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Emergent BioSolutions Inc.
Form 10-K/A
March 28, 2007
UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-K/A

AMENDMENT NO. 1

ANNUAL REPORT

PURSUANT TO SECTIONS 13 OR 15(d)

OF THE SECURITIES EXCHANGE ACT OF 1934

(Mark One)

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 2006

OR

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: 001-33137

EMERGENT BIOSOLUTIONS INC.

(Exact Name of Registrant as Specified in Charter)

Delaware
(State or Other Jurisdiction of Organization)

14-1902018
(IRS Employer Identification No.)

2273 Research Boulevard, Suite 400
Rockville, Maryland
(Address of Principal Executive Offices)

20850
(Zip Code)

Registrant's telephone number, including area code (301) 795-1800

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

Title of Each Class

Name of Each Exchange on Which Registered

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Common stock, \$0.001 par value per share
Series A junior participating preferred stock purchase rights

New York Stock Exchange
New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act: **None**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of Securities Act. Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

The aggregate market value of voting and non-voting common equity held by non-affiliates of the registrant as of March 15, 2007 was approximately \$66,322,000 based on the price at which the common stock was last sold on that date as reported on the New York Stock Exchange.

As of March 15, 2007, the registrant had 28,000,552 shares of common stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's definitive proxy statement for its 2007 annual meeting of stockholders scheduled to be held on June 14, 2007, which is expected to be filed with the Securities and Exchange Commission not later than 120 days after the end of the registrant's fiscal year ended December 31, 2006, are incorporated by reference into Part III of this annual report on Form 10-K. With the exception of the portions of the registrant's definitive proxy statement for its 2007 annual meeting of stockholders that are expressly incorporated by reference into this annual report on Form 10-K, such proxy statement shall not be deemed filed as part of this annual report on Form 10-K.

BioThrax® and *spi*-VEC are our trademarks. Each of the other trademarks, trade names or service marks appearing in this annual report on Form 10-K are the property of their respective owners.

EXPLANATORY NOTE

We are filing this Amendment No. 1 on Form 10-K/A to our annual report on Form 10-K for the fiscal year ended December 31, 2006, as originally filed with the Securities and Exchange Commission on March 27, 2007, solely for the following purposes:

to correct a typographical error regarding the total number of shares of our common stock held by stockholders that adopted the written consent described in Item 4, Submission of Matters to a Vote of Security Holders; and

to include the conformed signature of Ernst & Young LLP in the Report of Independent Registered Public Accounting Firm contained in Item 8, Financial Statements and Supplementary Data, which was unintentionally omitted from the original filing.

This Amendment No. 1 does not reflect the restatement of any previously reported financial statements or, except as noted above, change any other disclosures. Filed as exhibits with this Amendment No. 1 are new certifications in accordance with Rule 13a-14(a) and Rule 13a-14(b) of the Exchange Act.

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

In October 2006, in connection with our initial public offering, we solicited the written consent of our stockholders to the following matters pursuant to Section 228 of the General Corporation Law of the State of Delaware:

the amendment of our amended and restated certificate of incorporation to reclassify our previously outstanding class A common stock as common stock, increase the number of authorized shares of common stock and adjust the par value of our authorized and undesignated preferred stock;

the approval of our restated certificate of incorporation that became effective upon the closing of our initial public offering;

the approval of our amended and restated by-laws that became effective upon the closing of our initial public offering;

the approval of our 2006 stock incentive plan;

the approval of the rights agreement, dated November 14, 2006, with American Stock Transfer & Trust Company, as rights agent, providing for the implementation of our stockholder rights plan;

the termination of the stockholders' agreements that we had entered into with the holders of our previously outstanding class B common stock;

the waiver of any and all prior notice requirements and any rights with respect to the registration of our securities in connection with, or arising from, the transactions contemplated by our initial public offering;

the waiver of any right of first refusal and/or pre-emptive rights in connection with, or arising from, the transactions contemplated our initial public offering;

the election of Fuad El-Hibri, Jerome M. Hauer and Ronald B. Richard as Class I directors;

the election of Zsolt Harsanyi and Louis W. Sullivan as Class II directors;

the election of Shahzad Malik and Joe M. Allbaugh as Class III directors; and

the ratification of Ernst & Young LLP as our independent registered public accounting firm.

We received the requisite consents of our stockholders on October 27, 2006. The written consent with respect to all such matters was adopted by holders of 5,096,454 of the 7,792,714 shares of our common stock issued and outstanding as of October 27, 2006, consisting of 5,075,054 of the 7,752,001 shares of our previously outstanding class A common stock and 21,400 of the 40,715 shares of our previously outstanding class B common stock.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Stockholders of

Emergent BioSolutions Inc. and Subsidiaries

We have audited the accompanying consolidated balance sheets of Emergent BioSolutions Inc. and Subsidiaries as of December 31, 2005 and 2006, and the related consolidated statements of operations, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2006. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of the Company's internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also 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 our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Emergent BioSolutions Inc. and Subsidiaries at December 31, 2005 and 2006, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2006, in conformity with U.S. generally accepted accounting principles.

As discussed in Note 2 to the consolidated financial statements, in 2006 the Company changed its method of accounting for share-based payments.

/s/Ernst & Young LLP

McLean, Virginia

March 21, 2007

Emergent BioSolutions Inc. and Subsidiaries
Consolidated Balance Sheets
(in thousands, except share and per share data)

| | December 31, | |
|---|---------------------|-------------|
| | 2005 | 2006 |
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 36,294 | \$ 76,418 |
| Accounts receivable | 2,530 | 43,331 |
| Inventories | 16,441 | 24,721 |
| Income taxes receivable | 763 | 869 |
| Deferred tax assets | 1,989 | 295 |
| Prepaid expenses and other current assets | 1,099 | 1,703 |
| Total current assets | 59,116 | 147,337 |
| Property, plant and equipment, net | 30,645 | 78,174 |
| Deferred tax assets, net of current | 9,981 | 11,477 |
| Other assets | 590 | 1,267 |
| Total assets | \$ 100,332 | \$ 238,255 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Accounts payable | \$ 10,425 | \$ 27,366 |
| Accrued expenses and other current liabilities | 2,609 | 3,253 |
| Accrued compensation | 6,177 | 7,190 |
| Indebtedness under lines of credit | - | 8,930 |
| Long-term indebtedness, current portion | 902 | 2,456 |
| Notes payable to employees, current portion | 506 | 17 |
| Income taxes payable | 2,134 | 13,703 |
| Deferred revenue, current portion | 7,340 | 1,432 |
| Total current liabilities | 30,093 | 64,347 |
| Long-term indebtedness, net of current portion | 10,471 | 31,368 |
| Notes payable to employees, net of current portion | 31 | - |
| Deferred revenue, net of current portion | - | 2,997 |
| Other liabilities | - | 1,071 |
| Total liabilities | 40,595 | 99,783 |
| Commitments and contingencies | - | - |
| Stockholders' equity: | | |
| Preferred Stock \$0.001 par value; 3,000,000 and 15,000,000 shares authorized, 0 shares issued and outstanding at December 31, 2005 and 2006, respectively | - | - |
| Common Stock, Class A, \$0.001 par value; 100,000,000 shares authorized, 22,303,280 issued and outstanding at December 31, 2005; 0 shares authorized, issued and outstanding at December 31, 2006 | 22 | - |
| Common Stock, Class B, \$0.01 par value; 2,000,000 shares authorized, 21,283 issued and outstanding at December 31, 2005; 0 shares authorized, issued and outstanding at December 31, 2006 | - | - |
| Common Stock, \$0.001 par value; 0 shares authorized, issued and outstanding at December 31, 2005; 100,000,000 shares authorized, 27,596,249 shares issued and outstanding at December 31, 2006 | - | 28 |
| Additional paid-in capital | 34,595 | 90,920 |
| Accumulated other comprehensive loss | (276) | (473) |
| Retained earnings | 25,396 | 47,997 |
| Total stockholders' equity | 59,737 | 138,472 |
| Total liabilities and stockholders' equity | \$ 100,332 | \$ 238,255 |

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

Emergent BioSolutions Inc. and Subsidiaries
Consolidated Statements of Operations
(in thousands, except share and per share data)

| | 2004 | 2005 | 2006 |
|--|-------------------|-------------------|-------------------|
| Revenues: | | | |
| Product sales | \$ 81,014 | \$ 127,271 | \$ 147,995 |
| Contracts and grants | 2,480 | 3,417 | 4,737 |
| Total revenues | 83,494 | 130,688 | 152,732 |
| Operating expense (income): | | | |
| Cost of product sales | 30,102 | 31,603 | 24,125 |
| Research and development | 10,117 | 18,381 | 45,501 |
| Selling, general and administrative | 30,323 | 42,793 | 44,601 |
| Purchased in-process research and development | - | 26,575 | 477 |
| Settlement of State of Michigan obligation | (3,819) | - | - |
| Litigation settlement | - | (10,000) | - |
| Income from operations | 16,771 | 21,336 | 38,028 |
| Other income (expense): | | | |
| Interest income | 65 | 485 | 846 |
| Interest expense | (241) | (767) | (1,152) |
| Other income (expense), net | 6 | 55 | 293 |
| Total other income (expense) | (170) | (227) | (13) |
| Income before provision for income taxes | 16,601 | 21,109 | 38,015 |
| Provision for income taxes | 5,129 | 5,325 | 15,222 |
| Net income | \$ 11,472 | \$ 15,784 | \$ 22,793 |
| Earnings per share - basic | \$ 0.61 | \$ 0.77 | \$ 0.99 |
| Earnings per share - diluted | \$ 0.56 | \$ 0.69 | \$ 0.93 |
| Weighted-average number of shares - basic | 18,919,850 | 20,533,471 | 23,039,794 |
| Weighted-average number of shares - diluted | 20,439,252 | 22,751,733 | 24,567,302 |
| Cash dividends per share - basic | \$ - | \$ 0.26 | \$ - |

