protected by emergent biosolutions™

Our mission is simple:

to protect life.

Dear Stockholders:

FUAD EL-HIBRI
Chairman and Chief Executive Officer

2006 was a record year for total revenues and represented our fifth consecutive year of profitable operations. It was also a record year in terms of our accomplishments in the areas of corporate development as well as product development and manufacturing of immunobiotics in our two business segments — biodefense and commercial. These accomplishments were driven by our five core strategies for growth, which are:

- Pursue two attractive business segments.
- Focus on development versus research.
- Leverage manufacturing core competency.
- Mitigate costs with non-dilutive relationships.
- Grow through acquisition.

Corporate Developments
We made significant progress on a number of corporate initiatives, including:

- We completed an initial public offering raising approximately $58 million, and listed our common stock on the New York Stock Exchange.
- We acquired ViVacs GmbH, a German-based biotechnology company with a promising technology platform.
- We leveraged our assets by securing approximately $32 million in additional debt financing.

Biodefense Business Segment
We continued to lead the way in the expanding biodefense market, including:

- We completed the required deliveries of BioThrax® (Anthrax Vaccine Adsorbed) to the U.S. Department of Health and Human Services (HHS) under our initial 5 million dose contract seven months ahead of schedule.
- We completed a contract modification with HHS for the delivery of an additional 5 million doses of BioThrax, with over 4 million doses delivered by December 2006.
- We signed a contract amendment with the U.S. Department of Defense (DoD) for the delivery of approximately 1 million additional doses of BioThrax, with final delivery scheduled by September 2007.
- We positioned the sale of BioThrax to additional domestic and international customers, including first responders at the state and local levels, and signed agreements with marketing representatives to develop regional international markets where we see sales opportunities.
- We received certification and designation of BioThrax as a "qualified anti-terrorism technology" by the U.S. Department of Homeland Security, making BioThrax the first vaccine to receive this recognition.

Commercial Business Segment
We further advanced our commercial product development initiatives in the fight against global infectious diseases, including:

- We completed a Phase I clinical trial for our single dose, drinkable typhoid vaccine candidate in adults in Vietnam, where typhoid

Selected 2006 Accomplishments

- Completed an initial public offering raising approximately $58 million, and listed our common stock on the New York Stock Exchange.
- Acquired ViVacs GmbH, a German-based biotechnology company, and gained access to a MVA technology platform.
- Completed a contract modification with HHS for the delivery of an additional 5 million doses of BioThrax, with over 4 million doses delivered by December 2006.
- Signed a contract amendment with the DoD for the delivery of approximately 1 million additional doses of BioThrax, with final delivery scheduled by September 2007.
- Initiated a Phase II clinical development program for our typhoid vaccine candidate in adolescents and children in Vietnam, and initiated a Phase II clinical trial for our hepatitis B therapeutic vaccine candidate in chronic carriers in the U.K.
- Signed a clinical trial agreement with the NIAID under which the NIAID will conduct a follow-on Phase I clinical trial for our advanced group B streptococcus vaccine candidate.
- Finalized a license and development agreement with Sanofi Pasteur for the continued development of our meningitis B vaccine.
- Completed the construction phase of our new large-scale manufacturing facility in Lansing, Michigan.

is endemic, and we initiated a Phase II clinical development program for a trial in adolescents and children, also in Vietnam.

- We initiated a Phase II clinical trial for our hepatitis B therapeutic vaccine candidate in chronic carriers in the U.K., and we expanded the clinical sites for this trial to accelerate recruitment.
- We completed a Phase I clinical trial for our group B streptococcus vaccine candidate that uses a single novel recombinant protein and, building on the promising results of that study, the National Institute of Allergy and Infectious Diseases (NIAID) agreed to conduct a follow-on Phase I clinical trial for our advanced vaccine candidate.
- We finalized a license and development agreement with Sanofi Pasteur for the continued development of our meningitis B vaccine.
- We continued to develop our two technology platforms — *spi*-VEC™ and MVA (modified vaccinia Ankara) — as vectors for the development of potential new candidates against other life threatening diseases.

Manufacturing Operations

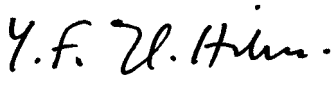
We completed the construction phase of our new large-scale manufacturing facility in Lansing, Michigan. This facility is designed to manufacture up to 40 million doses of BioThrax per year on a single line, and it is potentially expandable to up to 80 million doses with the introduction of a second line. This facility has been designed for flexibility and will allow us to manufacture multiple vaccine products in addition to BioThrax.

Positioned For Growth

Our 2006 accomplishments position us well for future growth. Vaccines and therapeutics remain a critically important component of global public health. With our talent, our focus on product development and manufacturing, our balanced approach between vaccines and therapeutics across two attractive markets, and our measurable financial performance, we are well positioned to continue our progress and growth. We believe there are significant opportunities in both markets, and we look forward to capturing them.

In closing, I would like to thank all of our employees around the world for their tireless effort and sustained commitment, and to our Board of Directors for their continued counsel and guidance. I would also like to acknowledge the continued support of our key customers and the contributions of our collaborators and vendors. Finally, thank you to our stockholders for your confidence in and support of our company.

Sincerely yours,

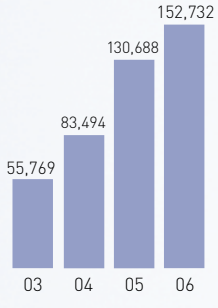


Fuad El-Hibri
Chairman and Chief Executive Officer

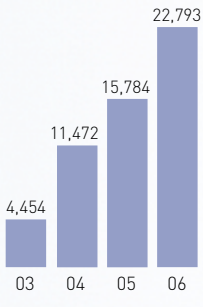
April 2007

Financial Highlights

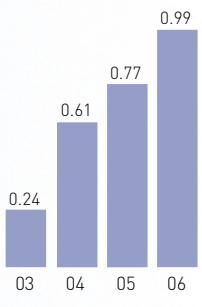
REVENUE
(dollars in thousands)



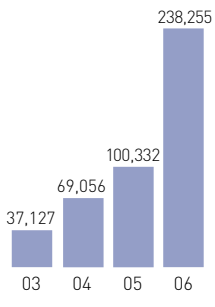
NET INCOME
(dollars in thousands)



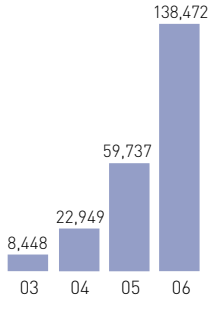
EARNINGS PER SHARE
(dollars)



TOTAL ASSETS
(dollars in thousands)



STOCKHOLDERS' EQUITY
(dollars in thousands)



Emergent BioSolutions Inc. is a biopharmaceutical company focused on the development, manufacture and commercialization of immunobiotics, consisting of vaccines and therapeutics that induce or assist the body's immune system to prevent or treat disease.

Our accomplishments are measurable: we deliver results.

We are focused.

Our strategy is to focus on product development, from proof-of-concept to commercialization.

We seek to avoid the time, risk and cost of early stage research by concentrating instead on development. We acquire product candidates that are at the proof-of-concept stage and take them from the lab into the real world.

We are balanced.

Our approach is to achieve balance in the markets that we serve and the products that we develop.

We employ a balanced approach to business. We operate in the biodefense and commercial business segments, both of which are attractive markets providing opportunity for growth. We maintain a product portfolio comprised of both vaccines and therapeutics. We use multiple established technologies to develop and manufacture our product candidates.

We are profitable.

Our model is to reinvest our profits to generate long-term growth.

We have achieved five consecutive years of profitability as a result of both growth in revenues and disciplined financial operations. Our fundamental approach to managing our business includes operating within our means and balancing growth with financial responsibility.

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We deliver results.

Our approach has enabled us to reliably manufacture and deliver our biodefense product, significantly enhance our portfolio of product candidates and steadily grow our financial performance.

We take pride in what we have accomplished over the past nine years. We delivered 19 million doses of BioThrax and helped protect over 1.5 million military personnel. We were first to supply a vaccine into the strategic national stockpile under Project BioShield. We have acquired three product development companies and established and further developed a portfolio of promising product candidates that address global public health needs.

The future is ours to create.
Why not create one free of disease?

Driving corporate performance through five key strategies for growth.

Our goal is to improve the health and protect the lives of people around the globe by becoming a worldwide leader in developing, manufacturing and commercializing immunobiotics. Core to achieving this goal are our five key strategies for growth.

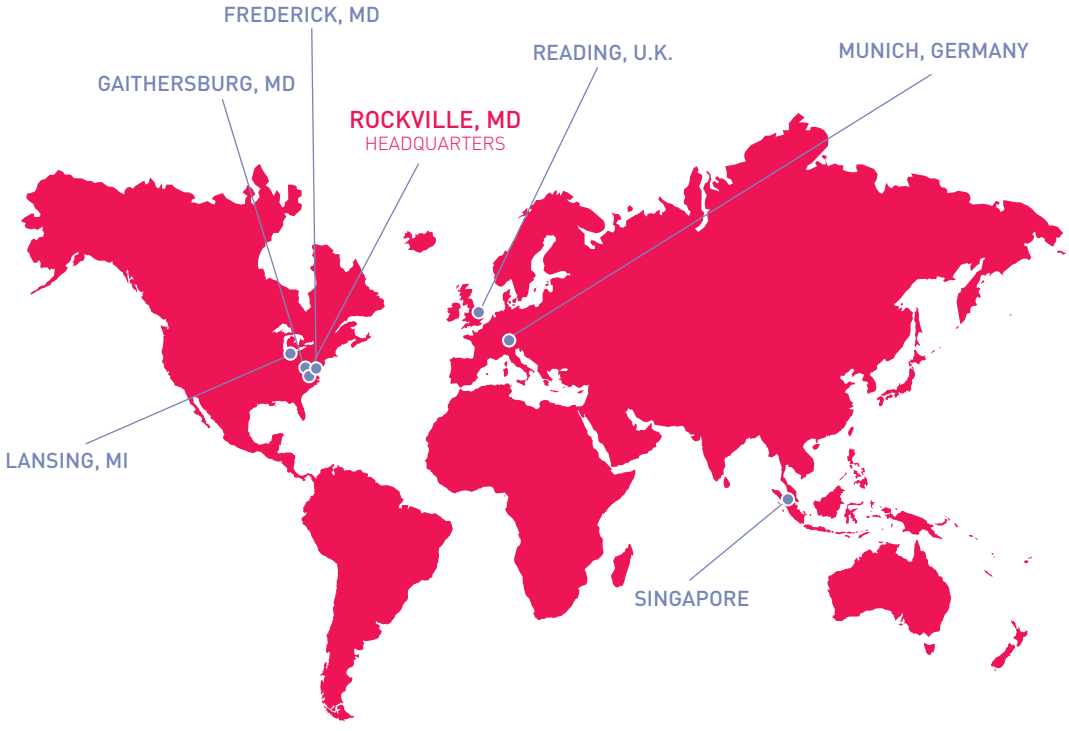
- **Operate in two attractive business segments.**
  We operate in two business segments — biodefense and commercial — both of which provide attractive opportunities for growth. We seek to maintain a balanced product portfolio consisting of vaccines and therapeutics to diversify product development and commercialization risk. We use multiple established technologies to develop and manufacture our product candidates, which further reduces our risk.

