922

Rent expense approximated $652,000, $388,000 and $322,000, for the years ended December 31, 1999, 1998 and 1997, respectively.

At December 31, 1999, $250,000 (in German Deutsche Mark) of cash was restricted in terms of a guarantee issued by the Company. The guarantee expired in January 2000.

The Company is engaged in certain legal and administrative proceedings incidental to its normal business activities. While it is not possible to determine the ultimate outcome of these actions at this time, management believes that any liabilities resulting from such proceedings, or claims which are pending or known to be threatened, will not have a material adverse effect on the Company's financial position or results of operations.

10. SHAREHOLDERS' EQUITY:

Common Stock.... The notes receivable from shareholders for common stock bear interest at a rate of 9% and are payable ten years from the date of issuance.

Under the terms of certain agreements with the Company, the holders of approximately 1,489,000 shares of common stock have certain demand and piggyback registration rights. All registration expenses generally would be borne by the Company.

Warrants.... The Company has issued warrants to purchase shares of its common stock to certain directors and consultants of the Company. These warrants, which were granted at the fair market value of the common stock at the date of grant as determined by the Board of Directors, expired on varying dates through 1999.

In connection with its public offering in August 1994, the Company issued to the underwriters, RvR Securities Corp. and Van Kasper & Company, warrants (the Underwriters' warrants) to purchase up to 100,000 shares of the Company's common stock at an exercise price equal to 120% of the initial offering price of $4.50 per share. The Underwriters' warrants were exercisable for a period of five years from the date of the public offering and expired on August 18, 1999.

Warrant activity comprised:

	Warrants Outstanding		
	Shares	Exercise Price	Amount (in thousands)
Balances, December 31, 1995	126,666	$0.90-$5.40	$ 564
Warrants exercised	(15,625)	$0.90	(14)
Balances, December 31, 1996 & 1997	111,041	$0.90-$5.40	$ 550
Warrants exercised/cancelled	(11,041)	$0.90	(10)
Balances, December 31, 1998	100,000	$5.40	$ 540
Warrants cancelled	100,000)	$5.40	(540)
Balances, December 31, 1999	—		$ —

At December 31, 1999, there were no outstanding warrants.

1988 Stock Option Plan.... Upon adoption of the 1994 Stock Option Plan (see below), the Company's Board of Directors determined to make no further grants under the 1988 Stock Option Plan (the 1988 Plan). Upon cancellation or expiration of any options granted under the 1988 Plan, the related reserved shares of common stock will become available instead for options granted under the 1994 Stock Option Plan.

1994 Stock Option Plan.... At December 31, 1999, an aggregate of 1,350,000 shares of the Company's common stock are reserved for issuance under the 1994 Stock Option Plan to employees, officers, directors and consultants at prices not lower than the fair market value of the common stock of the Company on the date of grant. Options granted may be either incentive stock options or nonstatutory stock options. The plan administrator (the Board of Directors or a committee of the Board) determines the terms of options granted under the plan including the number of shares subject to the option, exercise price, term and exercisability.

1994 Directors' Stock Option Plan.... At December 31, 1999, a total of 300,000 shares of common stock has been reserved for issuance under the 1994 Directors' Stock Option Plan. The plan provides for the granting of nonstatutory stock options to nonemployee directors of the Company.

Activity Under the Stock Option Plans.... Option activity under all plans comprised:

	Options Available for Grant (in thousands)	Options Outstanding: Number of Shares (in thousands)	Weighted Average Exercise Price Per Share	Amount (in thousands)
Balances, December 31, 1996	452	786		$ 3,367
Granted	(356)	356	$ 4.93	1,866
Cancelled	23	(23)	$ 4.83	(114)
Exercised		(88)	$ 0.99	
				(97)
Balances, December 31, 1997	119	1,031		5,022
Additional shares reserved	550			
Granted	(282)	282	$ 4.04	1,088
Cancelled	18	(18)	$ 4.93	(90)
Exercised		(46)	$ 3.54	(164)
Balances, December 31, 1998	405	1,249		5,856
Additional shares reserved	100			
Granted	(563)	563	$ 3.87	2,411
Cancelled	106	(106)	$ 6.10	(637)
Exercised		(13)	$ 0.93	(11)
Balances, December 31, 1999	48	1,693		$ 7,619

At December 31, 1999, 1998 and 1997, options to purchase 869,336, 623,169 and 436,497 shares of common stock, respectively were exercisable at weighted average fair values of $4.71, $4.78 and $4.44 respectively. As of December 31, 1999 the Company has 61,079 options granted in excess of amounts available and are subject to shareholder approval at the next shareholder meeting in May 2000. The average price for these options is $4.68.