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

Emergent BioSolutions Inc. and Subsidiaries
Consolidated Statements of Cash Flows
(in thousands)

| | Year Ended December 31, | | |
|--|--------------------------------|-------------|-------------|
| | 2004 | 2005 | 2006 |
| Cash flows from operating activities: | | | |
| Net income | \$ 11,472 | \$ 15,784 | \$ 22,793 |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities (net of effects of acquisitions): | | | |
| Stock-based compensation expense (credit) | 4,310 | (17) | 723 |
| Non-cash gain on settlement | (3,819) | - | - |
| Depreciation and amortization | 1,867 | 3,549 | 4,715 |
| Deferred income taxes | (418) | (10,968) | 987 |
| Other obligations | 200 | - | - |
| Loss on disposal of property and equipment | 43 | 32 | 27 |
| Purchased in-process research and development | - | 26,575 | 477 |
| Excess tax benefit from stock based compensation | - | - | (789) |
| Changes in operating assets and liabilities: | | | |
| Accounts receivable | (15,664) | 16,107 | (40,801) |
| Inventories | (1,609) | (3,189) | (8,280) |
| Income taxes | 5,794 | (2,390) | 11,463 |
| Prepaid expenses and other assets | 50 | (865) | (792) |
| Accounts payable | 2,472 | 5,463 | 5,801 |
| Accrued compensation | 585 | 2,466 | 1,013 |
| Accrued expenses and other liabilities | 44 | 619 | 1,513 |
| Deferred revenue | 3,869 | (10,916) | (2,911) |
| Net cash provided by (used in) operating activities | 9,196 | 42,250 | (4,061) |
| Cash flows from investing activities: | | | |
| Purchases of property, plant and equipment | (17,072) | (6,532) | (41,228) |
| Acquisitions, net of cash received | - | (559) | (218) |
| Restricted cash deposits | (1,250) | 1,250 | (192) |
| Proceeds from investment maturities | 147 | - | - |
| Net cash used in investing activities | (18,175) | (5,841) | (41,638) |
| Cash flows from financing activities: | | | |
| Proceeds from borrowings on long term indebtedness and lines of credit | 10,992 | 31 | 32,430 |
| Proceeds from notes payable to employees | 947 | 123 | - |
| Repayments on product supply and royalty obligations | (2,351) | - | - |
| Issuance of common stock in initial public offering (net of issuance cost) | - | - | 54,229 |
| Issuance of common stock subject to exercise of stock options | 12 | 33 | 590 |
| Redemption of Class B common stock | (665) | (337) | (192) |
| Principal payments on long term indebtedness, notes payable to employees, and lines of credits | (184) | (1,110) | (1,569) |
| Proceeds from excess tax benefits | - | - | 789 |
| Debt issuance costs | (70) | - | (257) |
| Payment of dividend | - | (5,400) | - |
| Net cash provided by (used in) financing activities | 8,681 | (6,660) | 86,020 |
| Effect of exchange rate changes on cash and cash equivalents | - | (276) | (197) |
| Net increase (decrease) in cash and cash equivalents | (298) | 29,473 | 40,124 |
| Cash and cash equivalents at beginning of year | 7,119 | 6,821 | 36,294 |
| Cash and cash equivalents at end of year | 6,821 | 36,294 | 76,418 |
| Supplemental disclosure of cash flow information: | | | |
| Cash paid during the year for interest | \$ 170 | \$ 696 | \$ 1,681 |
| Cash paid during the year for income taxes | \$ - | \$ 17,985 | \$ 2,788 |
| Supplemental information on non-cash investing and financing activities: | | | |
| Issuance of common stock to acquire Microscience Limited | \$ - | \$ 27,001 | \$ - |
| Purchases of property, plant and equipment unpaid at year end | \$ - | \$ - | \$ 11,140 |

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

Emergent BioSolutions Inc. and Subsidiaries
Consolidated Statement of Changes in Stockholders' Equity
(in thousands, except share and per share data)

| | Class A No-Par | | Class B No-Par | | Class A \$0.001 Par | | Class B \$0.01 Par | | \$0.001 Par Value | | Accumulated | | Retained Earnings |
|---|---------------------|----------|---------------------|--------|---------------------------|--------|---------------------------|--------|---------------------|--------|-----------------|--------------------------|-------------------|
| | Common Stock Shares | Amount | Common Stock Shares | Amount | Value Common Stock Shares | Amount | Value Common Stock Shares | Amount | Common Stock Shares | Amount | Paid-In Capital | Other Comprehensive Loss | |
| Balance at December 31, 2003 | 18,017,994 | \$ 2,940 | 1,099,223 | \$ 101 | - | \$ - | - | \$ - | - | \$ - | \$ - | \$ - | \$ 5,300 |
| Redemption of common stock | - | - | (573,322) | (53) | - | - | - | - | - | - | - | - | (1,500) |
| Issuance of common stock | - | - | 122,584 | 12 | - | - | - | - | - | - | - | - | - |
| Conversion of class A no-par common stock to class A \$.001 par value common stock | (18,017,994) | (2,940) | - | - | 18,017,994 | 18 | - | - | - | - | 2,922 | - | - |
| Conversion of class B no-par common stock to class A \$.01 par value common stock | - | - | (648,485) | (60) | 648,485 | 1 | - | - | - | - | 59 | - | - |
| Stock-based compensation expense | - | - | - | - | - | - | - | - | - | - | 4,310 | - | - |
| Tax benefit related to the disqualifying disposition | - | - | - | - | - | - | - | - | - | - | 319 | - | - |
| Net Income | - | - | - | - | - | - | - | - | - | - | - | - | 11,400 |
| Balance at December 31, 2004 | - | - | - | - | 18,666,479 | 19 | - | - | - | - | 7,610 | - | 15,300 |
| Issuance of common stock to acquire Microscience Limited | - | - | - | - | 3,636,801 | 3 | - | - | - | - | 26,998 | - | - |
| Exercise of stock options | - | - | - | - | - | - | 133,451 | 1 | - | - | 32 | - | - |
| Redemption of common stock | - | - | - | - | - | - | (112,168) | (1) | - | - | (28) | - | (300) |
| Forfeiture of stock options | - | - | - | - | - | - | - | - | - | - | (17) | - | - |
| Payment of dividend | - | - | - | - | - | - | - | - | - | - | - | - | (5,400) |
| Net income | - | - | - | - | - | - | - | - | - | - | - | - | 15,700 |
| Foreign currency translation | - | - | - | - | - | - | - | - | - | - | - | (276) | - |
| Comprehensive income | - | - | - | - | - | - | - | - | - | - | - | - | - |
| Balance at December 31, 2005 | - | \$ - | - | \$ - | 22,303,280 | \$ 22 | 21,283 | \$ - | - | \$ - | \$ 34,595 | \$ (276) | \$ 25,300 |
| Exercise of stock options | - | - | - | - | - | - | 95,858 | 1 | 175,828 | - | 589 | - | - |
| Redemption of common stock | - | - | - | - | - | - | - | - | - | - | - | - | (190) |
| Conversion of class A \$0.001 and class B par value \$0.001 to common stock \$.001 par value common stock | - | - | - | - | (22,303,280) | (22) | (117,141) | (1) | 22,420,421 | 23 | - | - | - |
| Issuance of common stock in initial public offering (net of issuance cost) | - | - | - | - | - | - | - | - | 5,000,000 | 5 | 54,224 | - | - |
| Stock-based compensation expense | - | - | - | - | - | - | - | - | - | - | 723 | - | - |
| Excess tax benefits from exercises of non-qualified stock options | - | - | - | - | - | - | - | - | - | - | 789 | - | - |
| Net income | - | - | - | - | - | - | - | - | - | - | - | - | 22,700 |
| Foreign currency translation | - | - | - | - | - | - | - | - | - | - | - | (197) | - |
| Comprehensive income | - | - | - | - | - | - | - | - | - | - | - | - | - |
| Balance at December 31, 2006 | - | \$ - | - | \$ - | - | \$ - | - | \$ - | 27,596,249 | \$ 28 | \$ 90,920 | \$ (473) | \$ 47,300 |

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

Emergent BioSolutions Inc. and Subsidiaries

Notes to consolidated financial statements

(dollars in thousands, except per share data)

1. Nature of the business and organization

Emergent Biosolutions Inc. (the Company or Emergent) is a biopharmaceutical company focused on the development, manufacture and commercialization of immunobiotics. The Company operates in two business segments: biodefense and commercial. The Company commenced operations as BioPort Corporation (BioPort) in September 1998 through an acquisition from the Michigan Biologic Products Institute of rights to the marketed product, BioThrax, vaccine manufacturing facilities at a multi-building campus on approximately 12.5 acres in Lansing, Michigan and vaccine development and production know-how. Following this acquisition, the Company completed renovations at the Lansing facilities that had been initiated by the State of Michigan. In December 2001, the U.S. Food and Drug Administration (FDA) approved a supplement to the Company's manufacturing facility license for the manufacture of BioThrax at the renovated facilities. In June 2004, the Company completed a corporate reorganization (Reorganization) in which:

Emergent issued 18,666,479 shares of Class A Common Stock in exchange for 18,017,994 shares of BioPort class A common stock and 648,485 shares of BioPort class B common stock;

all other issued and outstanding shares of BioPort class B common stock were repurchased and retired; and

all outstanding stock options to purchase BioPort class B common stock were assumed by Emergent and option holders were granted replacement stock options to purchase an equal number of shares of Class B Common Stock of Emergent.

As a result of the Reorganization, BioPort became a wholly owned subsidiary of Emergent. The Company has renamed BioPort as Emergent BioDefense Operations Lansing Inc. (Emergent BioDefense Operations). The Company acquired its portfolio of commercial vaccine candidates through an acquisition of Microscience Limited (Microscience) in a share exchange in June 2005 and an acquisition of substantially all of the assets, for cash, of Antex Biologics Inc. (Antex) in May 2003 and ViVacs GmbH, Germany in July 2006. The Company has renamed Microscience as Emergent Product Development UK Limited and Antex as Emergent Product Development Gaithersburg and ViVacs as Emergent Product Development Germany GmbH.

2. Summary of significant accounting policies

Basis of presentation and consolidation

The accompanying consolidated financial statements include the accounts of Emergent and its wholly owned subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation.

Use of estimates

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

Cash and cash equivalents

Cash equivalents are highly liquid investments with a maturity of 90 days or less at the date of purchase and consist of time deposits and investments in money market funds with commercial banks and financial institutions. Also, the Company maintains cash balances with financial institutions in excess of insured limits. The Company does not anticipate any losses with such cash balances. At December 31, 2005 and 2006 the Company maintained all of its cash and cash equivalents in three financial institutions.

Fair value of financial instruments

The carrying amounts of the Company's short-term financial instruments, which include cash and cash equivalents, accounts receivable and accounts payable, approximate their fair values due to their short maturities. The fair value of the Company's long-term indebtedness is estimated based on the quoted prices for the same or similar issues or on the current rates offered to the Company for debt of the same remaining maturities. The carrying value and fair value of long-term indebtedness were \$11,910 and \$11,497, respectively, at December 31, 2005 and \$33,841 and \$33,233, respectively, at December 31, 2006.

Restricted cash

Restricted cash at December 31, 2006 consists of a certificate of deposit held by a bank as collateral for a letter of credit acting as a security deposit on a loan. As of December 31, 2005 and 2006 the Company had restricted cash of \$0 and \$192, respectively.

Significant customers and accounts receivable

The Company's primary customers are the U.S. Department of Defense (DoD) and U.S. Department of Health and Human Services (HHS). For the years ended December 31, 2004, 2005 and 2006, sales of BioThrax to the DoD and HHS comprised 99%, 96% and 97% of total revenues, respectively. As of December 31, 2005 and 2006, the Company's receivable balances were comprised of 38% and 100%, respectively, from these customers. The balance of the receivables in 2005 was attributable to government funding for NIAID. Unbilled accounts receivable, included in accounts receivable, totaling \$1,418 and \$26 as of December 31, 2005 and 2006, respectively, relate to various service contracts for which product has been delivered or work has been performed, though invoicing has not yet occurred. Accounts receivable are stated at invoice amounts and consist primarily of amounts due from the DoD and HHS as well as amounts due under reimbursement contracts with other government entities and non-government and philanthropic organizations. If necessary, the Company records a provision for doubtful receivables to allow for any amounts which may be unrecoverable. This provision is based upon an analysis of the Company's prior collection experience, customer creditworthiness and current economic trends. As of December 31, 2005 and 2006, an allowance for doubtful accounts was not recorded, as the prior collection history from these customers indicates collection is likely.