- **Focus on development, not research.**
  We focus our efforts on our core capabilities of immunobiotic product development and manufacturing. This approach enables us to avoid the expense and time entailed in early stage research activities while reducing product development and commercialization risk.

- **Leverage core competency in manufacturing.**
  We are constructing a new 50,000 square-foot manufacturing facility on our Lansing, Michigan campus to augment our existing manufacturing capabilities. We are constructing our new facility as a large-scale commercial manufacturing plant that we can use to produce multiple vaccine products.

- **Mitigate costs with non-dilutive relationships.**
  We continuously pursue grants, clinical trial support and other non-dilutive arrangements with governmental and non-governmental agencies to advance the development of both our biodefense and commercial product candidates.

- **Grow through acquisition.**
  We seek to opportunistically obtain products and product candidates through acquisitions and licensing arrangements with third parties. We believe that we have secured — and will be able to continue to secure — rights to a diverse product pipeline focused on immunobiotics for use against biological agents that are potential weapons of bioterrorism or biowarfare or that address significant unmet or undeserved public health needs. We also believe that this approach may enable us to accelerate product development timelines.



Creating a global footprint.

Because our products address worldwide needs, we are expanding our presence around the globe. That includes manufacturing facilities in the United States, product development operations in the United States and Europe, and marketing and sales offices in the United States, Singapore and Germany. We also work with third-party marketing representatives in the Middle East, Turkey, India, Australia and several Scandinavian countries.

Leading the way in the expanding biodefense market.

Our product portfolio is focused on countering biological agents that are potential weapons of bioterrorism and biowarfare.

BIODEFENSE PRODUCTS

	PRECLINICAL	PHASE 1	PHASE 2	PHASE 3
BioThrax®(Anthrax Vaccine Adsorbed)				
Next Generation Anthrax Vaccine				
Anthrax Immune Globulin				
Recombinant Botulinum Vaccine				
Botulinum Immune Globulin				

Since 1998, we have supplied a total of 19 million doses of BioThrax® (Anthrax Vaccine Adsorbed) to the U.S. Department of Defense for active immunization of military personnel and to the U.S. Department of Health and Human Services for placement into the nation's strategic national stockpile.

APPROVED

The biodefense market for immunobiotics has grown dramatically as a result of the increased awareness of the threat of global terror activity in the wake of the September 11, 2001 terrorist attacks and the October 2001 anthrax letter attacks. At Emergent BioSolutions, we take seriously the role we play to help combat bioterrorism.

Our biodefense product portfolio focuses on two category A biological agents, which are the class of biological agents that the Centers for Disease Control and Prevention has identified as the greatest possible threat to public health.

We market and sell BioThrax to the DoD and HHS with a small, targeted marketing and sales group, and since 1998, we have delivered 19 million doses of BioThrax under our contracts with the DoD and HHS.

In our effort to expand the domestic customer base for BioThrax, we are approaching first responders, which include fire, police and emergency medical personnel, at the state and local levels.

Internationally, we have opened offices in Munich and Singapore, hired personnel to develop international market opportunities and signed agreements with marketing representatives to develop regional markets.

We are also evaluating several potential product candidates in connection with the development of a next generation anthrax vaccine featuring attributes such as use with antibiotics as a post-exposure treatment for anthrax infection, an extended shelf life, new routes of administration, a reduced number of required doses and stability at room temperature.

In addition, our biodefense product portfolio includes our anthrax immune globulin (AIG), which we are developing as a therapeutic treatment for patients with symptoms of anthrax disease. We received a development grant from NIAID of up to $3.7 million to support pivotal animal studies and assay development related to our AIG product candidate. We also entered into an exclusive agreement with Talecris to use its FDA-licensed manufacturing process to produce our AIG product candidate, and they have already manufactured our first consistency lot. More recently, we filed an Investigational New Drug Application (IND) with the United States Food and Drug Administration (FDA) to conduct a Phase I clinical trial of our AIG product candidate.

Helping the helpers.

Our biodefense product portfolio focuses on two category A biological agents, the class identified by the Centers for Disease Control and Prevention as having the greatest potential for adversely impacting public health.

Advancing the fight against global infectious diseases.

Our product candidates are intended to improve and protect the lives of millions around the world.

COMMERCIAL PRODUCTS

	PRECLINICAL	PHASE 1	PHASE 2	PHASE 3
Typhoid Vaccine				
Hepatitis B Therapeutic Vaccine				
Group B Streptococcus Vaccine				
Meningitis B Vaccine				
Chlamydia Vaccine				

Vaccines have long been recognized as a safe and cost-effective method for preventing infection caused by various bacteria and viruses. Because of an increased emphasis on preventative medicine in industrialized countries, vaccines are now well recognized as an important part of public health management strategies. According to Frost & Sullivan, a market research organization, from 2002 to 2005 annual worldwide vaccine sales increased from $6.7 billion to $9.9 billion, a compound annual growth rate of approximately 14%. Frost & Sullivan estimates that the worldwide sales of vaccines will grow at a compound annual rate of approximately 10.5% from 2005 through 2012.

In our commercial business, we are developing a range of immunobiotic product candidates that are designed to address significant unmet or underserved public health needs caused by infectious diseases.

With a typhoid vaccine, hepatitis B therapeutic vaccine and a group B streptococcus vaccine in clinical development, and a chlamydia vaccine and a meningitis B vaccine in preclinical development, we are seeking to establish Emergent BioSolutions as an important global vaccine developer.

We continue to seek ways to mitigate the financial hurdles inherent in the development of commercial vaccines. For example, The Wellcome Trust provided funding for the Phase I clinical trial of our typhoid vaccine candidate in Vietnam and has agreed to provide funding for the Phase II clinical trial of this vaccine candidate in Vietnam.

Additionally, in 2006 we entered into a clinical trial agreement with NIAID under which NIAID has agreed to fund, manage and conduct an additional clinical trial of our group B streptococcus vaccine product candidate.

Working to help conquer typhoid.

Each year some 22 million cases of typhoid occur worldwide, killing approximately 200,000 people. We are developing a single dose, drinkable typhoid vaccine that, if approved, would provide an enhanced course of treatment compared to the currently approved typhoid vaccines.

Leveraging our expertise in manufacturing.

Our core competence in manufacturing is a cornerstone of our competitive advantage and a source of tangible corporate differentiation.

Independently manufacturing our product and expanding our ability to manufacture product candidates gives us a number of important advantages. It saves money, gives us greater control over the manufacturing and regulatory approval process, and can accelerate product development.

We manufacture BioThrax at our 12.5-acre campus located in Lansing, Michigan using cGMP manufacturing procedures. In order to enhance our ability to address our expanding product development requirements, we recently commissioned a pilot plant facility on our Lansing campus. In addition, we are constructing a new 50,000 square-foot manufacturing facility on our Lansing campus to expand our manufacturing capacity and to meet the needs of both current and future customers. We completed construction of this facility in 2006 and expect to conduct installation, validation and qualification activities required for regulatory approval during 2007 and 2008. This high tech, state-of-the-art facility is designed for flexibility in both upstream and down-stream manufacturing.

We are constructing this new facility as a large-scale manufacturing plant that will enable us to manufacture multiple vaccine products in addition to BioThrax.

We anticipate that we will begin large-scale manufacturing of BioThrax for commercial sale at the new facility in 2008. This facility is designed to manufacture up to 40 million doses of BioThrax per year on a single production line and can produce up to 80 million doses with the introduction of a second production line. By comparison, our current facility has a current maximum production capacity of approximately 9 million doses of BioThrax per year.

In addition to the Lansing campus, we own two buildings of approximately 145,000 square feet each, on a 15-acre site in Frederick, Maryland. We are establishing plans to build out this site to provide laboratory space, product development and pilot plant production capabilities, full-scale commercial manufacturing operations, warehouse and storage facilities, fill and finish operations and administrative office space.

These manufacturing initiatives provide us with greater flexibility and independence in addressing our future requirements for process development, the manufacture of clinical supplies of our product candidates and, ultimately, commercial production of approved products.

Expanding manufacturing capacity.

Our multi-building campus in Lansing, Michigan consists of facilities for bulk manufacturing (including fermentation, filtration and formulation) of BioThrax. The campus also provides raw material storage and in-process and final product warehousing.

Our Lansing expansion includes a new 50,000 square-foot manufacturing facility. This high-tech, state-of-the-art facility is designed for flexibility and will provide manufacturing capability of multiple vaccine products in addition to BioThrax.

Our Frederick, Maryland site consists of two facilities that are available for future product development, pilot plant production, full-scale commercial manufacturing operations, warehouse and storage, fill and finish operations and administrative office space.

Delivering results for nearly a decade.

Our history shows a track record of delivering financial results, manufacturing consistency, product advancement and improvement, and an unwavering commitment to protecting lives through the delivery of 19 million doses of BioThrax.

Company Milestones

1998

Michigan Biologic Products Institute assets acquired

2001

Lansing facility renovation approved by FDA

2003

Antex Biologics (U.S.) acquired

Business Achievements

1998

$129M, 5.5M dose, 3-year (extended to 6-year) BioThrax contract signed with DoD
DELIVERED

2001

$83M, 2-year cost reimbursement contract signed with DoD
COMPLETED

Our story

Even though we just became a public company in 2006, our roots go back to 1998 when we were incorporated as BioPort Corporation and acquired the assets of the Michigan Biologic Products Institute. In this acquisition, we secured rights to BioThrax, vaccine manufacturing facilities, and vaccine development and production technology. We acquired our pipeline of commercial product candidates through our acquisition of Antex Biologics, Inc. in 2003, Microscience Limited in 2005, and ViVacs GmbH in 2006.