Activity Under the Stock Option Plans....

	Options Outstanding			Options Currently Exercisable	
Exercise Prices	Number of Shares Outstanding (in thousands)	Weighted Average Remaining Contractual Life (in years)	Weighted Average Exercise Price	Number Exercisable (in thousands)	Weighted Average Exercise Price
$0.90-$0.90	52	2.4	$ 0.90	52	$ 0.90
$3.78-$3.94	336	5.0	$ 3.56	64	$ 3.68
$4.00-$4.88	841	3.9	$ 4.56	403	$ 4.58
$5.13-$5.88	404	2.7	$ 5.45	290	$ 5.45
$6.25-$6.50	60	1.1	$ 6.46	60	$ 6.46

1994 Employee Stock Purchase Plan.... At December 31, 1999, a total of 100,000 shares of common stock has been reserved for issuance under the 1994 Employee Stock Purchase Plan. The plan permits eligible employees to purchase common stock through payroll deductions at a price equal to the lower of 85% of the fair market value of the Company's common stock at the beginning or ending of the offering period. Employees may end their participation at any time during the offering period, and participation ends automatically on termination of employment with the Company. At December 31, 1999, 47,770 shares had been issued under this plan.

Stock-Based Compensation.... The Company has adopted the disclosure only provision of Statement of Financial Accounting Standards No. 123 ("SFAS 123"), "Accounting for Stock-Based Compensation." The Company, however, continues to apply APB 25, "Accounting for Stock Issued to Employees," and related interpretations in accounting for its plans. Accordingly, no compensation cost has been recognized for options granted under the Stock Option Plans nor for shares issued under the Employee Stock Purchase Plan. Had compensation cost for these plans been determined based on the fair value of the options at the grant date for awards in 1999, 1998 and 1997 consistent with the provisions of SFAS 123, the Company's net income and net income per share would have been reduced to the pro forma amounts indicated below (in thousands, except per share amounts):

			December 31,
	1999	1998	1997
Net income - as reported	$ 1,413	$ 762	$ 644
Net income - pro forma	$ 1,072	$ 538	$ 480
Basic earnings per share - as reported	$ 0.35	$ 0.21	$ 0.19
Basic earnings per share - pro forma	$ 0.27	$ 0.15	$ 0.14
Diluted earnings per share - as reported	$ 0.35	$ 0.21	$ 0.18
Diluted earnings per share - pro forma	$ 0.26	$ 0.15	$ 0.13

The fair value of each option grant is estimated on the date of grant using a type of Black-Scholes option pricing model with the following weighted-average assumptions used for grants in 1999, 1998 and 1997:

	1999	1998	1997
Fair value of options issued	$ 1.60	$ 1.72	$ 2.38
Exercise price	$ 4.30	$ 3.80	$ 5.20
Expected life of option	3.95 years	3.88 years	3.91 years
Risk-free interest rate	5.69%	4.82%	6.00%
Expected volatility	37%	50%	50%

11. INCOME TAXES

The components of the provision for income taxes are as follows (in thousands):

			Years Ended December 31,
	1999	1998	1997
Current:			
Federal	$ (783)	$ (265)	$ (20)
State	(127)	(47)	(10)
	(910)	(312)	(30)
Deferred:			
Federal	59	(115)	(386)
State	9	(20)	(21)
	68	(135)	(407)
Provision for income taxes	$ (842)	$ (447)	$ (437)

The principal items accounting for the difference between income taxes computed at the United States statutory rate and the provision for income taxes reflected in the statements of operations are as follows:

	Years Ended December 31,		
	1999	1998	1997
United States statutory rate	(34.0)%	(34.0)%	(34.0)%
State Taxes (net of federal tax benefit)	(5.5)%	(5.5)%	(3.9)%
Other	2.2%	2.5%	(2.5)%
	(37.3)%	(37.0)%	(40.4)%