Concentrations of credit risk

Financial instruments that potentially subject the Company to concentrations of credit risk consist primarily of cash and cash equivalents and accounts receivable. The Company places its cash and cash equivalents with high quality financial institutions. Management believes that the financial risks associated with its cash and cash equivalents are minimal. Because accounts receivable consist of amounts due from the U.S. federal government for product sales and from government agencies under government grants, management deems there to be minimal credit risk.

Inventories

Inventories are stated at the lower of cost or market, with cost being determined using a standard cost method, which approximates average cost. Average cost consists primarily of material, labor and manufacturing overhead expenses and includes the services and products of third party suppliers. The Company analyzes its inventory levels quarterly and writes down, in the applicable period, inventory that has become obsolete, inventory that has a cost basis in excess of its expected net realizable value and inventory in excess of expected customer demand. The Company also writes off in the applicable period the costs related to expired inventory.

Property, plant and equipment

Property, plant and equipment are stated at cost. Depreciation is computed using the straight-line method over the following estimated useful lives:

| | |
|-------------------------|---|
| Buildings | 39 years |
| Furniture and equipment | 3-7 years |
| Software | Lesser of 3 years or product life |
| Leasehold improvements | Lesser of the asset life or life of lease |

Upon retirement or sale, the cost of assets disposed of and the related accumulated depreciation are removed from the accounts and any resulting gain or loss is credited or charged to operations. Repairs and maintenance costs are expensed as incurred.

Under the provisions of the Statement of Position No. 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*, the Company capitalizes costs associated with software developed or obtained for internal use when the preliminary project stage is completed. Capitalized costs include only: (1) external direct costs of materials and services consumed in developing or obtaining internal use software and (2) payroll and payroll-related costs for employees who are directly associated with and who devote time to the internal use software project during the development stage. Capitalization of such costs ceases before training and other post implementation software activities occur. Computer software maintenance costs related to software development are expensed as incurred.

Income taxes

Income taxes are accounted for using the liability method. Deferred tax assets and liabilities are recognized for future tax consequences attributable to differences between financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the year in which those temporary differences are expected to be recovered or settled.

The Company records valuation allowances to reduce deferred tax assets to the amounts that more likely than not will be realized. The Company considers future taxable income and ongoing tax planning strategies in assessing the need for valuation allowances. In general, if the Company determines that it is able to realize more than the recorded amounts of net deferred tax assets in the future, net income will increase in the period in which the determination is made. Likewise, if the Company determines that it is not able to realize all or part of the net deferred tax asset in the future, net income will decrease in the period in which the determination is made. The Company applies any reversals of valuation allowance related to an acquired deferred tax asset against other intangibles before impacting net income.

Under sections 382 and 383 of the Internal Revenue Code, if an ownership change occurs with respect to a loss corporation, as defined, there are annual limitations on the amount of net operating losses and deductions that are available. Due to the acquisition of Microscience in 2005 and the Company's initial public offering, the Company believes the use of the operating losses will be significantly limited.

The Company's ability to realize deferred tax assets depends upon future taxable income as well as the limitations discussed above. For financial reporting purposes, a deferred tax asset must be reduced by a valuation allowance if it is more likely than not that some portion or all of the deferred tax assets will not be realized prior to expiration.

Revenue recognition

The Company recognizes revenues from product sales in accordance with Staff Accounting Bulletin No. 104, *Revenue Recognition* (SAB No. 104). SAB No. 104 requires recognition of revenues from product sales that require no continuing performance by the Company if four basic criteria have been met:

- there is persuasive evidence of an arrangement;
- delivery has occurred and title has passed to the Company's customer;
- the fee is fixed and determinable and no further obligation exists; and
- collectibility is reasonably assured.

All revenues from product sales are recorded net of applicable allowances for sales returns, rebates, special promotional programs, and discounts. For arrangements where the risk of loss has not passed to the customer, the Company defers the recognition of revenue until such time that risk of loss has passed. Also, the cost of revenue associated with amounts recorded as deferred revenue is recorded in inventory until such time as risk of loss has passed.

Under the Company's contract with the DoD, title to the product passes to the DoD upon submission of the first invoice. The earnings process is complete upon FDA release of the product for sale and distribution. Following FDA release of the product, the product is segregated for later shipment, and all deferred revenue related to the released product is recognized in accordance with the bill and hold requirements under SAB 104.

In December 2005, the Securities and Exchange Commission released an interpretation with respect to the accounting for sales of vaccines and bioterror countermeasures to the federal government for placement into the Strategic National Stockpile (SNS). This interpretation provides for revenue recognition for specifically identified products purchased for the SNS in the event that all requirements for revenue recognition, as specified in Statement of Financial Accounting Concepts No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, are not met. This interpretation is applicable to the Company's contracts with HHS, but because the Company recognizes revenue upon delivery of product to HHS, the Company has not applied this guidance.

Collaborative research and development agreements can provide for one or more up-front license fees, research payments, and milestone payments. Agreements with multiple components (deliverables or items) are evaluated in accordance with Emerging Issues Task Force (EITF) Issue No. 00-21, *Accounting for Revenue Arrangements with Multiple Deliverables* (EITF No. 00-21), to determine if the deliverables can be divided into more than one unit of accounting. An item can generally be considered a separate unit of accounting if all of the following criteria

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are met: (1) the delivered item(s) has value to the customer on a stand-alone basis; (2) there is objective and reliable evidence of the fair value of the undelivered

items(s); and (3) if the arrangement includes a general right of return relative to the delivered item(s), delivery or performance of the undelivered item(s) is considered probable and substantially in control of the Company. Items that cannot be divided into separate units are combined with other units of accounting, as appropriate. Consideration received is allocated among the separate units based on their respective fair values or based on the residual value method and is recognized in full when the criteria in the discussion of SAB No. 104 above are met. The Company deems service to have been rendered if no continuing obligation exists on the part of the Company.

Revenue associated with non-refundable up-front license fees under arrangements where the license fees and research and development activities cannot be accounted for as separate units of accounting is deferred and recognized as revenue on a straight-line basis over the expected term of the Company's continued involvement in the research and development process. Revenues from the achievement of research and development milestones, if deemed substantive, are recognized as revenue when the milestones are achieved, and the milestone payments are due and collectible. If not deemed substantive, the Company would recognize such milestone as revenue on a straight-line basis over the remaining expected term of continued involvement in the research and development process. Milestones are considered substantive if all of the following conditions are met; (1) the milestone is non-refundable; (2) achievement of the milestone was not reasonably assured at the inception of the arrangement; (3) substantive effort is involved to achieve the milestone; and (4) the amount of the milestone appears reasonable in relation to the effort expended, the other milestones in the arrangement and the related risk associated with the achievement of the milestone and any ongoing research and development or other services are priced at fair value. Payments received in advance of work performed are recorded as deferred revenue.

Payments received by the Company for the reimbursement of expenses for research and development activities are recorded in accordance with EITF Issue No. 99-19, *Reporting Revenue Gross as Principal Versus Net as an Agent* (EITF No. 99-19). Pursuant to EITF No. 99-19, for transactions in which the Company acts as principal, with discretion to choose suppliers, bears credit risk and performs a substantive part of the services, revenue is recorded at the gross amount of the reimbursement. Costs associated with these reimbursements are reflected as a component of research and development expenses.

Impairment of long-lived assets

In accordance with Statement of Financial Accounting Standards No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* (SFAS No. 144), the Company assesses the recoverability of its long-lived assets by determining whether the carrying value of such assets can be recovered through undiscounted future operating cash flows. If an impairment is indicated, the Company measures the amount of such impairment by comparing the fair value to the carrying value. The Company has recorded no impairment losses for the years ended December 31, 2004, 2005 and 2006.

Research and development

Research and development costs are expensed as incurred. Research and development costs primarily consist of salaries, materials and related expenses for personnel and facility expenses. Other research and development expenses include fees paid to consultants and outside service providers and the costs of materials used in clinical trials and research and development.

Purchased in-process research and development

The Company accounts for purchased in-process research and development in accordance with the Statement of Financial Accounting Standards No. 2, *Accounting for Research and Development Costs* (SFAS No. 2) along with Financial Accounting Standards Board (FASB) Interpretation No. 4, *Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method - an interpretation of FASB Statement No. 2* (FIN 4). Under these standards, the Company is required to determine whether the technology relating to a particular research and development project acquired through an acquisition has an alternative future use. If the determination is that the technology has no alternative future use, the acquisition amount assigned to assets to be used in the particular research and development project is expensed. Otherwise, the Company capitalizes and amortizes the costs incurred over their estimated useful lives of the technology acquired.

Comprehensive income

Statement of Financial Accounting Standards No. 130, *Reporting Comprehensive Income* (SFAS No. 130), requires the presentation of the comprehensive income and its components as part of the financial statements. Comprehensive income is comprised of net income and other changes in equity that are excluded from net income. The Company includes gains and losses on intercompany transactions with foreign subsidiaries that are considered to be long-term investments and translation gains and losses incurred when converting its subsidiaries' financial statements from their functional currency to the U.S. dollar in accumulated other comprehensive income (loss).

Foreign currencies

The local currency is the functional currency for the Company's foreign subsidiaries and, as such, assets and liabilities are translated into U.S. dollars at year-end exchange rates. Income and expense items are translated at average exchange rates during the year. Translation adjustments resulting from this process are charged or credited to other comprehensive income (loss).

Capitalized interest

The Company capitalizes interest based on the cost of major ongoing capital projects which have not yet been placed in service. For the years ended December 31, 2004, 2005 and 2006, the Company capitalized \$0, \$0 and \$759 of interest, respectively.

Certain risks and uncertainties

The Company has derived substantially all of its revenue from sales of BioThrax under contracts with the DoD and HHS. The Company's ongoing U.S. government contracts do not necessarily increase the likelihood that it will secure future comparable contracts with the U.S. government. The Company expects that a significant portion of the business that it will seek in the near future, in particular for BioThrax, will be under government contracts that present a number of risks that are not typically present in the commercial contracting process. U.S. government contracts for BioThrax require annual funding decisions by the government and are subject to unilateral termination or modification by the government. The Company may fail to achieve significant sales of BioThrax to customers in addition to the U.S. government, which would harm its growth opportunities. The Company may not be able to sustain or increase profitability. The Company is spending significant amounts for the expansion of its manufacturing facilities. The Company may not be able to manufacture BioThrax consistently in accordance with FDA specifications. Other than BioThrax, all of the Company's product candidates are undergoing clinical trials or are in early stages of development, and failure is common and can occur at any stage of development. None of the Company's product candidates other than BioThrax has received regulatory approval.