EBS
LISTED
NYSE

Emergent BioSolutions' common stock began trading on November 15, 2006 on the New York Stock Exchange under the symbol **EBS.**

2004

Future manufacturing facility (U.S.) acquired

2005

Microscience Ltd. (U.K.) acquired

$124M, 5M dose, 3-year BioThrax contract signed with DoD
DELIVERY IN PROGRESS

$123M, 5M dose BioThrax contract signed with HHS
DELIVERED

2006

ViVacs GmbH (Germany) acquired

Initial Public Offering and NYSE listing completed

Meningitis B vaccine collaboration signed with Sanofi Pasteur providing payments of up to €73M
DEVELOPMENT UNDERWAY

$120M, 5M dose BioThrax amended contract signed with HHS
DELIVERED

2007

Building an executive management team for future success.

Our leadership team comprises senior level executives with experience and relationships in both the biodefense and commercial business segments.

Senior Executive Team

Thomas K. Zink, M.D.
Chief Medical Officer

Edward J. Arcuri, Ph.D.
Chief Operating Officer

Fuad El-Hibri
Chief Executive Officer
and Chairman of the
Board of Directors

R. Don Elsey
Chief Financial Officer

Robert G. Kramer, Sr.
Executive Vice President,
Worldwide Manufacturing

Daniel J. Abdun-Nabi
President

Steven N. Chatfield, Ph.D.
Chief Scientific Officer

Board of Directors

Fuad El-Hibri
Chairman and
Chief Executive Officer,
Emergent BioSolutions Inc.

Zsolt Harsanyi, Ph.D. [1*,2,3*,4]
Chairman and
Chief Executive Officer,
Exponential Biotherapies, Inc.

Ronald B. Richard [1,2*,3]
President and
Chief Executive Officer,
The Cleveland Foundation

Jerome M. Hauer
Chief Executive Officer,
The Hauer Group, LLC;
Former Director,
City of New York Office of
Emergency Management

Shahzad Malik, M.D. [1,2]
General Partner,
Advent Venture
Partners LLP

Louis W. Sullivan, M.D.
President Emeritus,
Morehouse School of Medicine;
Former Secretary, Department
of Health and Human Services

Joseph M. Allbaugh
President and Chief Executive Officer,
The Allbaugh Company, LLC;
Former Director, Federal Emergency
Management Agency

1 Audit Committee
2 Compensation Committee
3 Nominating & Corporate
Governance Committee
4 Lead Independent Director
* Chairman of Committee

Corporate Executive Officers

Fuad El-Hibri
Chairman of the Board of Directors
and Chief Executive Officer

Daniel J. Abdun-Nabi
President and Secretary

Edward J. Arcuri, Ph.D.
Chief Operating Officer

R. Don Elsey
Vice President, Finance,
Chief Financial Officer and Treasurer

Robert G. Kramer, Sr.
Executive Vice President,
Worldwide Manufacturing

Steven N. Chatfield, Ph.D.
Senior Vice President
and Chief Scientific Officer

Thomas K. Zink, M.D.
Senior Vice President
and Chief Medical Officer

Kyle W. Keese
Senior Vice President,
Marketing and Communications

Denise Esposito
Senior Vice President,
Legal Affairs, and General Counsel

Mauro Gibellini
Senior Vice President,
Corporate Development

Heads of Operating Subsidiaries

Robert G. Kramer, Sr.
President and Chief Executive Officer,
Emergent Biodefense Operations
Lansing Inc.

Steven N. Chatfield, Ph.D.
President, Emergent Product
Development U.K. Limited

Michael J. Langford, DVM, Ph.D.
President, Emergent Product
Development Gaithersburg Inc.

Andreas Hartmann, Ph.D.
Managing Director, Emergent
Product Development
Germany GmbH

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2006 FINANCIAL REPORT

SELECTED CONSOLIDATED FINANCIAL DATA

You should read the following selected consolidated financial data together with our consolidated financial statements and the related notes included in this annual report and the "Management's Discussion and Analysis of Financial Condition and Results of Operations" section of this annual report.

We have derived the consolidated statement of operations data for the years ended December 31, 2004, 2005 and 2006 and the consolidated balance sheet data as of December 31, 2005 and 2006 from our audited consolidated financial statements, which are included in this annual report. We have derived the consolidated statements of operations data for the years ended December 31, 2002 and 2003 and the consolidated balance sheet data as of December 31, 2002, 2003 and 2004 from our audited consolidated financial statements, which are not included in this annual report. Our historical results for any prior period are not necessarily indicative of results to be expected in any future period.

	Year Ended December 31,				
	2002	2003	2004	2005	2006
(in thousands, except share and per share data)					
Statements of operations data:					
Revenues:					
Product sales	$ 61,253	$ 55,536	$ 81,014	$ 127,271	$ 147,995
Contracts and grants	17,288	233	2,480	3,417	4,737
Total revenues	78,541	55,769	83,494	130,688	152,732
Operating expenses (income):					
Cost of product sales	24,569	22,342	30,102	31,603	24,125
Research and development	2,808	6,327	10,117	18,381	45,501
Selling, general & administrative	13,397	19,547	30,323	42,793	44,601
Purchased in-process research and development	—	1,824	—	26,575	477
Settlement of State of Michigan obligation	—	—	(3,819)	—	—
Litigation settlement	—	—	—	(10,000)	—
Total operating expenses	40,774	50,040	66,723	109,352	114,704
Income (loss) from operations	37,767	5,729	16,771	21,336	38,028
Other income (expense):					
Interest income	80	100	65	485	846
Interest expense	(451)	(293)	(241)	(767)	(1,152)
Other income (expense), net	(271)	168	6	55	293
Total other income (expense)	(642)	(25)	(170)	(227)	(13)
Income before provision for income taxes	37,125	5,704	16,601	21,109	38,015
Provision for income taxes	733	1,250	5,129	5,325	15,222
Net income	$ 36,392	$ 4,454	$ 11,472	$ 15,784	$ 22,793
Earnings per share—basic	$ 1.97	$ 0.24	$ 0.61	$ 0.77	$ 0.99
Earnings per share—diluted	$ 1.75	$ 0.22	$ 0.56	$ 0.69	$ 0.93
Weighted average number of shares—basic	18,441,235	18,904,992	18,919,850	20,533,471	23,039,794
Weighted average number of shares—diluted	20,752,243	20,316,752	20,439,252	22,751,733	24,567,302

	As of December 31,				
	2002	2003	2004	2005	2006
(in thousands)					
Balance sheet data:					
Cash and cash equivalents	$ 4,891	$ 7,119	$ 6,821	$ 36,294	$ 76,418
Working capital	1,130	(3,147)	7,509	29,023	82,990
Total assets	22,790	37,127	69,056	100,332	238,255
Total long-term liabilities	4,592	1,228	11,921	10,502	35,436
Total stockholders' equity	4,155	8,448	22,949	59,737	138,472

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

You should read the following discussion and analysis of our financial condition and results of operations together with our financial statements and the related notes and other financial information included elsewhere in this annual report. Some of the information contained in this discussion and analysis or set forth elsewhere in this annual report, including information with respect to our plans and strategy for our business and related financing, includes forward-looking statements that involve risks and uncertainties. You should review the "Special Note Regarding Forward Looking Statements" section of this annual report for a discussion of important factors that could cause actual results to differ materially from the results described in or implied by the forward-looking statements contained in the following discussion and analysis.

OVERVIEW

We are a biopharmaceutical company focused on the development, manufacture and commercialization of immunobiotics. We operate in two business segments: biodefense and commercial. We commenced operations as BioPort Corporation in September 1998 through an acquisition from the Michigan Biologic Products Institute of rights to our 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, we 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 our manufacturing facility license for the manufacture of BioThrax at the renovated facilities.

In June 2004, we completed a corporate reorganization in which we:

- 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;
- repurchased and retired all other issued and outstanding shares of BioPort class B common stock; and
- assumed all outstanding stock options to purchase BioPort class B common stock and granted option holders replacement stock options to purchase an equal number of shares of our class B common stock.

As a result of the reorganization, BioPort became a wholly owned subsidiary of Emergent. We subsequently renamed BioPort as Emergent BioDefense Operations Lansing Inc. We acquired our portfolio of commercial vaccine candidates through our acquisition of Microscience Limited in a share exchange in June 2005 and our acquisition for cash of substantially all of the assets of Antex Biologics Inc. in May 2003 and ViVacs GmbH in July 2006. We subsequently renamed Microscience as Emergent Product Development UK Limited, Antex as Emergent Product Development Gaithersburg Inc., and ViVacs as Emergent Product Development Germany GmbH. We expect to continue to seek to obtain marketed products and development stage product candidates through acquisitions and licensing arrangements with third parties.

Our biodefense business has generated net income for each of the last three fiscal years. However, in our commercial business, we have not received approval to market any of our product candidates and, to date, have received no product sales revenues. Our only sources of revenue in our commercial business are development grant funding and an upfront license fee and additional payments for development work under a collaboration agreement with Sanofi Pasteur. As a result, our commercial business has incurred a net loss for each of the last three fiscal years.

Biodefense

In our biodefense business, we develop and commercialize immunobiotics for use against biological agents that are potential weapons of bioterrorism or biowarfare. Our marketed product, BioThrax, is the only vaccine approved by the FDA for the prevention of anthrax infection. The U.S. Department of Defense (DoD) and the U.S. Department of Health and Human Services (HHS) have been the principal customers for BioThrax. In addition, we have supplied small amounts of BioThrax directly to several foreign governments. Since 1998, we have been a party to two supply agreements for BioThrax with the DoD. Pursuant to these contracts, we have supplied over nine million doses of BioThrax through December 2006 for immunization of military personnel. Our most recent contract with the DoD, which was amended in October 2006, provides for the supply of a minimum of approximately 1.5 million doses of BioThrax to the DoD through September 2007. We delivered to the DoD approximately 480,000 of these doses in December 2006, and we expect to deliver the balance by September 2007. The DoD's right to order additional doses of BioThrax under this contract expired in February 2007. Since May 2005, we have supplied 10 million doses of BioThrax to HHS for inclusion in the Strategic National Stockpile (SNS). In May 2005, we entered into an agreement to supply five million doses of BioThrax for the strategic national stockpile, or SNS, for a fixed price of $123 million. We completed delivery of all five million doses by February 2006, seven months earlier than required. In May 2006, we entered into a contract modification with HHS for the delivery of an additional five million doses of BioThrax for the SNS by May 2007 for a fixed price of $120 million. We delivered approximately four million of those doses in 2006 and the balance in February 2007, more than two months earlier than required.