The tax effects of temporary differences that give rise to significant portions of the deferred tax asset are as follows (in thousands):

	Years Ended December 31,	
	1999	1998
Allowance for doubtful accounts	$ 119	$ 126
Accrued expenses and other reserves	599	606
Depreciation and amortization	1	60
Installment sales	(125)	(213)
Foreign currency translation adjustment	86	0
Other	68	17
Total deferred tax asset	$ 748	$ 596

The deferred tax is not reduced by a valuation allowance as management believes it will fully realize the benefit from its deferred tax assets. Realization is dependent on generating sufficient future taxable income. Although realization is not assured, management believes it is more likely than not that all of the deferred tax asset will be realized. The amount of the deferred tax asset considered realizable, however, could be reduced in the near term if estimates of future taxable income are reduced.

12. Segments and Geographic Sales:

The Company has adopted the Financial Accounting Standards Board's Statement of Financial Accounting Standards No. 131 ("SFAS 131"), "Disclosures about Segments of an Enterprise and Related Information", effective for fiscal years beginning after December 31, 1997.

The Company operates in a single industry segment that manufactures, markets and sells fiber optic lighting products. The Company markets its products for worldwide distribution primarily through independent sales representatives, distributors and swimming pool builders in North America, Europe and the Far East.

A summary of geographic sales is as follows (in thousands):

	Years Ended December 31,		
	1999	*1998*	*1997*
U.S. Domestic	$ 22,972	$ 18,912	$ 14,736
U.S. Export	2,330	3,002	3,135
European subsidiaries	8,009	768	—
	$ 33,311	$ 22,682	$ 17,871

13. Employee Retirement Plan:

The Company maintains a 401(k) profit sharing plan for its employees who meet certain qualifications. The Plan allows eligible employees to defer up to 15% of their earnings, not to exceed the statutory amount per year on a pretax basis through contributions to the Plan. The Plan provides for employer contributions at the discretion of the Board of Directors; however, no such contributions were made in 1999, 1998 and 1997.

14. Related Party Transactions:

In previous years, the Company advanced amounts to certain officers by way of promissory notes. The notes are collateralized by certain issued or potentially issuable shares of the Company's common stock. The notes bear interest at rates ranging from 6% to 8% per annum and are repayable at various dates through April 2000. At December 31, 1999 and 1998, $159,000 and $196,000 were outstanding and included with notes receivable.

15. Subsequent Event (Unaudited):

On February 1, 2000 the Company completed the acquistion of selected assets of Unison Fiber Optic Systems, LLC, a joint venture between Advanced Lighting Technologies, Inc. ("ADLT") and Rohm & Haas Company. The Company acquired key personnel, technologies, fixed assets totaling $600,000 and, subject to achievement of development milestones, up to $2 million in development funds from Unison. In exchange for this the Company issued warrants to ADLT for the purchase of up to 1 million shares of the Company's common stock at $0.01 per share. These warrants may not be exercised until the price of the Company's stock reaches certain trading levels on the Nasdaq National Market, as follows: 250,000 will be exercisable when the the Company's stock price reaches $6.00; 250,000 when the price reaches $8.00; 250,000 when the price reaches $10.00; and 250,000 when the price reaches $12.00. These prices must be maintained as an average over at least 30 days. In addition, at each price level, certain sales milestones must be reached on products of Unison technology before the warrants can be exercised. At ADLT's option, the warrants may be exchanged by ADLT, regardless of their exercisability, for up to 445,000 newly issued Fiberstars shares.

Report of Independent Accountants

To the Board of Directors and Shareholders of
Fiberstars, Inc.
Fremont, California

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of income, comprehensive income, shareholders' equity and cash flows present fairly, in all material respects, the financial position of Fiberstars, Inc. and its subsidiaries (the Company) at December 31, 1999 and 1998 and the results of their operations and their cash flows for each of the three years in the period ended December 31, 1999 in conformity with accounting principles generally accepted in the United States. These financial statements are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance auditing standards generally accepted in the United States, which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for the opinion expressed above.

PricewaterhouseCoopers llp

San Jose, California
February 11, 2000