Earnings per share

Basic net income per share of common stock excludes dilution for potential common stock issuances and is computed by dividing net income by the weighted average number of shares outstanding for the period. Diluted net income per share reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock.

The following table presents the calculation of basic and diluted net income per share:

| | Year Ended December 31, | | |
|---|--------------------------------|-------------|-------------|
| | 2004 | 2005 | 2006 |
| Numerator: | | | |
| Net Income | \$ 11,472 | \$ 15,784 | \$ 22,793 |
| Denominator: | | | |
| Weighted-average number of shares - basic | 18,919,850 | 20,533,471 | 23,039,794 |
| Dilutive securities - stock options | 1,519,402 | 2,218,262 | 1,527,508 |
| Weighted-average number of shares - diluted | 20,439,252 | 22,751,733 | 24,567,302 |
| Earnings per share-basic | \$ 0.61 | \$ 0.77 | \$ 0.99 |
| Earnings per share-diluted | \$ 0.56 | \$ 0.69 | \$ 0.93 |

For the years ending December 31, 2004, 2005 and 2006, outstanding stock options to purchase approximately 0, 21,000 and 160,000 shares, respectively, of common stock are not considered in the diluted earnings per share calculation because the exercise price of these options is greater than the average per share closing price during the year.

The Company has taken into consideration the disclosure required by the Participating Securities and the Two-Class Method under FASB Statement No. 128 (EITF No. 03-6).

Accounting for stock-based compensation

As of December 31, 2006, the Company has two stock-based employee compensation plans, the Emergent BioSolutions Inc. 2006 Stock Incentive Plan (the 2006 Plan) and the Emergent BioSolutions Employee Stock Option Plan (the 2004 Plan), described more fully in Note 10 Stockholders' Equity. Through December 31, 2005, the Company accounted for grants under the 2004 Plan using the intrinsic value method in accordance with the provisions of Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees* (APB No. 25) and has provided the pro forma disclosures of net income and net income per share in accordance with SFAS No. 123, *Accounting for Stock-Based Compensation* (SFAS No. 123) as amended by SFAS No. 148, *Accounting for Stock-Based Compensation-Transition and Disclosures* using the fair value method. Under APB No. 25, compensation expense is based on the difference, if any, on the date of the grant between the fair value of the Company's stock and the exercise price of the option and is recognized ratably over the vesting period of the option. The Company accounts for equity instruments issued to non-employees in accordance with SFAS No. 123 and EITF Issue No. 96-18, *Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling Goods or Services*, (EITF No. 96-18).

Effective January 1, 2006, the Company adopted the fair value provisions of SFAS No. 123 (revised 2004), *Share-Based Payment* (SFAS No. 123(R)), using the modified prospective method. Under the fair value recognition provisions of SFAS No. 123(R), the Company recognizes stock-based compensation net of an estimated forfeiture rate.

Under the modified prospective method, compensation cost recognized in 2006 includes: (1) compensation cost for all share-based payments granted prior to but not yet vested as of December 31, 2005, based on the grant date fair value estimated in accordance with the original provisions of SFAS No. 123, and (2) compensation cost for all share-based payments granted and vested subsequent to December 31, 2005, based on the grant date fair value estimated in accordance with the provisions of SFAS No. 123(R). As a result of adopting SFAS No. 123(R) on January 1, 2006, the Company's income before income taxes and net income for the year ended December 31, 2006 are approximately \$723 and \$470 lower, respectively, than if it had continued to account for share-based compensation under APB No. 25.

Both basic and diluted income per share for the year ended December 31, 2006 are \$0.02 lower than if the Company had continued to account for share-based compensation under APB No. 25. Results for prior periods have not been restated. Based on options granted to employees as of December 31, 2006, total compensation expense not yet recognized related to unvested options is approximately \$3,119, after tax. The Company expects to recognize that expense over a weighted average period of 2.9 years.

The Company has utilized the Black-Scholes valuation model for estimating the fair value of all stock options granted. The fair value of each option is estimated on the date of grant. Set forth below are the weighted-average assumptions used in valuing the stock options granted and a discussion of the Company's methodology for developing each of the assumptions used:

| | Year Ended December 31, | | |
|----------------------------------|-------------------------|------------|------------|
| | 2004 | 2005 | 2006 |
| Expected dividend yield | 0% | 0% | 0% |
| Expected volatility | 52% | 50% | 50% |
| Risk-free interest rate | 2.93% | 3.33-4.32% | 4.58-5.21% |
| Expected average life of options | 2.5 years | 2.9 years | 3.0 years |

Expected dividend yield The Company does not pay regular dividends on its common stock and does not anticipate paying any dividends in the foreseeable future.

Expected volatility Volatility is a measure of the amount by which a financial variable, such as share price, has fluctuated (historical volatility) or is expected to fluctuate (expected volatility) during a period. The Company analyzed the expected historical volatility used by similar companies at a similar stage of development to estimate expected volatility. The volatility used by these similar companies ranged from 33% to 79%, with an average estimated volatility of 53%.

Risk-free interest rate This is the average U.S. Treasury rate with a term that most closely resembles the expected life of the option for the quarter in which the option was granted.

Expected average life of options This is the period of time that the options granted are expected to remain outstanding. This estimate is based primarily on the employee position profile of option holders and the trading lock out periods that result from the employees access to stock price sensitive information.

Prior to the adoption of SFAS No. 123(R), the Company presented all tax benefits of deductions resulting from the exercise of stock options as operating cash flows in the statement of cash flows. SFAS No. 123(R) requires the cash flows resulting from the tax benefits of deductions in excess of the compensation cost recognized for those options (excess tax benefits) to be classified as financing cash flows.

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The following table illustrates the effect on net income and net income per share if the Company had applied the fair value recognition provisions of SFAS No. 123 to stock-based employee compensation for the years ended December 31, 2004 and 2005.

| | Year Ended December 31, | |
|--|--------------------------------|-------------|
| | 2004 | 2005 |
| Net income, as reported | \$ 11,472 | \$ 15,784 |
| Add: Stock-based compensation in reported net income, net of taxes | 2,801 | - |
| Deduct: Total stock-based compensation expense determined under the fair value based method for all awards, net of taxes | (3,185) | (258) |
| Pro forma net income | \$ 11,088 | \$ 15,526 |
| | | |
| Net income per common share basic | \$ 0.61 | \$ 0.77 |
| Net income per common share diluted | \$ 0.56 | \$ 0.69 |
| Pro forma net income per common share basic | \$ 0.59 | \$ 0.76 |
| Pro forma net income per common share diluted | \$ 0.54 | \$ 0.68 |

Recent accounting pronouncements

In June 2006, the FASB issued FASB Interpretation 48, *Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109, Accounting for Income Taxes (FIN 48)*. FIN 48 clarifies the accounting for uncertainty in income taxes. FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 requires that the Company recognize in its financial statements, the impact of a tax position, if that position is more likely than not of being sustained on audit, based on the technical merits of the position. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods and disclosure. The provisions of FIN 48 are effective for fiscal years beginning after December 15, 2006.

The Company will adopt FIN 48 as of January 1, 2007, as required. The cumulative effect of adopting FIN 48 will be recorded as an adjustment to beginning retained earnings and other accounts as applicable. Although the Company has not made a final determination of the effect the adoption of FIN 48 will have on the Company's financial position and results of operations, it is expected that the cumulative adjustment to retained earnings will not have a material effect on its financial statements. The adoption of FIN 48 will impact the amount of, and balance sheet classification of, deferred tax assets and liabilities, and other accounts as applicable, and result in greater volatility in the effective tax rate.

In February 2007, the FASB issued Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities - Including an Amendment of FASB Statement No. 115* (SFAS No. 159). SFAS No. 159 permits entities to choose to measure many financial instruments and certain other items at fair value. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. The provisions of SFAS No. 159 are effective for fiscal years beginning after November 15, 2007. The Company has not yet determined the impact of adoption of this statement on its financial statements.

In September 2006, the SEC issued Staff Accounting Bulletin, or SAB, No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* (SAB 108). SAB 108 requires that registrants quantify errors using both a balance sheet and statement of operations approach and evaluate whether either approach results in a misstated amount that, when all relevant quantitative and qualitative factors are considered, is material. SAB 108 became effective during the fourth quarter of 2006. The Company has determined that adoption of this statement had no impact on the financial statements.

In September 2006, the FASB issued Statement No. 157, *Fair Value Measurements* (SFAS No. 157). SFAS No. 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. SFAS No. 157 emphasizes that fair value is a market-based measurement, not an entity-specific measurement. Therefore, a fair value measurement should be determined based on the assumptions that market participants would use in pricing the asset or liability. The provisions of SFAS No. 157 are effective for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. The

Company has not yet determined the impact of adoption of this statement on its financial statements.

3. Acquisitions

ViVacs GmbH

On July 13, 2006, Emergent International, Inc., a wholly owned subsidiary of the Company incorporated in Delaware (EII), completed the acquisition of ViVacs GmbH, a German limited liability company (ViVacs) to expand the Company's commercial vaccine portfolio, pursuant to the terms and conditions of the Share Purchase and Assignment Agreement dated July 13, 2006 by and between EII and ViVacs. EII paid \$150 in cash on the closing date of the agreement and agreed to pay \$50 on each of the first and second anniversaries of the closing date. The acquisition agreement also provides for a potential variable earn-out purchase price of up to \$220, based on future payments from third party licensees of the technology. As of December 31, 2006, the Company has not received any such payments from third party licensees. Because ViVacs was a development stage company and had not commenced its planned principal operations, the transaction was accounted for as an acquisition of assets rather than as a business combination and, therefore, goodwill was not recorded.

Total purchase consideration consisted of:

| | |
|---|--------|
| Cash (including future guaranteed cash payments of \$100) | \$ 250 |
| Direct acquisition costs | 180 |
| Total purchase consideration | \$ 430 |

The assets acquired were accounted for in accordance with the provisions of SFAS No. 141, *Business Combinations* (SFAS No. 141). All of the tangible and intangible assets acquired and liabilities assumed of ViVacs were recorded at their estimated fair market values on the acquisition date.

The purchase price was allocated as follows:

| | |
|-------------------------------------|--------|
| Current assets | \$ 153 |
| Property and equipment | 97 |
| Current liabilities | (297) |
| Net liabilities acquired | (47) |
| In-process research and development | 477 |
| Total purchase consideration | \$ 430 |

In connection with the transaction, the Company recorded a charge of \$477 for acquired research projects associated with product candidates in development for which, at the acquisition date, technological feasibility had not been established and, for accounting purposes, no alternative future use existed.

Microscience Limited

On June 23, 2005, Emergent Europe, Inc., a wholly owned subsidiary of the Company incorporated in Delaware (EEI), completed the acquisition of Microscience pursuant to the terms and conditions of the Share Exchange Agreement dated June 23, 2005 by and between EEI and Microscience Holdings PLC, a public limited liability company incorporated in England. At the closing date, the Company, through EEI, issued Microscience shareholders 3,636,801 shares of the Company's Class A Common Stock in exchange for all of the outstanding stock of Microscience. Shares of Class A Common Stock of the Company were valued for financial statement purposes at \$7.42 per share based on a determination of the estimated fair value by the Company's board of directors. Because Microscience was a development stage company and had not commenced its planned principal operations, the transaction was accounted for as an acquisition of assets rather than as a business combination and, therefore, goodwill was not recorded.