We have derived and expect for the foreseeable future to continue to derive substantially all of our revenue from sales of BioThrax. Our total revenues from BioThrax sales were $81.0 million in 2004, $127.3 million in 2005 and $148.0 million in 2006. We are focused on increasing sales of BioThrax to U.S. government customers, expanding the market for BioThrax to other customers and pursuing label expansions and improvements for BioThrax.

In addition to BioThrax, our biodefense product portfolio includes three biodefense product candidates in preclinical development. We are independently developing an anthrax immune globulin candidate, in part with funding from the National Institute of Allergy and Infectious Disease (NIAID). We are collaborating with the U.K. Health Protection Agency (HPA) in the development of a recombinant bivalent botulinum vaccine candidate and a new botulinum toxoid vaccine that we plan to use as the basis for a botulinum immune globulin candidate. We are actively pursuing additional government sponsored development grants and working with various government agencies to encourage them to conduct studies relating to BioThrax and our other biodefense product candidates.

Commercial

In our commercial business, we are developing a range of immunobiotic product candidates that are designed to address significant unmet or underserved public health needs caused by infectious diseases. Our commercial product portfolio includes a typhoid vaccine candidate and a hepatitis B therapeutic vaccine candidate, both of which are in Phase II clinical development, a group B streptococcus vaccine candidate in Phase I clinical development and a chlamydia vaccine candidate and a meningitis B vaccine candidate, both of which are in preclinical development. In May 2006, we entered into a license and co-development agreement with Sanofi Pasteur under which we granted Sanofi Pasteur an exclusive, worldwide license under our proprietary technology to develop and commercialize a meningitis B vaccine candidate.

We plan to encourage government entities and non-government and philanthropic organizations to provide development funding for, or to conduct clinical studies of, one or more of our commercial product candidates. For example, the Wellcome Trust provided funding for our Phase I clinical trial of our typhoid vaccine candidate in Vietnam and is providing funding for our Phase II clinical trial of this vaccine candidate in Vietnam. In addition, the NIAID agreed to sponsor Phase I clinical development of our group B streptococcus vaccine candidate.

Manufacturing Infrastructure

To augment our existing manufacturing capabilities, we are constructing a new 50,000 square foot manufacturing facility on our Lansing, Michigan campus. We expect the construction of the facility to cost approximately $75 million, including approximately $55 million for the building and associated capital equipment, with the balance related to validation and qualification activities required for regulatory approval and initiation of manufacturing. We incurred costs of approximately $37 million for these purposes through 2006. We substantially completed construction of this facility in 2006, and expect to conduct installation, validation and qualification activities required for regulatory approval during 2007 and 2008. We are constructing this new facility as a large scale manufacturing plant that we can use to produce multiple vaccine products, subject to complying with appropriate change-over procedures. We anticipate that we will initiate large scale manufacturing of BioThrax for commercial sale at the new facility in 2008. Our plans assume that the FDA will not require us to complete a human bridging trial demonstrating that BioThrax manufactured at our new facility is bioequivalent to BioThrax manufactured at our existing facility. We currently expect to rely on non-clinical studies for these purposes. However, the FDA has not approved our plan to rely on non-clinical studies without conducting a human bridging trial and may not do so. If the FDA requires us to conduct a human bridging trial, the initiation of large scale manufacturing of BioThrax for commercial sale at our new facility will be delayed and we will incur additional unanticipated costs.

We also own two buildings in Frederick, Maryland that are available to support our future manufacturing requirements. We incurred costs of approximately $1 million related to initial engineering design and preliminary utility build out of these facilities during 2006. Because we are in the preliminary planning stages of our Frederick build out, we cannot reasonably estimate the timing and costs that will be necessary to complete this project. If we proceed with this project, we expect the costs to be substantial and to likely require external sources of funds to finance the project. We may elect to lease all or a substantial portion of one of these facilities to third parties.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Our discussion and analysis of our financial condition and results of operations are based on our financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts

of assets, liabilities and expenses. On an ongoing basis, we evaluate our estimates and judgments, including those related to accrued expenses, fair valuation of stock related to stock-based compensation and income taxes. We based our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities and the reported amounts of revenues and expenses that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

We believe the following critical accounting policies affect our more significant judgments and estimates used in the preparation of our financial statements.

Revenue Recognition

We recognize revenues from product sales in accordance with Staff Accounting Bulletin No. 104, *Revenue Recognition,* or SAB 104. SAB 104 requires recognition of revenues from product sales that require no continuing performance on our part if four basic criteria have been met:

- there is persuasive evidence of an arrangement;
- delivery has occurred or title has passed to our customer based on contract terms;
- the fee is fixed and determinable and no further obligation exists; and
- collectibility is reasonably assured.

We cannot sell BioThrax to our customers without written FDA approval for each lot that we manufacture. As part of the FDA review process, we submit a detailed lot protocol for each BioThrax lot that we produce for sale. We also are required to submit product samples to the FDA for testing. Although we generally submit lot protocols and product samples promptly following the satisfactory completion of internal testing, we are permitted to submit product samples in advance of the lot protocols. The length of the FDA review process is approximately four to six weeks. However, individual lots may be released sooner or later depending on factors such as reviewer questions, license supplement approval, reviewer availability and whether our internal testing of product samples is completed before or concurrently with FDA testing. During the period covered by our financial statements included in this annual report, the FDA has not denied the sale of any BioThrax lots that we have submitted for approval.

We have generated BioThrax sales revenues under U.S. government contracts with the DoD and HHS. Under our DoD contract, we invoice the DoD for progress payments upon reaching contractually specified stages in the manufacture of BioThrax. We record as deferred revenue the full amount of each progress payment invoice that we submit to 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, we segregate the product for later shipment and recognize as period revenue all deferred revenue related to the released product in accordance with the "bill and hold" sale requirements under SAB 104. At that time, we also invoice the DoD for the final progress payment and recognize the amount of that invoice as period revenue. Our contract with HHS does not provide for progress payments. We invoice HHS and recognize the related revenue upon delivery of the product to the government carrier, at which time title to the product passes to HHS. We do not record allowances for sales returns, rebates or special promotional programs for sales of BioThrax or provisions for sales made in prior periods.

Under the collaboration agreement that we entered into with Sanofi Pasteur in May 2006 for our meningitis B vaccine candidate, we received an upfront license fee and are entitled to additional payments for development work under the collaboration and upon achieving contractually defined development and commercialization milestones. We evaluate the various components of a collaboration in accordance with Emerging Issues Task Force, or EITF, Issue No. 00-21, *Accounting for Revenue Arrangements with Multiple Deliverables,* or EITF No. 00-21, which addresses whether, for revenue recognition purposes, there is one or several elements in an arrangement. We concluded that under EITF No. 00-21, the upfront license fee, the development work and the milestone payments under our agreement with Sanofi Pasteur should be accounted for as a single unit of accounting. We recognize amounts received under this agreement over the estimated development period as we perform services. We recorded the amount of the upfront license fee as deferred revenue. We are recognizing this revenue over the estimated development period under the contract, currently estimated at seven years, as adjusted from time to time for any delays or acceleration in the development of the product candidate. Under the collaboration agreement, we are entitled to payments up to specified levels for development work we perform for Sanofi Pasteur. We invoice Sanofi Pasteur in advance of each quarter for the estimated work to occur in the upcoming quarter. We record the invoice amount as deferred revenue. As services are completed, we recognize the amount of the related deferred revenue as period revenue. Under the collaboration agreement, we also will be entitled to royalty payments on any future net sales of this product candidate.

From time to time, we are awarded reimbursement contracts for services and development grant contracts with government entities and non-government and philanthropic organizations. Under these contracts, we typically are reimbursed for our costs in connection with specific development activities and may also be entitled to additional fees. We record the reimbursement of our costs and any associated fees as contract and grant revenue and the associated costs as research and development expense. We issue invoices under these contracts after we incur the reimbursable costs. We recognize revenue upon invoicing the sponsoring organization.

Accounts Receivable

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. Because the prior collection history for receivables from these entities indicate that collection is likely, we do not currently record an allowance for doubtful accounts.

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. We analyze our inventory levels quarterly and write 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. We also write off in the applicable period the costs related to expired inventory. We capitalize the costs associated with the manufacture of BioThrax as inventory from the initiation of the manufacturing process through the completion of manufacturing, labeling and packaging.

Accrued Expenses

As part of the process of preparing financial statements, we are required to estimate accrued expenses. This process involves identifying services that have been performed on our behalf and estimating the level of service performed and the associated cost incurred for such service where we have not yet been invoiced or otherwise notified of actual cost. We make these estimates as of each balance sheet date in our financial statements. Examples of estimated accrued expenses include:

- fees payable to contract research organizations in conjunction with clinical trials;
- fees payable to third party manufacturers in conjunction with the production of clinical trial materials; and
- professional service fees.

In accruing service fees, we estimate the time period over which services were provided and the level of effort in each period. If the actual timing of the provision of services or the level of effort varies from the estimate, we will adjust the accrual accordingly. The majority of our service providers invoice us monthly in arrears for services performed. In the event that we do not identify costs that have begun to be incurred or we underestimate or overestimate the level of services performed or the costs of such services, our actual expenses could differ from such estimates. The date on which some services commence, the level of services performed on or before a given date and the cost of such services are often subjective determinations. We make judgments based upon the facts and circumstances known to us.

Purchased In-process Research and Development

We account for purchased in-process research and development in accordance with Statement of Financial Accounting Standards, or SFAS, No. 2, *Accounting for Research and Development Costs along with Financial Accounting Standards Board,* or FASB, Interpretation No. 4, *Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method.*

Under these standards, we are required to determine whether the technology relating to a particular research and development project we acquire has an alternative future use. If we determine that the technology has no alternative future use, we expense the value of the research and development project not directly attributed to fixed assets. Otherwise, we capitalize the value of the research and development project not attributable to fixed assets as an intangible asset and conduct an impairment analysis at least annually. In connection with our acquisition of Microscience and our acquisition of substantially all of the assets of Antex and ViVacs, we allocated the value of the purchase consideration to current assets, current liabilities, fixed assets and development programs. Because we determined that the development programs at Microscience, Antex and ViVacs had no future alternative use, we charged the value attributable to the development programs as in-process research and development. For the Microscience acquisition, which was a share exchange, our board of directors determined the fair value of our shares issued in the exchange for financial statement purposes. For the Antex and ViVacs acquisitions, which were cash transactions, no fair value determination was necessary.