Total purchase consideration consisted of:

| | |
|------------------------------|-----------|
| Fair value of common stock | \$ 27,001 |
| Direct acquisition costs | 1,194 |
| Total purchase consideration | \$ 28,195 |

The assets acquired were accounted for in accordance with the provisions of SFAS No. 141. All of the tangible and intangible assets acquired and liabilities assumed of Microscience were recorded at their estimated fair market values on the acquisition date. The purchase price was allocated as follows:

| | | |
|-------------------------------------|----|--------|
| Current assets | \$ | 1,441 |
| Property and equipment | | 863 |
| Current liabilities | | (684) |
| Net assets acquired | | 1,620 |
| In-process research and development | | 26,575 |
| Total purchase consideration | \$ | 28,195 |

In connection with the transaction, the Company recorded a charge of \$26,575 for acquired research projects associated with products in development for which, at the acquisition date, technological feasibility had not been established and, for accounting purposes, no alternative future use existed.

4. Accounts receivable

Accounts receivable consist of the following:

| | December 31, | |
|----------|---------------------|-------------|
| | 2005 | 2006 |
| Billed | \$ 1,112 | \$ 43,305 |
| Unbilled | 1,418 | 26 |
| Total | \$ 2,530 | \$ 43,331 |

5. Inventories

Inventories consist of the following:

| | December 31, | |
|----------------------------|---------------------|-------------|
| | 2005 | 2006 |
| Raw materials and supplies | \$ 2,229 | \$ 2,133 |
| Work-in-process | 9,547 | 22,239 |
| Finished goods | 4,665 | 349 |
| Total inventories | \$ 16,441 | \$ 24,721 |

6. Property, plant and equipment

Property, plant and equipment consist of the following:

| | December 31, | |
|---|---------------------|-------------|
| | 2005 | 2006 |
| Land and improvements | \$ 2,995 | \$ 5,173 |
| Buildings and leasehold improvements | 14,143 | 25,074 |
| Furniture and equipment | 12,520 | 15,963 |
| Software | 3,937 | 3,937 |
| Construction-in-progress | 6,197 | 41,563 |
| | 39,792 | 91,710 |
| Less: Accumulated depreciation and amortization | (9,147) | (13,536) |
| Total Property, plant and equipment, net | \$ 30,645 | \$ 78,174 |

Depreciation and amortization expense was \$1,867, \$3,549 and \$4,715 for the years ended December 31, 2004, 2005 and 2006, respectively. For the years ended December 31, 2004, 2005 and 2006, depreciation and amortization expense included approximately \$209, \$1,257 and \$1,257 respectively, related to the amortization of internal-use software. As of December 31, 2005 and 2006, un-amortized software cost was \$2,471 and \$1,214, respectively.

7. Accrued expenses and other current liabilities

Accrued expenses and other current liabilities consist of the following:

| | December 31, | |
|--------------------------|---------------------|-----------------|
| | 2005 | 2006 |
| Contract costs | \$ 445 | \$ 1,218 |
| Professional fees | 1,390 | 1,115 |
| Interest payable | 146 | 222 |
| Property taxes and other | 628 | 698 |
| | \$ 2,609 | \$ 3,253 |

8. Long-term debt and related party notes payable

The components of long term-debt and related party notes payable are as follows:

| | December 31, | |
|--|---------------------|------------------|
| | 2005 | 2006 |
| Term Loan dated August 2006; Libor plus 3.75%, due August 2011 | \$ - | \$ 10,000 |
| Revolving credit loan, Libor plus 3.75% | - | 5,000 |
| Term Loan dated October 2004; 6.625%, due October 2011 | 7,000 | 6,955 |
| Forgivable Loan dated October 2004; 3.0%, due March 2013 | 2,500 | 2,500 |
| ERP Term Loan; Prime less 0.375%, due September 2007 | 1,760 | 960 |
| Term Loan dated April 2006; Libor plus 3%, due April 2011 | - | 8,383 |
| Employee notes payable for stock redemption; 6%, due 2006 | 537 | 17 |
| Other | 113 | 26 |
| Total long-term indebtedness and related party notes payable | 11,910 | 33,841 |
| Less current portion of long-term indebtedness and related party notes payable | (1,408) | (2,473) |
| Noncurrent portion of long-term indebtedness and related party notes payable | \$ 10,502 | \$ 31,368 |

In August 2006, the Company entered into a term loan for \$10,000 and a revolving credit loan that provides for borrowings up to \$5,000. Under the term loan, the Company is required to make monthly principal payments beginning in April 2007. A residual principal payment of approximately \$5,600 is due upon maturity in August 2011. At the Company's request, the term loan is subject to an extension term at the sole discretion of the lender for five additional years until August 2016 for an extension fee of 1.00% of the principal balance of the loan. If the term of the loan were extended, the Company would be required to continue to make monthly principal payments through maturity in August 2016 in lieu of the residual principal payment otherwise due in August 2011. Interest is payable monthly and accrues at an annual rate equal to LIBOR plus 3.75% (9.11% as of December 31, 2006).

Under the revolving credit loan, the Company is not required to repay outstanding principal until October 2007. In October 2007, the outstanding principal under the revolving credit loan will convert to a term loan with required monthly principal payments through maturity in August 2011. Interest is payable monthly and accrues at an annual rate equal to LIBOR plus 3.75% (9.11% as of December 31, 2006). The Company also is required to pay a fee on a quarterly basis equal to 0.50% of the average daily difference between \$5,000 and the amount outstanding under the revolving credit loan.

The term loan and revolving credit loan are secured by substantially all of Emergent BioDefense Operations' assets, other than accounts receivable under BioThrax supply contracts with the DoD and HHS. The Company is required to maintain on an annual basis a minimum tangible net worth of not less than the sum of 85% of tangible net worth for the most recently completed fiscal year plus 25% of current net operating profit after taxes. In addition, the Company is required to maintain on a quarterly basis a ratio of earnings before interest, taxes, depreciation and amortization for the most recent four quarters to the sum of current obligations under capital leases and principal obligations and interest expenses for borrowed money, in each case due and payable for the following four quarters, of not less than 1.25 to 1.00. The Company is in compliance with these covenants as of December 31, 2006.

In April 2006, the Company completed the acquisition of a 145,000 square foot facility in Frederick, Maryland for \$9,750. This facility was previously under a lease which contained an option to purchase the facility. The Company paid \$1,250 in cash and financed the remaining balance with a bank loan in the amount of \$8,500. This loan requires monthly principal and interest payments from May 2006 through April 2011 of \$72 with a balloon payment for the remaining unpaid principal and interest due in April 2011. The interest rate is a floating rate based on the three month LIBOR plus 3% (8.36% as of December 31, 2006). The loan is collateralized by the facility. The loan requires the Company to comply with certain non-financial covenants. The Company is in compliance with these covenants as of December 31, 2006.

In October 2004, the Company entered into a Secured Conditional Loan with the Maryland Economic Development Assistance Fund for \$2,500. The proceeds of the loan were used to reimburse the Company for eligible costs it incurred to purchase a building in Frederick, Maryland. The loan is secured by a \$1,250 letter of credit and a security interest in the building. The Company is required to pay an annual fee of 1% to maintain the letter of credit. The borrowing bears interest at 3% per annum, and the term of the loan ends March 31, 2013. The principal and related accrued interest may be forgiven if specified employment levels are achieved and maintained through December 2012, at least \$42,900 in project costs are expended prior to December 2009, and the Company occupies the building through December 2012. For the loan to be forgiven, the Company must employ at least 280 full-time employees at the Company's facilities in Frederick, Maryland as of December 31, 2009 and maintain at least 280 full-time employees through December 31, 2012. If as of December 31, 2009, 2010, 2011 or 2012 the Company employs fewer than 280 and more than 225 full-time employees at the Company's facilities in Frederick, Maryland, then the Company will be required to repay \$9 of principal plus accrued interest for each position not filled below the target level of 280 employees. If as of December 31, 2009, 2010, 2011 or 2012 the Company employs fewer than 225 full-time employees at the Company's facilities in Frederick, Maryland, then the Company will be required to repay the entire outstanding principal amount of the loan plus accrued interest. This loan is guaranteed by all of the subsidiaries of the Company.

In connection with the 2004 purchase of the first building in Frederick, Maryland discussed above, the Company entered into a loan agreement for \$7,000 with a bank to finance the remaining portion of the purchase price. The borrowing accrued interest at 6.625% per annum through October 2006. The Company was required to make interest only payments through that date. Beginning in November 2006, the Company began to make monthly payments of \$62, based upon a 15 year amortization schedule. In November 2009, the monthly payments will be adjusted based upon a 12 year amortization schedule. Beginning in November 2009, the loan will bear interest at a fixed rate equal to 3.2% over the yield on actively traded U.S. Government securities issues adjusted to a constant maturity of two years, rounded up to the nearest one-eighth of one percent (1/8 of 1%). All unpaid principal and interest is due in full in October 2011. The Company is required to maintain certain financial and non-financial covenants including a minimum tangible net worth of not less than \$5,000 and a debt coverage ratio of not less than 1.1 to 1. The Company is in compliance with these covenants as of December 31, 2006. This loan is guaranteed by all of the subsidiaries of the Company.

During 2004, the Company implemented an Enterprise Resource Planning (ERP) system. The Company financed \$2,280 of the costs through the issuance of a term loan. The loan bears interest at prime less 0.375% (7.88% as of December 31, 2006) and is due in September 2007. Monthly payments escalate from \$40 to \$106 over the term. The ERP system provides security for the loan.

In 2004, the Company issued notes as consideration for the repurchase of outstanding class B common stock of BioPort. These notes were issued to various current and past employees who were issued equity as a result of earlier stock option exercises. Amounts are payable in annual installments, through 2007, and bear interest at 6%.

Scheduled principal repayments and maturities on long-term debt as of December 31, 2006 are as follows:

| | | |
|------------|----|--------|
| 2007 | \$ | 2,473 |
| 2008 | | 2,624 |
| 2009 | | 5,265 |
| 2010 | | 2,916 |
| 2011 | | 15,313 |
| Thereafter | | 5,250 |
| | \$ | 33,841 |

9. Line of credit

On April 1, 2005, the Company, through Emergent BioDefense Operations, formerly BioPort, obtained a line of credit that provides for borrowings of up to \$10,000. The line of credit is scheduled to expire on May 15, 2007. The line of credit is secured by accounts receivable under the Company's DOD and HHS contracts and bears interest at the prime rate less 0.375% (7.88% as of December 31, 2006). Emergent BioDefense Operations is subjected to certain covenants, including maintenance of specified equity levels on a quarterly basis. Emergent BioDefense Operations is currently in compliance with those covenants. A total of \$8,930 was outstanding under this line of credit as of December 31, 2006. This amount was repaid in January 2007. No borrowings were outstanding under this line of credit as of December 31, 2005.