Stock-based Compensation

Through December 31, 2005, in accordance with SFAS No. 123, *Accounting for Stock-Based Compensation,* we elected to account for our employee stock-based compensation using the intrinsic value method in accordance with Accounting Principles Board, or APB, Opinion No. 25, *Accounting for Stock Issued to Employees, and related interpretations,* or APB No. 25, rather than the alternative fair value accounting method provided for under SFAS No. 123. Accordingly, we did not record compensation expense on employee stock options granted in fixed amounts and with fixed exercise prices when the exercise prices of the options were equal to the fair value of the underlying common stock on the date of grant. Pro forma information regarding net loss and loss per share is required by SFAS No. 123 and has been determined as if we had accounted for employee stock option grants under the fair value method prescribed by that statement. We provide this pro forma disclosure in our financial statements. We account for transactions in which services are received in exchange for equity instruments based on the fair value of the services received from non-employees or of the equity instruments issued, whichever is more reliably measured, 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,* or EITF No. 96-18. In accordance with EITF No. 96-18, we periodically remeasure stock-based compensation for options granted to non-employees as the underlying options vest. As of December 31, 2006, we had no outstanding options that had been granted to non-employees other than our directors.

We adopted SFAS No. 123 (revised 2004), *Share-Based Payment,* or SFAS No. 123(R), on January 1, 2006 using the modified prospective method. SFAS No. 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their estimated fair values. Pro forma disclosure is no longer an alternative. We will continue to value our share-based payment transactions using a Black-Scholes valuation model. Under the modified prospective method, we recognize compensation cost in our financial statements for all awards granted after January 1, 2006 and for all awards outstanding as of January 1, 2006 for which the requisite service had not been rendered as of the date of adoption. Prior period operating results have not been restated. We measure the amount of compensation cost based on the fair value of the underlying common stock on the date of grant. We recognize compensation cost over the period that an employee provides service in exchange for the award.

As a result of our adoption of SFAS No. 123(R) effective January 1, 2006, we recorded stock-based compensation expense of $513,000 in 2006 related to stock options that were outstanding and had not completely vested as of January 1, 2006. During 2006, we granted 1,289,433 stock options. We recorded additional stock-based compensation expense of $210,000 related to these options in 2006. Both basic and diluted net income per share for 2006 are $0.02 less than if we had continued to account for stock-based compensation under APB No. 25. The effect of adopting SFAS No. 123(R) on net loss and net loss per share is not necessarily representative of the effects in future years due to, among other things, the vesting period of the stock options and the fair value of additional stock option grants in future years. Based on options granted to employees as of December 31, 2006, total compensation expense not yet recognized related to unvested options is approximately $3.1 million, after tax. We expect to recognize that expense over a weighted average period of 2.9 years. Based on options granted to employees as of December 31, 2006, we expect to recognize amortization of stock-based compensation, after tax, of $1.3 million in 2007, $1.0 million in 2008 and $815,000 in 2009.

Income Taxes

We account for income taxes in accordance with SFAS No. 109, *Accounting for Income Taxes.* Under the asset and liability method of SFAS No. 109, deferred tax assets and liabilities are determined based on the differences between the financial reporting and the tax bases of assets and liabilities and are measured using the tax rates and laws that are expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. A net deferred tax asset or liability is reported in the balance sheet. Our deferred tax assets include the unamortized portion of in-process research and development expenses, the anticipated future benefit of the net operating losses that we have incurred and other timing differences between the financial reporting basis of assets and liabilities. We have historically incurred net operating losses for income tax purposes in some states and in some foreign jurisdictions, primarily the United Kingdom. The amount of the deferred tax assets on our balance sheet reflects our expectations regarding our ability to use our net operating losses to offset future taxable income. The applicable tax rules in particular jurisdictions limit our ability to use net operating losses as a result of ownership changes. In particular, we believe that these rules will significantly limit our ability to use net operating losses generated by Microscience and Antex prior to our acquisition of Microscience in June 2005 and our acquisition of substantially all of the assets of Antex in May 2003.

We review our deferred tax assets on a quarterly basis to assess our ability to realize the benefit from these deferred tax assets. If we determine that it is more likely than not that the amount of our expected future taxable income will not be sufficient to allow us to fully utilize our deferred tax assets, we increase our valuation allowance against deferred tax assets by recording a provision for income taxes on our income statement, which reduces net income, or increases net loss, for that period and reduces our deferred tax assets on our balance sheet. If we determine that the amount of our expected future taxable income will allow us to utilize net operating losses in excess of our net deferred tax assets, we reduce our valuation allowance by recording a benefit from income taxes on our income statement, which increases net income, or reduces net loss, for that period and increases our deferred tax assets on our balance sheet.

FINANCIAL OPERATIONS OVERVIEW

Revenues

We have generated substantially all of our revenues from sales of BioThrax. We delivered approximately 5.2 million and 6.1 million total doses of BioThrax in 2005 and 2006, respectively, representing 97% of our total revenues in both years. The DoD and HHS have been the principal customers for BioThrax. We also have had limited sales of BioThrax to foreign governments and private industry. In addition, we periodically realize revenues from grants from government entities and non-government and philanthropic organizations and from licensing fees, milestone payments and development reimbursement payments. These items accounted for 3% of our total revenues in each of 2005 and 2006. If our ongoing development efforts are successful, we would expect to generate revenues from sales of additional products and milestone payments, development payments and royalties on sales of products that we license to third parties.

In May 2005, we entered into an agreement to supply five million doses of BioThrax to HHS for the SNS for a fixed price of $123 million. We completed delivery of all five million doses by February 2006, seven months earlier than required. In May 2006, we entered into a contract modification with HHS for the delivery of an additional five million doses of BioThrax for the SNS by May 2007 for a fixed price of $120 million. We delivered approximately four million of these doses in December 2006 and the balance in February 2007, more than two months earlier than required.

In January 2004, we entered into our current contract with the DoD for the delivery of a minimum number of doses of BioThrax over one base contract year plus two option periods for a minimum fixed price of approximately $91 million. Under the original terms of this contract, we were required to deliver a minimum of approximately 3.8 million total doses through September 2006. We delivered approximately 4.9 million total doses under this contract from 2004 through September 30, 2006 pursuant to DoD purchase orders. Our current contract with the DoD was amended to provide for the supply of a minimum of approximately 1.5 million additional doses of BioThrax to the DoD through September 2007. We delivered to the DoD approximately 480,000 of these doses in December 2006, and we expect to deliver the balance by September 2007. We have invoiced the DoD, as contemplated under this contract, for progress payments as doses of BioThrax are manufactured for sale to the DoD. In accordance with our revenue recognition policy, we record deferred revenue for invoiced amounts until the FDA releases the product for sale and delivery. As of December 31, 2006, we had no deferred revenue for DoD sales. In April 2006, the DoD issued a notice that it intends to negotiate a sole source fixed price contract for the purchase of up to an additional 11 million doses of BioThrax over one base year plus four option years. The DoD has not issued a formal request for proposals for such a contract and we have not yet entered into an agreement with the DoD for this procurement.

In May 2006, we entered into a collaboration agreement with Sanofi Pasteur relating to the development and commercialization of our meningitis B vaccine candidate and received a $3.8 million upfront license fee. This agreement also provides for a series of milestone payments upon the achievement of specified development and commercialization objectives, payments for development work under the collaboration and royalties on net sales of this product. We deferred the upfront license fee, milestone payments and development reimbursement payments under this agreement, and will record revenue in accordance with our revenue recognition policies.

Our revenue, operating results and profitability have varied, and we expect that they will continue to vary, on a quarterly basis primarily because of the timing of our fulfilling orders for BioThrax. We expect contracts and grant revenues to increase in 2007 compared to 2006 as we receive reimbursement for development expenses under our meningitis B collaboration with Sanofi Pasteur, funding from the Wellcome Trust for costs associated with our completed Phase I clinical trial and initiated Phase II clinical trial of our typhoid vaccine candidate in Vietnam and funding from NIAID for costs associated with our animal efficacy studies for our anthrax immune globulin candidate.

Cost of Product Sales

The primary expense that we incur to deliver BioThrax to our customers is manufacturing costs, which are primarily fixed costs. These fixed manufacturing costs consist of attributable facilities, utilities and salaries and personnel related expenses for indirect manufacturing support staff. Variable manufacturing costs for BioThrax consist primarily of costs for materials, direct labor and contract filling operations. In 2005, we improved manufacturing efficiencies for BioThrax. As a result, the cost of product sales per dose of BioThrax decreased in 2006 compared to 2005, as well as in 2005 compared to 2004. We do not expect further significant improvements in manufacturing efficiencies for BioThrax until we complete our new manufacturing facility in Lansing, Michigan. We expect our manufacturing costs to remain relatively stable during 2007.

We determine the cost of product sales for doses sold for a period based on the average manufacturing cost per dose for that period. We calculate the average manufacturing cost per dose by dividing the actual costs of manufacturing in the applicable period by the number of units produced in that period. In addition to the fixed and variable manufacturing costs described above, the average manufacturing cost per dose depends on the efficiency of the manufacturing process, utilization of available manufacturing capacity and the production yield for any period.

Research and Development Expenses

We expense research and development costs as incurred. Our research and development expenses consist primarily of:

- salaries and related expenses for personnel;
- fees to professional service providers for, among other things, preclinical and analytical testing, independently monitoring our clinical trials and acquiring and evaluating data from our clinical trials;
- costs of contract manufacturing services;
- costs of materials used in clinical trials and research and development;
- depreciation of capital assets used to develop our products; and
- operating costs, such as the operating cost of facilities and the legal costs of pursuing patent protection of our intellectual property.

The successful development of our product candidates is highly uncertain. We believe that significant investment in product development is a competitive necessity and plan to continue these investments in order to be in a position to realize the potential of our product candidates. We cannot reasonably estimate or know the nature, timing and projected costs of the efforts that will be necessary to complete the remainder of the development for our product candidates, or the period, if any, in which material net cash inflows may commence from any of our product candidates. This is due to the numerous risks and uncertainties associated with developing drugs, including the uncertainty of:

- the scope, rate of progress and expense of our clinical trials and other research and development activities;
- our ability to obtain adequate supplies of our product candidates required for later stage clinical trials, including from third party manufacturers;
- the potential benefits of our product candidates over other products;
- our ability to market, commercialize and achieve market acceptance for any of our product candidates that we are developing or may develop in the future;
- future clinical trial results;
- the terms and timing of regulatory approvals; and
- the expense of filing, prosecuting, defending and enforcing any patent claims and other intellectual property rights.

A change in the outcome of any of these variables with respect to the development of a product candidate could mean a significant change in the costs and timing associated with the development of that product candidate.