10. Stockholders equity

Preferred stock

The Company is authorized to issue up to 15,000,000 shares of preferred stock, \$0.001 par value per share (Preferred Stock). Any preferred stock issued may have dividend rates, voting rights, conversion privileges, redemption characteristics, and sinking fund requirements as approved by the Company's board of directors. As of December 31, 2006, no preferred stock has been issued.

Common stock

The Company currently has one class of \$0.001 par value per share common stock (Common Stock) authorized and outstanding. The Company is authorized to issue up to 100,000,000 shares of the Common Stock. Holders of Common Stock are entitled to one vote for each share of Common Stock held on all matters as may be provided by law.

On November 14, 2006, the Company completed its initial public offering, or IPO, which resulted in the issuance of 5,000,000 shares of common stock at a price of \$12.50 per share for gross proceeds of \$62,500. Issuance costs related to the offering were \$8,271, resulting in net proceeds from the offering of \$54,229. In conjunction with the completion of the IPO, all outstanding shares of Class A and Class B common stock were converted into 22,420,421 shares of \$0.001 Common Stock at a conversion rate of one share of common stock for one share of Class A and Class B common stock.

On September 20, 2006, the Company's board of directors recommended to the stockholders of the Company an amendment of the Company's amended and restated certificate of incorporation, which the stockholders approved on October 27, 2006, that, among other things, reclassifies the Class A Common Stock as \$0.001 par value per share Common Stock, increases the number of authorized shares of Common Stock to 100,000,000 shares and adjusts the par value of the Preferred Stock from \$0.01 par value per share to \$0.001 par value per share. The amendment became effective on October 27, 2006. On September 20, 2006, the Company's board of directors also authorized the pricing committee of the board of directors to effect a stock split of both the Common Stock, in the form of a dividend of shares of Common Stock, and the Class B Common Stock, in the form of a dividend of shares of Class B Common Stock. The pricing committee subsequently declared a 2.8771-for-one stock split of the Common Stock and the Class B Common Stock effective as of October 27, 2006. The par values, the number of authorized shares and all share and per share amounts in the consolidated financial statements have been retroactively adjusted to give effect to the filing of the certificate of amendment of the Company's amended and restated certificate of incorporation and the stock split. The consolidated financial statements do not reflect the reclassification of the Class A Common Stock as Common Stock, other than the related adjustment to par value and the increase in the number of authorized shares.

Holders of Common Stock are entitled to receive ratably dividends payable as and when declared by the Company's board of directors. On June 15, 2005, the Company's board of directors declared a special cash dividend to the holders of outstanding shares of Class A Common Stock and Class B Common Stock in an aggregate amount of \$5,400. The Company's board of directors declared this special dividend in order to distribute the net proceeds of a payment received as a result of the settlement of litigation initiated in 2002 by the Company against Elan Pharmaceuticals, Inc., Athena Neurosciences, Inc. and Solstice Neurosciences, Inc. in an effort to clarify intellectual property rights, including the recovery of royalties and other costs and fees, to which the Company believed it was entitled under a series of agreements regarding the development of botulinum toxin products. The Company paid the special cash dividend on July 13, 2005 to stockholders of record as of June 15, 2005. No regular dividends have been declared or paid.

In June 2004, in connection with the Reorganization, the Company issued 18,666,479 shares of Class A Common Stock in exchange for 18,017,994 shares of BioPort Class A Common Stock and 648,485 shares of BioPort Class B Common Stock held by BioPharm, L.L.C. The Company repurchased and retired the remaining issued and outstanding shares of BioPort Class B Common Stock from former employees. Approximately 544,000 BioPort shares were repurchased at \$2.74 per share and approximately 28,000 BioPort shares were repurchased at \$4.12 per share. Shares were repurchased for \$665 in cash and the issuance of \$947 in notes payable. See Note 8 Long-term debt and related party notes payable, for additional information related to the former employee notes payable.

During the year ended December 31, 2005, the Company repurchased 112,168 shares of Class B Common Stock with an original weighted average cost of \$0.26 per share, for \$337.

Stock options

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As of December 31, 2006, the Company has two stock-based employee compensation plans, the 2006 Plan and the 2004 Plan, under which the Company has granted options to purchase shares of Common Stock. The Emergent Plans have both incentive and non-qualified stock option features.

The Company established the 2006 Plan in connection with its initial public offering in November 2006. Under the 2006 Plan, the Company may grant options for a total of 503,500 shares of Common Stock, plus the number of shares of Common Stock reserved for issuance under the 2004 Plan that remained available for grant immediately prior to the initial public

offering on November 14, 2006, of 585,961 shares. Accordingly, the 2006 Plan initially authorizes the issuance of up to 1,089,461 shares. In addition, the 2006 Plan contains an evergreen provision that allows for increases in the number of shares available for issuance under the 2006 Plan in the first and third quarter of each year from 2007 through 2009. The maximum number of options that may be granted per year under the 2006 Plan to a single participant is 287,700. The exercise price of each incentive option must be not less than 100% of the fair market value of the shares on the date of grant. Options granted under the 2006 Plan have a vesting period of no more than 5 years and contractual life of no more than 10 years.

In conjunction with the establishment of the 2006 Plan, as noted above, the shares reserved for issuance under the 2004 Plan that remained available for grant became available for grant under the 2006 Plan. The exercise price of each incentive option granted under the 2004 Plan must be not less than 100% of the fair market value of the shares on the date of grant, except in the case of the incentive stock option being granted to a 10% stockholder, in which case the exercise price must be not less than 110% of the fair market value of the shares on the date of grant.

Prior to the Reorganization, BioPort had a separate stock option plan (BioPort plan) under which options were granted to purchase BioPort Class B Common Stock. The exercise price and vesting schedule for options were determined by BioPort's board of directors, or a committee thereof, which was established to administer the BioPort plan options.

As of June 30, 2004, options to purchase 1,948,892 shares of BioPort Class B Common Stock were outstanding under the BioPort plan. Pursuant to the Reorganization, all outstanding BioPort plan options were assumed by Emergent and option holders were granted replacement stock options to purchase an equal number of shares of Class B Common Stock of Emergent. The exercise period for the replacement options was extended to June 30, 2007. The BioPort options were scheduled to expire on June 30, 2004.

In connection with the Reorganization, the Company recorded stock-based compensation expense as a result of the issuance of the stock options to purchase Class B Common Stock. Based upon the guidance in APB No. 25, because the stock options granted for Class B Common Stock provided for an extended term over that of the cancelled BioPort plan options, a new measurement date was created and the Company recorded as stock-based compensation expense the excess of the intrinsic value of the modified options over the intrinsic value of the BioPort plan options when originally issued. This resulted in stock-based compensation expense of \$4,310, or \$2,801 net of taxes, for the year ended December 31, 2004.

Outside of the Reorganization, options to purchase an additional 322,235 shares of Class B common stock of Emergent under the 2004 Plan were granted during the year ended December 31, 2004.

The terms and conditions of stock options (including price, vesting schedule, term and number of shares) under the Emergent Plans are determined by the Company's compensation committee, which administers the Emergent Plans.

Each option granted under the Emergent Plans becomes exercisable as specified in the relevant option agreement, and no option can be exercised after ten years from the date of grant. The following is a summary of stock option plan activity:

| | Emergent 2004 Plan | | Emergent 2006 Plan | | |
|----------------------------------|--------------------|---------------------------------|--------------------|---------------------------------|---------------------------|
| | Number of Shares | Weighted-Average Exercise Price | Number of Shares | Weighted-Average Exercise Price | Aggregate Intrinsic Value |
| Outstanding at December 31, 2005 | 3,141,829 | \$ 1.78 | - | \$ - | |
| Exercisable at December 31, 2005 | 2,452,483 | \$ 1.22 | - | \$ - | |
| Granted | 258,933 | 11.36 | 1,030,500 | 10.13 | |
| Exercised | (271,686) | 2.16 | - | - | |
| Forfeited | (195,851) | 2.63 | - | - | |
| Outstanding at December 31, 2006 | 2,933,225 | \$ 2.53 | 1,030,500 | \$ 10.13 | 26,375,147 |
| Exercisable at December 31, 2006 | 2,395,693 | \$ 1.43 | - | \$ - | 23,310,093 |

The weighted average remaining contractual term of options outstanding and exercisable as of December 31, 2005 and December 31, 2006 was 2.46 years and 3.18 years, and 2.12 years and 1.06 years, respectively.

The weighted average grant date fair value of options granted during the years ended December 31, 2004, 2005 and 2006 was \$0.95, \$1.37 and \$3.94, respectively. The total intrinsic value of options exercised during the years ended December 31, 2004, 2005 and 2006 was \$325, \$563 and \$2,337, respectively. The total fair value of shares vested during 2006 was \$434.

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During 2006, the Company recognized pre-tax share-based compensation cost of \$723. Of this amount, \$623 is included in Selling, General and Administrative Expense, \$97 is included in Research and Development Expense, and \$3 is included in Cost of Product Sales.

A summary of the status of the Company's nonvested stock options at December 31, 2006 is presented below:

| | Emergent 2004 Plan | | Weighted-Average Price | Emergent 2006 Plan | |
|--------------------------------|--------------------|----|------------------------|--------------------|------------------------|
| | Number of Shares | | | Number of Shares | Weighted-Average Price |
| Nonvested at December 31, 2005 | 684,551 | \$ | 3.77 | - | \$ |
| Granted | 258,933 | | 11.23 | 1,030,500 | 10.13 |
| Exercised | - | | - | - | - |
| Vested | (345,536) | | 1.28 | - | - |
| Forfeited | (60,416) | | 1.49 | - | - |
| Nonvested at December 31, 2006 | 537,532 | \$ | 9.21 | 1,030,500 | \$ 10.13 |

During the year ended December 31, 2006, the Company received a tax benefit from stock options exercised of approximately \$1,300.

11. Income taxes

Significant components of the provision for income taxes attributable to operations consist of the following:

| | Year Ended December 31, | | |
|----------------------------------|-------------------------|-----------|-----------|
| | 2004 | 2005 | 2006 |
| Current | | | |
| Federal | \$ 5,547 | \$ 16,093 | \$ 14,212 |
| State | - | 200 | 812 |
| Total Current | 5,547 | 16,293 | 15,024 |
| Deferred | | | |
| Federal | (372) | (9,769) | 100 |
| State | (46) | (1,199) | 98 |
| Total Deferred | (418) | (10,968) | 198 |
| Total Provision for Income Taxes | \$ 5,129 | \$ 5,325 | \$ 15,222 |

The Company's net deferred tax asset consists of the following:

| | December 31, | |
|--|--------------|-----------|
| | 2005 | 2006 |
| Net operating loss carryforward | \$ 2,242 | \$ 4,160 |
| Research and development credit carryforward | 721 | 549 |
| Stock compensation | 1,696 | 1,452 |
| Foreign deferrals | 27,797 | 32,534 |
| Other | 1,219 | 1,681 |
| Deferred tax asset | 33,675 | 40,376 |
| Fixed assets | (1,387) | (888) |
| Other | (393) | (433) |
| Deferred tax liability | (1,780) | (1,321) |
| Valuation allowance | (19,925) | (27,283) |
| Net deferred tax asset | \$ 11,970 | \$ 11,772 |

Net operating loss carryforwards consist of \$91 million for state jurisdictions and \$77 million for foreign jurisdictions. The state net operating loss carryforwards will begin to expire in 2018. The foreign net operating loss carryforwards will have an indefinite life unless the foreign entities have a change in the nature or conduct of the business in the three years following a change in ownership. The use of the Company's net operating loss carryforwards may be restricted due to changes in Company ownership.

The provision for income taxes differs from the amount of taxes determined by applying the U.S. federal statutory rate to loss before provision for income taxes as a result of the following:

| | Year ended December 31, | | |
|-------------------------------------|-------------------------|-----------|-----------|
| | 2004 | 2005 | 2006 |
| US | \$ 16,601 | \$ 54,259 | \$ 56,698 |
| International | - | (33,150) | (18,683) |
| Earnings before taxes on income | 16,601 | 21,109 | 38,015 |
| Federal tax at statutory rates | 5,863 | \$ 7,388 | \$ 13,305 |
| State taxes, net of federal benefit | (714) | (2,329) | (395) |
| Impact of foreign operations | - | (17,982) | (6,050) |
| Change in valuation allowance | 479 | 16,901 | 4,248 |
| Effect of foreign rates | - | 2,358 | 3,110 |
| Tax credits | (492) | (474) | (759) |
| Other differences | 11 | (212) | 1,043 |
| Permanent differences | (18) | (325) | 720 |
| Provision for income taxes | \$ 5,129 | \$ 5,325 | \$ 15,222 |

The estimated effective annual tax rate for the years ended December 31, 2005 and 2006 was 25% and 40%, respectively. The increase in the estimated rate is due primarily to the impact of foreign and state net operating losses and an increase in permanent differences, including incentive stock options.

The Company is the subject of an ongoing federal income tax audit for the tax years ended December 31, 2004 and 2005. The financial statement impact of the audit has been estimated at approximately \$760. This amount has been accrued as of December 31, 2006.

12. 401(k) savings plan

The Company has established a defined contribution savings plan under Section 401(k) of the Internal Revenue Code. The 401(k) Plan covers substantially all employees. Under the 401(k) Plan, employees may make elective salary deferrals. The Company provides for matching of qualified deferrals up to 50% of the first 6% of the employee's salary. During the years ended December 31, 2004, 2005 and 2006, the Company made matching contributions of approximately \$452, \$520 and \$573, respectively.

13. Commitments and settlement gains

Leases

The Company leases laboratory and office facilities, office equipment and vehicles under various operating lease agreements. The Company leases office and laboratory space in Gaithersburg, Maryland under a non-cancelable operating lease that contains a 3% annual escalation and expires on November 30, 2008.

The Company leases approximately 23,000 square feet of office space in Rockville, Maryland under a non-cancelable operating lease that contains a 3% annual escalation clause over the ten year term of the lease. The Company has a five year renewal option at the end of the initial term. For the years ended December 31, 2004, 2005 and 2006, total rent expense was \$1,334, \$2,526 and \$2,386, respectively.

Future minimum payments under operating lease obligations as of December 31, 2006 are as follows:

| | |
|------------------------------|----------|
| 2007 | \$ 1,726 |
| 2008 | 1,866 |
| 2009 | 634 |
| 2010 | 651 |
| 2011 | 669 |
| 2011 and beyond | 3,633 |
| Total minimum lease payments | \$ 9,179 |

Vendor contracts

In accordance with a recently signed research contract, the Company is committed to spending a minimum of \$100 in research and development activities by September 2007. To date, the Company has incurred minimal expenditures under this contract.

Litigation

In June 2002, the Company initiated a lawsuit against Élan Pharmaceuticals and related entities in an effort to clarify intellectual property rights, including the recovery of royalties and other costs and fees, to which the Company believed it was entitled under a set of 1991 agreements and to clarify intellectual property rights associated with those agreements. The Company sought damages, injunctive relief and declaratory relief. On June 27, 2005, the Company obtained a settlement pursuant to which Élan and related entities agreed to pay the Company \$10,000. Payment of such settlement was received by the Company in July 2005. The agreement also clarified the parties' intellectual property rights. Upon receipt of the settlement from Élan Pharmaceuticals and related entities, the Company distributed a net settlement amount (total proceeds from the settlement less reserves for applicable federal and state income taxes, legal expenses related to the suit and other miscellaneous expenses) of \$5,400 to all Company stockholders of record as of June 15, 2005.

In 1998, the Company recorded obligations related to the initial purchase agreement of Michigan Biologic Products Institute of \$10,119. During 2004, the Company settled its entire remaining purchase obligations to the State of Michigan for \$6,300, resulting in a gain of \$3,819, which is reflected as a component of operations on the accompanying statement of operations.

From time to time, the Company is involved in product liability claims and other litigation considered normal in the nature of its business. The Company does not believe that any such proceedings would have a material, adverse effect on the results of its operations. For claims filed against the Company for use of BioThrax by the DoD, we expect to rely on contractual indemnification provisions with the DoD and statutory protections to limit our potential liability resulting from the pending lawsuits.

14. Related party transactions

Simba LLC, a Maryland based limited liability company 100% owned by the Company's Chief Executive Officer and his wife, provides chartered air transportation. Simba offers its services to the Company on a discount from Simba's normal commercial rate. For the years ended December 31, 2004, 2005 and 2006, the Company paid approximately \$32, \$34 and \$13, respectively, for transportation on an as needed basis for business purposes. As of May 2006, this arrangement has been terminated.

The Company has entered into marketing and sales contracts with entities controlled by family members of the Chief Executive Officer to market and sell BioThrax in certain international territories if certain conditions are met. A consulting arrangement with the Chief Executive Officer's sister required a payment of 4% of net sales, not to exceed \$2.00 per dose, under the agreement. A marketing arrangement with an entity affiliated with the Chief Executive Officer and his family requires a payment of 40% of gross sales in countries in the Middle East and North Africa, except Israel. No royalty payments under these agreements have been triggered for the years ended December 31, 2004, 2005 and 2006. The arrangement with the Chief Executive Officer's sister has been terminated.

For the years ended December 31, 2004, 2005 and 2006, the Company paid approximately \$494, \$794 and \$419, respectively, in consulting, lease and transportation arrangements with various persons or entities affiliated with the Chief Executive Officer or two members of the board of directors. For the year ended December 31, 2005 and 2006, there was \$22 and \$17 respectively, in accounts payable for these services. The Company currently has an agreement with a director to perform corporate strategic issues consultation and directed project support to the marketing and communications group and an agreement with East West Resources Corporation, a company owned by the Chief Executive Officer, to provide transportation and logistical support.

15. Segment information

The Company operates in two business segments: biodefense and commercial. In the biodefense business, the Company develops, manufactures and commercializes products for use against biological agents that are potential weapons of bioterrorism. Revenues in this segment relate to the Company's FDA-approved product, BioThrax. In the commercial business, the Company develops products for use against infectious diseases with significant unmet or underserved medical needs. Revenues in this segment consist predominantly of milestone payments and development and grant revenues received under collaboration and grant arrangements. The All Other segment relates to the general operating costs of the business and includes costs of the centralized services departments, which are not allocated to the other segments. The assets in this segment consist of cash and fixed assets.

| | Reportable Segments | | | |
|-------------------------------------|---------------------|------------|-----------|------------|
| | Biodefense | Commercial | All Other | Total |
| Year Ended December 31, 2006 | | | | |
| External revenue | \$ 147,707 | \$ 5,025 | \$ - | \$ 152,732 |
| Inter-segment revenue (expense) | - | - | - | - |
| Research and Development | 22,219 | 22,425 | 857 | 45,501 |
| Interest revenue | - | - | 846 | 846 |
| Interest expense | - | - | (1,152) | (1,152) |
| Depreciation and amortization | 3,586 | 830 | 299 | 4,715 |
| Net Income (Loss) | 55,074 | (24,538) | (7,743) | 22,793 |
| Assets | 125,562 | 13,732 | 98,961 | 238,255 |
| Expenditures for long-lived assets | 29,273 | 1,455 | 10,500 | 41,228 |
| Year Ended December 31, 2005 | | | | |
| External revenue | \$ 128,219 | \$ 2,469 | \$ - | \$ 130,688 |
| Inter-segment revenue | - | - | - | - |
| Research and Development | 10,327 | 6,962 | 1,092 | 18,381 |
| Interest revenue | - | - | 485 | 485 |
| Interest expense | - | - | (767) | (767) |
| Depreciation and amortization | 2,911 | 411 | 226 | 3,548 |
| Net Income (Loss) | 58,632 | (40,325) | (2,523) | 15,784 |
| Assets | 40,502 | 5,489 | 54,341 | 100,332 |
| Expenditures for long-lived assets | \$ 3,286 | \$ 3,052 | \$ 194 | \$ 6,532 |

The accounting policies of the segments are the same as those described in Note 2 Summary of significant accounting policies. There are no inter-segment transactions.

16. Quarterly financial data (unaudited)

Quarterly financial information for the years ended December 31, 2005 and 2006 is presented in the following tables:

| | March 31, | June 30, | September 30, | Three months ended December 31, |
|--------------------------------------|-----------|-----------|---------------|------------------------------------|
| Fiscal year 2006 | | | | |
| Revenue | \$ 12,223 | \$ 11,446 | \$ 42,174 | \$ 86,889 |
| Income (loss) from operations | (9,398) | (6,194) | 9,720 | 43,900 |
| Net income (loss) | (4,636) | (3,054) | 4,354 | 26,129 |
| Net income (loss) per share, basic | (0.21) | (0.14) | 0.19 | 1.04 |
| Net income (loss) per share, diluted | (0.21) | (0.14) | 0.18 | 0.99 |
| Fiscal year 2005 | | | | |
| Revenue | \$ 15,261 | \$ 44,058 | \$ 27,581 | \$ 43,788 |
| Income from operations | 425 | 3,699 | 4,498 | 12,714 |
| Net income | 225 | 2,616 | 3,410 | 9,533 |
| Net income per share, basic | 0.01 | 0.14 | 0.15 | 0.43 |
| Net income per share, diluted | 0.01 | 0.12 | 0.13 | 0.38 |

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

Financial Statements

The following financial statements and supplementary data are filed as a part of this annual report on Form 10-K.

Report of Independent Registered Public Accounting Firm

Consolidated Balance Sheets at December 31, 2005 and 2006

Consolidated Statements of Operations for the years ended December 31, 2004, 2005 and 2006

Consolidated Statements of Cash Flows for the years ended December 31, 2004, 2005 and 2006

Consolidated Statement of Changes in Stockholders' Equity for the years ended December 31, 2004, 2005 and 2006

Notes to Consolidated Financial Statements

Financial Statement Schedules

All financial statement schedules are omitted because they are not applicable or the required information is included in the financial statements or notes thereto.