We expect that development spending will increase for all of our biodefense product candidates as our product development activities continue and we prepare for regulatory submissions and other regulatory activities. We expect our development expenses in our commercial business to increase in connection with our ongoing activities, particularly as we conduct additional and later stage clinical trials for our product candidates.

We expect that the magnitude of any increase in our research and development spending will be dependent upon such factors as the results from our ongoing preclinical studies and clinical trials, the size, structure and duration of any follow on clinical program that we may initiate, cost associated with manufacturing our product candidates on a large scale basis for later stage clinical trials, our ability to use data generated by government agencies, such as the ongoing Centers for Disease Control and Prevention (CDC) studies with BioThrax, and our ability to rely upon and utilize clinical and non-clinical data, such as the data generated by CDC from use of the pentavalent botulinum toxoid vaccine previously manufactured by the State of Michigan. Furthermore, if the FDA or other regulatory authority were to require us to conduct clinical trials beyond those which we currently anticipate will be required for the completion of clinical development of a product candidate or if we experience significant delays in enrollment in any of our clinical trials, we could be required to expend significant additional financial resources and time on the completion of clinical development.

Selling, General and Administrative Expenses

Selling, general and administrative expenses consist primarily of salaries and other related costs for personnel serving the executive, sales and marketing, business development, finance, accounting, information technology, legal and human resource functions. Other costs include facility costs not otherwise included in cost of product sales or research and development expense and professional fees for legal and accounting services. We expect that our general and administrative expenses will increase as we add personnel to support the increased scale of our operations and become subject to the reporting obligations applicable to public companies. Our general and administrative expenses have increased as a result of preparing for our initial public offering and subsequently operating as a public company and supporting the overall growth of the company. We currently market and sell BioThrax directly to the DoD and HHS with a small, targeted marketing and sales group. As we seek to broaden the market for BioThrax and if we receive marketing approval for additional products, we expect that we will increase our spending for marketing and sales activities.

Total Other Income (Expense)

Total other income (expense) consists principally of interest income and interest expense. We earn interest on our cash, cash equivalents and short-term investments, and we incur interest expense on our indebtedness. Our interest income may increase in future periods as a result of the investment of the net proceeds from our initial public offering. Our net interest expense will increase in future periods as compared to prior periods as a result of the mortgage loan that we entered into in April 2006 and the term loan that we entered into in August 2006, as well as any borrowings under our revolving lines of credit. In addition, some of our existing debt arrangements provide for increasing amortization of principal payments in future periods. See "Liquidity and Capital Resources—Debt Financing" for additional information.

RESULTS OF OPERATIONS

YEAR ENDED DECEMBER 31, 2006 COMPARED TO YEAR ENDED DECEMBER 31, 2005

Revenues

Product sales revenues increased by $20.7 million, or 16%, to $148.0 million for 2006 from $127.3 million for 2005. This increase in product sales revenues was primarily due to a 18% increase in the number of doses of BioThrax delivered. Product sales revenues in 2006 consisted of BioThrax sales to HHS of $109.8 million, sales to the DoD of $37.4 million and aggregate international and other sales of $763,000. Product sales revenues in 2005 consisted of BioThrax sales to HHS of $111.2 million, sales to the DoD of $14.5 million and aggregate international and other sales of $1.6 million.

Contracts and grant revenues increased by $1.3 million, or 39%, to $4.7 million in 2006 from $3.4 million in 2005. Contracts and grant revenues for 2006 consisted of $3.2 million in upfront and development program revenue from the Sanofi Pasteur collaboration and $1.5 million in grant revenue from the Wellcome Trust. Contracts and grant revenues for 2005 resulted from reimbursement from the DoD for expenses related to production development and supply chain management improvements for BioThrax incurred in prior periods, and for additional work that we performed on a project basis for the DoD's Defense Advanced Research Projects Agency, or DARPA, to evaluate a new vaccine adjuvant for BioThrax.

Cost of Product Sales

Cost of product sales decreased by $7.5 million, or 24%, to $24.1 million for 2006 from $31.6 million for 2005. This decrease was attributable to improved utilization of our manufacturing capacity for BioThrax, partially offset by an increase of approximately 900,000 BioThrax doses delivered. Manufacturing efficiencies resulted in a cost savings of approximately $13.1 million. The increase in the number of doses delivered resulted in an increase in costs of approximately $5.6 million.

Research and Development Expenses

Research and development expenses increased by $27.1 million to $45.5 million for 2006 from $18.4 million for 2005. This increase reflects increased expenses of $11.9 million in the biodefense segment and $15.9 million in the commercial segment, offset by a reduction of $633,000 in other research and development expense.

The increase in biodefense spending was attributable to increased efforts on all our biodefense programs as we completed various studies and began subsequent studies and trials. This increase primarily reflects additional personnel and contract service costs. The increase in spending for BioThrax enhancements is related to preparing for animal efficacy studies to support applications for marketing approval of these enhancements, which we expect to submit to the FDA in late 2008 or early 2009. The increase in spending for immune globulin development related primarily to costs associated with our plasma donor stimulation program for our anthrax immune globulin candidate. The increase in spending for the recombinant botulinum vaccine program, which is in preclinical development, resulted from advancing this program to the process development stage and the manufacture of clinical trial material. The increase in spending for the next generation anthrax vaccine program, which has product candidates in preclinical and

Phase I clinical development, resulted from feasibility studies and formulation development of product candidates.

The increase in commercial spending was mainly attributable to spending on the commercial products listed in the table below following our acquisition of Microscience in June 2005. This increase primarily reflects additional personnel and contract service costs. Research and development spending by Microscience prior to our acquisition of Microscience in June 2005 is not included in our results for 2005. The spending for our typhoid vaccine candidate resulted from ongoing work for the Phase I clinical trial in Vietnam that we recently completed and preparing for our Phase II clinical trial in Vietnam that we initiated in the fourth quarter of 2006. The spending in 2006 for our hepatitis B therapeutic vaccine candidate resulted from preparing for our Phase II clinical trial, which we received regulatory clearance to commence in the fourth quarter of 2006. The spending in 2006 for our group B streptococcus vaccine candidate resulted from costs associated with our analysis of results from the Phase I clinical trial that we recently completed for one of the protein components of the vaccine candidate and preparation for Phase I clinical trials for two of the protein components of the vaccine candidate. In December 2006, we signed an agreement with the NIAID under which the NIAID has agreed to sponsor a Phase I clinical trial of a each of the two components seperately and the two-proteins in combination in healthy human volunteers. Both our chlamydia vaccine and meningitis B vaccine candidates are in preclinical development.

The decrease in other research and development expenses was primarily attributable to our discontinuation of preclinical programs that we acquired from Antex and determined not to pursue at that time.

Our principal research and development expenses for 2005 and 2006 are shown in the following table:

	Year ended December 31,	
	2005	**2006**
(in thousands)		
Biodefense:		
BioThrax enhancements	$ 2,883	$ 7,232
Immune globulin development	5,309	11,289
Recombinant bivalent botulinum vaccine	1,708	2,610
Next generation anthrax vaccine	427	1,088
Total biodefense	10,327	22,219
Commercial:		
Typhoid vaccine	1,477	9,642
Hepatitis B therapeutic vaccine	1,884	4,058
Group B streptococcus vaccine	1,032	3,759
Chlamydia vaccine	837	1,991
Meningitis B vaccine	1,334	2,975
Total commercial	6,564	22,425
Other	1,490	857
Total	$18,381	$45,501

Selling, General and Administrative Expenses

Selling, general and administrative expenses increased by $1.8 million, or 4%, to $44.6 million for 2006 from $42.8 million for 2005. Selling, general and administrative expenses related to our biodefense segment decreased by $508,000, or 1%, to $35.0 million for 2006 from $35.5 million for 2005. Selling, general and administrative expenses related to our commercial segment increased by $2.3 million, or 32%, to $9.6 million for 2006 from $7.3 million for 2005. The increase in the commercial segment was primarily attributable to an increase in general and administrative expenses of approximately $1.0 million resulting from the addition of personnel and increased legal and other professional services for our headquarters organization, and an increase of $937,000 related to the addition of personnel for Emergent Product Development UK.

Purchased In-process Research and Development

In June 2005, we recorded a non-cash charge for purchased in-process research and development of $26.6 million associated with our acquisition of Microscience. We valued the 3,636,801 shares of class A common stock that we issued in the acquisition at $28.2 million after the inclusion of acquisition costs. Of this amount, we identified $1.4 million as current assets, $0.9 million as fixed assets, $0.7 million as current liabilities and $26.6 million as the value attributable to development programs. Because we determined that the development programs had no future alternative use, we charged the value attributable to the development programs as purchased in-process research and development. We are amortizing this charge for tax purposes over 15 years.

In July 2006, we recorded a non-cash charge for purchased in-process research and development of $477,000 associated with our acquisition of ViVacs. We paid total purchase consideration of $250,000 and assumed a net deficit of liabilities in excess of assets of $47,000. We valued the acquisition at $430,000 after the inclusion of acquisition costs. Of this amount, we identified $153,000 as current assets, $97,000 as fixed assets, $297,000 as current liabilities and $477,000 as the value attributable to development programs and technology. Because we determined that the development programs and technology had no future alternative use, we charged the value attributable to the development programs and technology as purchased in-process research and development. We are amortizing this charge for tax purposes over 15 years.

Litigation Settlement

In June 2005, we recorded a gain of $10.0 million relating to a settlement of a litigation matter that we initiated to resolve a contract and intellectual property dispute. There were no material settlements during 2006.

Total Other Income (Expense)

Total other expense decreased by $214,000 to $13,000 for 2006 from $227,000 for 2005. This decrease resulted primarily from an increase in interest income of $361,000 as a result of higher investment return on increased average cash balances, including the net proceeds of our initial public offering, and an increase in other income of $238,000, offset by an increase in interest expense of $385,000 related primarily to the mortgage loan we entered into in April 2006 and the term loan we entered into in August 2006.

Income Taxes

Provision for income taxes increased by $9.9 to $15.2 million for 2006 from $5.3 million for 2005. The provision for income taxes for 2006 resulted primarily from our income before provision for income taxes of $38.0 million and an effective annual tax rate of 40%. The provision for income taxes for 2005 resulted primarily from our income before provision for income taxes of $21.1 million and an effective annual tax rate of 25%. The increase in the effective annual tax 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 provision for income taxes also reflects research and development tax credits of $759,000 for 2006 and $474,000 for 2005.