Exhibits

Those exhibits required to be filed by Item 601 of Regulation S-K are listed in the Exhibit Index immediately preceding the exhibits hereto and such listing is incorporated herein by reference.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

EMERGENT BIOSOLUTIONS INC.

By: /s/Fuad El-Hibri

Fuad El-Hibri

President, Chief Executive Officer and Chairman of the Board of Directors

Date: March 28, 2007

EXHIBIT INDEX

Exhibit

| Number | Description |
|---------------|---|
| 3.1 (2) | Restated Certificate of Incorporation of the Registrant |
| 3.2 (2) | Amended and Restated By-laws of the Registrant |
| 4.1(1) | Specimen certificate evidencing shares of common stock |
| 4.2(1) | Registration Rights Agreement, dated June 23, 2005, between the Registrant and Microscience Investments Limited, formerly Microscience Holdings PLC |
| 4.3(1) | Registration Rights Agreement, dated September 22, 2006, among the Registrant and the entities listed on Schedule 1 thereto |
| 4.4(2) | Rights Agreement, dated November 14, 2006, between the Registrant and American Stock Transfer & Trust Company |
| 4.5 # | Assignment and Assumption Agreement by and between the Registrant, Microscience Investments Limited and the Investors named therein, dated March 8, 2007, relating to the Registration Rights Agreement, dated June 23, 2005, between the Registrant and Microscience Investments Limited |
| 9.1(1) | Voting and Right of First Refusal Agreement, dated October 21, 2005, between the William J. Crowe, Jr. Revocable Living Trust and Fuad El-Hibri |
| 9.2(1) | Voting Agreement, dated June 30, 2004, between BioPharm, L.L.C. and Michigan Biologic Products, Inc. |
| 9.3(1) | Voting Agreement, dated June 30, 2004, between BioPharm, L.L.C. and Biologika, L.L.C. |
| 9.4(1) | Voting Agreement, dated June 30, 2004, by and among the stockholders named therein |
| 9.5(1) | Voting Agreement, dated August 11, 2006, between BioPharm, L.L.C. and Microscience Investments Limited |
| 9.6 # | Assignment and Assumption Agreement by and between Microscience Investments Limited, the Investors named therein and BioPharm, L.L.C., dated March 8, 2007, relating to the Voting Rights Agreement, dated August 11, 2006, between BioPharm, L.L.C. and Microscience Investments Limited |
| 10.1(1) | Employee Stock Option Plan, as amended and restated |
| 10.2(1) | Form of Director Stock Option Agreement |
| 10.3(1) | 2006 Stock Incentive Plan |
| 10.4(1) | Form of Incentive Stock Option Agreement under 2006 Stock Incentive Plan |
| 10.5(1) | Form of Nonstatutory Stock Option Agreement under 2006 Stock Incentive Plan |
| 10.6(1) | Severance Plan and Termination Protection Program |
| 10.7(1) | Form of Indemnity Agreement |
| 10.8(1) | Contract No. W9113M-04-D-0002, dated January 3, 2004, between Emergent BioDefense Operations Lansing Inc., formerly BioPort Corporation, and U.S. Army Space and Missile Defense Command, as amended |
| 10.9(1) | Contract No. 200-2005-11811, dated May 5, 2005, between Emergent BioDefense Operations Lansing Inc., formerly BioPort Corporation, and Department of Health and Human Services, Office of Public Health Emergency |

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- 10.10(1) Preparedness and Office of Research and Development Coordination, as amended
Filling Services Agreement, dated March 18, 2002, between Emergent BioDefense Operations Lansing Inc., formerly BioPort Corporation, and Hollister-Stier Laboratories LLC, as amended
- 10.11(1) BT Vaccine License Agreement, dated November 23, 2004, between the Registrant and the Health Protection Agency
- 10.12(1) BT Vaccine Development Agreement, dated November 23, 2004, between the Registrant and the Health Protection Agency
- 10.13(1) rBot Vaccine License Agreement, dated November 23, 2004, between the Registrant and the Health Protection Agency
- 10.14(1) rBot Vaccine Development Agreement, dated November 23, 2004, between the Registrant and the Health Protection Agency
- 10.15(1) Exclusive Distribution Agreement, dated November 23, 2004, between the Registrant and the Health Protection Agency
- 10.16(1) Investment Agreement relating to Microscience Holdings PLC, dated March 18, 2005, among the Wellcome Trust, Microscience Investments Limited, formerly Microscience Holdings PLC, and Emergent Product Development UK Limited, formerly Microscience Limited, as amended
- 10.17(1) Standard Employment Contract, dated September 22, 2006, between Emergent Product Development UK Limited, formerly Emergent Europe Limited, and Steven N. Chatfield
- 10.18(1) Letter Agreement, dated July 11, 2006, between the Registrant and Steven N. Chatfield
- 10.19(1) Consulting Services Agreement, dated March 1, 2006, between the Registrant and The Hauer Group
- 10.20(1) Amended and Restated Marketing Agreement, dated January 1, 2000, between Emergent BioDefense Operations Lansing Inc., formerly BioPort Corporation, and Interger N.V., as amended
- 10.21(1) Lease, dated December 1, 1998, between ARE-QRS, Corp. and Antex Biologics Inc., as amended
- 10.22(1) Lease (540 Eskdale Road, Winnersh Triangle, Wokingham, Berkshire), dated December 13, 1996, between Slough Properties Limited and Azur Environmental Limited, as assigned to Emergent Product Development UK Limited, formerly Microscience Limited
- 10.23(1) Lease (545 Eskdale Road, Winnersh Triangle, Wokingham, Berkshire), dated December 13, 1996, between Slough Properties Limited and Azur Environmental Limited, as assigned to Emergent Product Development UK Limited, formerly Microscience Limited
- 10.24(1) Lease Agreement, dated June 27, 2006, between Brandywine Research LLC and the Registrant
- 10.25(1) Amended and Restated Loan Agreement, dated July 29, 2005, between Emergent BioDefense Operations Lansing Inc., formerly BioPort Corporation, and Fifth Third Bank, as amended
- 10.26(1) Loan and Security Agreement, dated October 14, 2004, among the Registrant, Emergent Commercial Operations Frederick Inc., formerly Advanced BioSolutions, Inc., Antex Biologics Inc., Emergent BioDefense Operations Lansing Inc., formerly BioPort Corporation, and Mercantile Potomac Bank
- 10.27(1) Promissory Note, dated October 14, 2004, from Emergent Commercial Operations Frederick Inc., formerly Advanced BioSolutions, Inc., to Mercantile Potomac Bank
- 10.28(1) Loan Agreement, dated October 15, 2004, between Emergent Commercial Operations Frederick Inc., formerly Advanced BioSolutions, Inc., and the Department of Business and Economic Development
- 10.29(1) Deed of Trust Note, dated October 14, 2004, between Emergent Commercial Operations Frederick Inc., formerly Advanced BioSolutions, Inc., and the Department of Business and Economic Development
- 10.30(1) Term Note, dated August 10, 2004, from Emergent BioDefense Operations Lansing Inc., formerly BioPort Corporation, to Fifth Third Bank
- 10.31(1) Loan Agreement, dated April 25, 2006, among the Registrant, Emergent Frederick LLC and HSBC Realty Credit Corporation (USA)
- 10.32(1) Bond Purchase Agreement, dated March 31, 2005, between the County Commissioners of Frederick County, Emergent Commercial Operations Frederick Inc., formerly Emergent Biologics Inc., and Mercantile Potomac Bank
- 10.33(1) License and Co-development Agreement, dated May 6, 2006, between Emergent Product Development UK Limited, formerly Emergent Europe Limited, and Sanofi Pasteur, S.A
- 10.34(1) Product Supply Agreement, dated June 12, 2006, between Emergent Product Development Gaithersburg Inc. and Talecris Biotherapeutics, Inc.
- 10.35(1) Election of Fuad El-Hibri to Participate in the Severance Plan and Termination Protection Program
- 10.36(1) Services Agreement, dated August 1, 2006, between East West Resources Corporation and the Registrant
- 10.37(1) Director Compensation Program
- 10.38(1) Revolving Credit Note, dated July 29, 2005, from Emergent BioDefense Operations Lansing Inc., formerly BioPort Corporation, to Fifth Third Bank
- 10.39(1) Promissory Note, dated April 25, 2006, from Emergent Frederick LLC to HSBC Realty Credit Corporation (USA)
- 10.40(1) Loan Agreement, dated August 25, 2006, among the Registrant, Emergent BioDefense Operations Lansing Inc., formerly BioPort Corporation, and HSBC Realty Credit Corporation (USA)
- 10.41(1) Promissory Note (Term Note), dated August 25, 2006, from Emergent BioDefense Operations Lansing Inc., formerly BioPort Corporation, to HSBC Realty Credit Corporation (USA)
- 10.42(1)

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- Promissory Note (Revolving Credit Loan), dated August 25, 2006, from Emergent BioDefense Operations Lansing Inc., formerly, BioPort Corporation to HSBC Realty Credit Corporation (USA)
- 10.43(1) Agreement, dated June 16, 2005, between the Free State of Bavaria and Emergent Product Development UK, formerly ViVacs GmbH
- 10.44 # Amendment to Consulting Services Agreement, effective March 30, 2007, between the Registrant and The Hauer Group
- 10.45# Fourth Amendment to Amended and Restated Loan Agreement, effective December 21, 2006, between Emergent BioDefense Operations Lansing Inc., formerly BioPort Corporation, and Fifth Third Bank
- 10.46# Fifth Amendment to Amended and Restated Loan Agreement, effective February 15, 2007, between Emergent BioDefense Operations Lansing Inc., formerly BioPort Corporation, and Fifth Third Bank
- 21.1(1) Subsidiaries of the Registrant
- 23.1## Consent of Independent Registered Public Accounting Firm
- 31.1# Certification of the Chief Executive Officer pursuant to Exchange Act Rule 13a-14(a)
- 31.2# Certification of the Chief Financial Officer pursuant to Exchange Act Rule 13a-14(a)
- 31.3## Certification of the Chief Executive Officer pursuant to Exchange Act Rule 13a-14(a)
- 31.4## Certification of the Chief Financial Officer pursuant to Exchange Act Rule 13a-14(a)
- 32.1 # Certification of the Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 32.2 # Certification of the Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 32.3 ## Certification of the Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 32.4 ## Certification of the Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

Filed herewith.

Filed with the annual report on Form 10-K originally filed with the Securities and Exchange Commission on March 27, 2007.

(1) Incorporated by reference to the exhibits to the Registrant's registration statement on Form S-1 (File No. 333-136622).

(2) Incorporated by reference to the exhibits to the Registrant's registration statement on Form S-8 (File No. 333-139190).

Confidential treatment granted by the Securities and Exchange Commission as to certain portions. Confidential materials omitted and filed separately with the Securities and Exchange Commission.

* Management contract or compensatory plan or arrangement.