YEAR ENDED DECEMBER 31, 2005 COMPARED TO YEAR ENDED DECEMBER 31, 2004

Revenues

Product sales revenues increased by $46.3 million, or 57%, to $127.3 million for 2005 from $81.0 million for 2004. This increase in product sales revenues was primarily due to a 52% increase in the number of doses delivered. Product sales revenues in 2005 consisted of BioThrax sales to HHS of $111.2 million, sales to the DoD of $14.5 million and aggregate international sales of $1.6 million. Product sales revenues in 2004 consisted of BioThrax sales to the DoD of $80.6 million and international sales of $360,000.

Contracts and grant revenues increased by $937,000, or 38%, to $3.4 million in 2005 from $2.5 million in 2004 primarily as a result of additional work that we performed on a project basis for DARPA to evaluate a new vaccine adjuvant for BioThrax.

Cost of Product Sales

Cost of product sales increased by $1.5 million, or 5%, to $31.6 million for 2005 from $30.1 million for 2004. This increase was attributable to the delivery of 1.8 million additional doses of BioThrax in 2005 and a decrease in production yield, resulting in a higher average manufacturing cost per dose in 2005, offset by improved utilization of our manufacturing capacity for BioThrax as a result of extending the hours of operation for our manufacturing facility. The increase in the number of doses delivered combined with the decrease in production yield resulted in additional costs of $6.6 million. Manufacturing efficiencies resulted in a cost savings of $5.1 million.

Research and Development Expenses

Research and development expenses increased by $8.3 million, or 82%, to $18.4 million for 2005 from $10.1 million for 2004. This increase reflects increased expenses of $4.0 million in the biodefense segment and $5.8 million in the commercial segment, offset by a reduction of $1.6 million in other research and development expenses.

The increase in spending in the biodefense segment resulted from costs associated with our plasma collection program for our anthrax immune globulin candidate, process development related to our recombinant botulinum vaccine candidate and evaluation of third party technology related to our next generation anthrax vaccine program for potential acquisition or in license, offset by decreased spending on BioThrax enhancements. In 2004, the immune globulin program was in initial development and we had not yet begun work on the recombinant botulinum vaccine and next generation anthrax vaccine candidates. The decrease in spending on BioThrax enhancements resulted from substantial completion during 2004 of research regarding manufacturing process development for BioThrax to improve the stability and consistency of production lots.

The increase in spending in the commercial segment was attributable to spending on the commercial programs listed in the table below following our acquisition of Microscience in June 2005. Research and development spending by Microscience is not included in our results prior to the acquisition date. The commercial spending in 2005 resulted from the Phase I clinical trial in Vietnam for our typhoid vaccine candidate, preparation for a planned Phase II clinical trial for our hepatitis B therapeutic vaccine candidate, including the manufacture of clinical trial material, preparation for one of three planned Phase I clinical trials related to one of the protein components of our group B streptococcus vaccine candidate and preclinical work for our chlamydia vaccine and meningitis B vaccine candidates.

The decrease in spending on other research and development expenses was attributable to our discontinuation of preclinical programs that we acquired from Antex and determined not to pursue at that time.

Our principal research and development expenses for 2004 and 2005 are shown in the following table:

	Year ended December 31,	
	2004	**2005**
(in thousands)		
Biodefense:		
BioThrax enhancements	$ 5,929	$ 2,883
Immune globulin development	350	5,309
Recombinant bivalent botulinum vaccine	—	1,708
Next generation anthrax vaccine	—	427
Total biodefense	6,279	10,327
Commercial:		
Typhoid vaccine	—	1,477
Hepatitis B therapeutic vaccine	—	1,884
Group B streptococcus vaccine	—	1,032
Chlamydia vaccine	1,136	837
Meningitis B vaccine	—	1,334
Total commercial	1,136	6,564
Other	2,702	1,490
Total	$10,117	$18,381

Selling, General and Administrative Expenses

Selling, general and administrative expenses increased by $12.5 million, or 41%, to $42.8 million for 2005 from $30.3 million for 2004. Selling, general and administrative expenses related to our biodefense segment increased by $6.4 million to $35.5 million for 2005 from $29.0 million for 2004. Selling, general and administrative expenses related to our commercial segment increased by $6.0 million to $7.3 million for 2005 from $1.3 million for 2004. The increase in the biodefense segment was attributable to an increase in general and administrative expenses of $5.5 million resulting from additional personnel and professional service providers for our headquarters organization who devoted time to the biodefense segment and an increase in sales and marketing expenses of $1.0 million resulting from the addition of sales personnel to investigate potential other markets for BioThrax. The increase in the commercial segment was attributable to an increase in general and administrative expenses of $5.3 million resulting from the addition of personnel for Emergent Product Development UK and legal expenses associated with reorganizing our corporate structure following our acquisition of Microscience in June 2005.

Purchased In-process Research and Development

In 2005, as described above, we recorded a non-cash charge of $26.6 million for purchased in-process research and development associated with our acquisition of Microscience.

Litigation Settlement

In 2005, we recorded a gain of $10.0 million relating to a settlement of a litigation matter that we initiated to resolve a contract and intellectual property dispute. There were no material settlements in 2004.

Total Other Income (Expense)

Total other expense increased by $57,000 to $227,000 for 2005 from $170,000 for 2004. This increase resulted primarily from an increase in interest expense associated with our financing of the acquisition costs for one building at our Frederick facility.

Income Taxes

Provision for income taxes increased by $196,000, or 4%, to $5.3 million for 2005 from $5.1 million for 2004. The provision for income taxes for 2005 resulted primarily from our income before provision for income taxes of $21.1 million and an effective annual tax rate of 25%. The provision for income taxes for 2004 resulted primarily from our income before provision for income taxes of $16.6 million and an effective annual tax rate of 31%. The provision for income taxes also reflects research and development tax credits of $474,000 for 2005 and $492,000 for 2004 and small amounts of permanent tax differences in each year.

LIQUIDITY AND CAPITAL RESOURCES

Sources of Liquidity

We require cash to meet our operating expenses and for capital expenditures, acquisitions and principal and interest payments on our debt. We have funded our cash requirements from inception through December 31, 2006 principally with a combination of revenues from BioThrax product sales, debt financings and facilities and equipment leases, revenues under our collaboration agreement with Sanofi Pasteur, development funding from government entities and non-government and philanthropic organizations and, to a lesser extent, from the sale of our common stock upon exercise of stock options. We have operated profitably for each of the years in the three year period ended December 31, 2006.

As of December 31, 2006, we had cash and cash equivalents of $76.4 million. On November 20, 2006, we completed our initial public offering, in which we raised $54.2 million, net of issuance costs.

Cash Flows

The following table provides information regarding our cash flows for the years ended December 31, 2004, 2005 and 2006.

	Year ended December 31,		
	2004	**2005**	**2006**
(in thousands)			
Net cash provided by (used in):			
Operating activities[1]	$ 9,196	$41,974	$ (4,258)
Investing activities	(18,175)	(5,841)	(41,638)
Financing activities	8,681	(6,660)	86,020
Total net cash provided (used)	$ (298)	$29,473	$ 40,124

(1) Includes the effect of exchange rate changes on cash and cash equivalents.

Net cash used in operating activities of $4.3 million in 2006 resulted principally from our net income of $22.8 million, an increase in income taxes payable of $11.5 million due to the timing of payment of the 2006 income tax liability, an increase in accounts payable of $5.8 million related to increased research and development and selling, general and administrative expenses, and depreciation and amortization expense of $4.7 million, offset by an increase in accounts receivable of $40.8 million due from the DoD and HHS reflecting amounts billed in December 2006 that were still outstanding at year end, and a reduction in inventory of $8.3 million reflecting product sales in December 2006.

Net cash provided by operating activities of $42.0 million in 2005 resulted principally from our net income of $15.8 million, a non-cash charge for purchased in-process research and development related to the Microscience acquisition, which reduced net income by $26.6 million, and a reduction of accounts receivable of $16.1 million as a result of the collection of amounts due from the DoD during 2005 for invoices outstanding at the end of 2004 for progress in the manufacture of BioThrax lots, offset by a reduction of deferred revenue of $10.9 million, reflecting the delivery to the DoD in the first quarter of 2005 of BioThrax lots for which we had previously invoiced the DoD for progress payments and been paid, and an increase in deferred tax assets of $11.0 million, reflecting a deferred tax asset recorded to reflect the timing differences between the book charge and the tax deferral of expense related to the purchased in-process research and development expense related to the Microscience acquisition.

Net cash provided by operating activities of $9.2 million in 2004 resulted principally from our net income of $11.5 million, a non-cash stock-based compensation charge that we incurred as a result of our issuance of new stock options in our corporate reorganization in June 2004, which reduced net income by $4.3 million, an increase in income taxes payable of $5.8 million related to the timing of payment of taxes and related deferred tax assets, and an increase in deferred revenue of $3.9 million, reflecting invoices to and payments from the DoD for progress in the manufacture of BioThrax lots, offset by an increase in accounts receivable of $15.7 million, reflecting invoices for amounts due from the DoD for progress in the manufacture of BioThrax lots, and a one-time non-cash gain of $3.8 million resulting from the satisfaction of an obligation to the State of Michigan for less than originally estimated.

Net cash used in investing activities for the years ended December 31, 2004, 2005 and 2006 resulted principally from the purchase of property, plant and equipment. Capital expenditures in 2004 include infrastructure investments of $4.7 million, $3.8 million for an enterprise resource planning system and $8.5 million for the purchase of our first facility in Frederick, Maryland. Capital expenditures in 2005 were primarily attributable to investments in information technology upgrades and miscellaneous facility enhancements. Capital expenditures in 2006 relate primarily to $25.7 million for construction of our new building in Lansing, Michigan, $10.2 million related to the acquisition of our second facility in Frederick, Maryland, and approximately $5.0 million in infrastructure investments and other equipment.

Net cash provided by financing activities of $86.0 million in 2006 resulted primarily from $54.2 million in proceeds from our initial public offering, $15.0 million in proceeds related to financing a portion of the costs related to the construction of our new building in Lansing, $8.5 million in proceeds from notes payable related to the financing of the purchase of our Frederick facility in April 2006, and $8.9 million in proceeds from our revolving line of credit with Fifth Third Bank.

Net cash used in financing activities of $6.7 million in 2005 resulted principally from the payment of a special dividend of $5.4 million from a portion of the proceeds of a litigation settlement and the repayment of notes payable to employees.

Net cash provided by financing activities of $8.7 million in 2004 resulted principally from an increase in notes payable as a result of $11.0 million of total debt incurred to finance the purchase of our first facility in Frederick, Maryland and to finance the purchase of an enterprise resource planning system, offset by the repayment of non-recurring royalty and product supply obligations to the State of Michigan of $2.4 million.

Contractual Obligations

The following table summarizes our contractual obligations at December 31, 2006.

	Payments due by period						
	Total	**2007**	**2008**	**2009**	**2010**	**2011**	**After 2011**
(in thousands)							
Contractual obligations:							
Short and long-term debt[1]	$52,413	$13,956	$5,049	$4,831	$4,626	$21,451	$2,500
Operating lease obligations	9,178	1,726	1,866	634	651	669	3,632
Contractual settlement liabilities	200	150	50	—	—	—	—
Total contractual obligations	$61,791	$15,832	$6,965	$5,465	$5,277	$22,120	$6,132

(1) Includes scheduled interest payments.

The preceding table excludes contingent contractual payments that we may become obligated to make upon achievement of specified research, development and commercialization milestones and contingent contractual royalty payments. The amount of contingent contractual milestone payments that we may become obligated to make is variable based on the actual achievement and timing of the applicable milestones and the characteristics of any products or product candidates that are developed, including factors such as number of products or product candidates developed, type and number of components of each product or product candidate, ownership of the various components and the specific markets affected. Based on our current development plans, we estimate that the maximum amount of these contingent contractual milestone payments under our existing contracts would be approximately $11 million. We are not obligated to pay any minimum royalties under our existing contracts.

Debt Financing

As of December 31, 2006, we had $42.8 million principal amount of debt outstanding, comprised primarily of the following:

- $2.5 million outstanding under a forgivable loan from the Department of Business and Economic Development of the State of Maryland used to finance eligible costs incurred to purchase the first facility in Frederick, Maryland;
- $7.0 million outstanding under a mortgage loan from Mercantile Potomac Bank used to finance the remaining portion of the purchase price for the Frederick facility;
- $8.4 million outstanding under a mortgage loan from HSBC Realty Credit Corporation used to finance the purchase price for the second facility on the Frederick site;
- $1.0 million outstanding under a term loan from Fifth Third Bank used to finance the purchase of an enterprise resource planning system;
- $8.9 million outstanding under a $10.0 million revolving line of credit with Fifth Third Bank;
- $10.0 million outstanding under a term loan from HSBC Realty Credit Corporation used to finance a portion of the costs of our facility expansion in Lansing, Michigan; and
- $5.0 million outstanding under a $5.0 million revolving line of credit with HSBC Realty Credit Corporation.

We can borrow under the line of credit with Fifth Third Bank through May 2007 and under the line of credit with HSBC Realty Credit Corporation through October 2007.

Some of these debt instruments contain financial and operating covenants. In particular:

- Under our forgivable loan from the State of Maryland, we are not required to repay the principal amount of the loan if beginning December 31, 2009 and through 2012 we maintain a specified number of employees at the Frederick site, by December 31, 2009 we have invested at least $42.9 million in total funds toward financing the purchase of the buildings on the site and for related improvements and operation of the facility, and we occupy the facility through 2012.
- Under our mortgage loan from Mercantile Potomac Bank for our Frederick facility, we are required to maintain at all times a minimum tangible net worth of not less than $5.0 million. In addition, we are required to maintain at all times a ratio of earnings before interest, taxes, depreciation and amortization to the sum of current obligations under capital leases and principal obligations and interest expenses for borrowed money, in each case due and payable within the following 12 months, of not less than 1.1 to 1.0.
- Under our revolving line of credit with Fifth Third Bank, our wholly owned subsidiary, Emergent BioDefense Operations, is required to maintain at all times a ratio of total liabilities to tangible net worth of not more than 2.5 to 1.0.
- Under our term loan and revolving credit loan with HSBC Realty Credit Corporation, we are required to maintain on an annual basis a minimum tangible net worth of not less than the sum of 85% of our tangible net worth for the most recently completed fiscal year plus 25% of current net operating profit after taxes. In addition, we are 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.

Our debt instruments also contain negative covenants restricting our activities. Our term loan and revolving line of credit with HSBC Realty Credit Corporation limit the ability of Emergent BioDefense Operations to incur indebtedness and liens, sell assets, make loans, advances or guarantees, enter into mergers or similar transactions and enter into transactions with affiliates. Our term loan and revolving line of credit with HSBC Realty Credit Corporation has various limitations on our ability to incur indebtedness and liens and enter into mergers or similar transactions among others. Our line of credit with Fifth Third Bank limits the ability of Emergent BioDefense Operations to incur indebtedness and liens, sell assets, make loans, advances or guarantees, enter into mergers or similar transactions, enter into transactions with affiliates and amend the terms of any government contract.

The facilities, software and other equipment that we purchased with the proceeds of our loans from Mercantile Potomac Bank, the State of Maryland, HSBC Realty Credit Corporation and Fifth Third Bank serve as collateral for these loans. Our line of credit with Fifth Third Bank is secured by accounts receivable under our DoD and HHS contracts. Our term loan and revolving line of credit with HSBC Realty Credit Corporation are secured by substantially all of Emergent BioDefense Operations' assets, other than accounts receivable under our DoD and HHS contracts. The covenants under our existing debt instruments and the pledge of our existing assets as collateral limit our ability to obtain additional debt financing.

Under our mortgage loan from Mercantile Potomac Bank, we began to make monthly principal payments beginning in November 2006. A residual principal repayment of approximately $5.0 million is due upon maturity in October 2011.

Interest is payable monthly and accrues at an annual rate of 6.625% through October 2009. In October 2009, the interest rate is scheduled to be adjusted to a fixed annual rate equal to 3.20% over the yield on U.S. government securities adjusted to a constant maturity of two years.

Under our mortgage loan from HSBC Realty Credit Corporation, we are required to make monthly principal payments. A residual principal repayment of approximately $7.5 million is due upon maturity in April 2011. Interest is payable monthly and accrues at an annual rate equal to LIBOR plus 3.00%.

Under our term loan from Fifth Third Bank, we make monthly principal payments through maturity in September 2007. Interest is payable monthly and accrues at an annual rate equal to 0.375% less than the prime rate of interest established from time to time by Fifth Third Bank.

Under our revolving line of credit with Fifth Third Bank, any outstanding principal is due upon maturity in May 2007. The principal amount outstanding at any time under the line of credit may not exceed 75% of total eligible accounts receivable under the DoD and HHS contracts. Consistent with the terms of this agreement, we repaid $8.9 million of outstanding principal under the line of credit in January 2007. Interest is payable monthly and accrues at an annual rate equal to 0.375% less than the prime rate of interest established from time to time by Fifth Third Bank.

Under our term loan with HSBC Realty Credit Corporation, we are required to make monthly principal payments beginning in April 2007. A residual principal payment of approximately $5.6 million is due upon maturity in August 2011. Upon our request, the term loan is subject to an extension term in the sole discretion of HSBC Realty Credit Corporation 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, we 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%.

Under our revolving line of credit with HSBC Realty Credit Corporation, we are not required to repay outstanding principal until October 2007. In October 2007, the outstanding principal under the revolving line of credit 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%. We also are required to pay a fee on a quarterly basis equal to 0.50% of the average daily difference between $5.0 million and the amount outstanding under the revolving line of credit. As of December 31, 2006, $5.0 million was outstanding under the revolving line of credit.

Tax Benefits

In connection with our facility expansion in Lansing, the State of Michigan and the City of Lansing have provided us a variety of tax credits and abatements. We estimate that the total value of these tax benefits may be up to $18.5 million over a period of up to 15 years. These tax benefits are based on our $75 million planned additional investment in our Lansing facilities. In addition, we must maintain a specified number of employees in Lansing to continue to qualify for these tax benefits.

Funding Requirements

We expect to continue to fund our anticipated operating expenses, capital expenditures and debt service requirements from existing cash and cash equivalents, revenues from BioThrax product sales and other committed sources of funding. There are numerous risks and uncertainties associated with BioThrax product sales and with the development and commercialization of our product candidates. We may seek to raise additional external debt financing of up to $20 million to fund our facility expansion in Lansing, Michigan and to provide additional financial flexibility. In addition to purchase obligations and orders under our contract with the DoD for BioThrax sales, our only committed external sources of funds are remaining borrowing availability under our revolving line of credit with Fifth Third Bank, development funding under our collaboration agreement with Sanofi Pasteur, funding from NIAID, including for animal efficacy studies of our anthrax immune globulin candidate, and funding from the Wellcome Trust for our Phase II clinical trial of our typhoid vaccine candidate in Vietnam. Our ability to borrow additional amounts under our loan agreements is subject to our satisfaction of specified conditions. Our future capital requirements will depend on many factors, including:

- the level and timing of BioThrax product sales and cost of product sales;
- the timing of, and the costs involved in, constructing our new manufacturing facility in Lansing, Michigan and the build out of our manufacturing facility in Frederick, Maryland;
- the scope, progress, results and costs of our preclinical and clinical development activities;
- the costs, timing and outcome of regulatory review of our product candidates;
- the number of, and development requirements for, other product candidates that we may pursue;
- the costs of commercialization activities, including product marketing, sales and distribution;
- the costs involved in preparing, filing, prosecuting,

maintaining and enforcing patent claims and other patent-related costs, including litigation costs and the results of such litigation;
- the extent to which we acquire or invest in businesses, products and technologies;
- our ability to obtain development funding from government entities and non-government and philanthropic organizations; and
- our ability to establish and maintain collaborations, such as our collaboration with Sanofi Pasteur.

We may require additional sources of funds for future acquisitions that we may make or, depending on the size of the obligation, to meet balloon payments upon maturity of our current borrowings. To the extent our capital resources are insufficient to meet our future capital requirements, we will need to finance our cash needs through public or private equity offerings, debt financings or corporate collaboration and licensing arrangements.

Additional equity or debt financing, grants, or corporate collaboration and licensing arrangements, may not be available on acceptable terms, if at all. If adequate funds are not available, we may be required to delay, reduce the scope of or eliminate our research and development programs or reduce our planned commercialization efforts. If we raise additional funds by issuing equity securities, our stockholders may experience dilution. Debt financing, if available, may involve agreements that include covenants limiting or restricting our ability to take specific actions, such as incurring additional debt, making capital expenditures or declaring dividends. Any debt financing or additional equity that we raise may contain terms, such as liquidation and other preferences, that are not favorable to us or our stockholders. If we raise additional funds through collaboration and licensing arrangements with third parties, it may be necessary to relinquish valuable rights to our technologies or product candidates or grant licenses on terms that may not be favorable to us.

Effects of Inflation

Our most liquid assets are cash, cash equivalents and short-term investments. Because of their liquidity, these assets are not directly affected by inflation. We also believe that we have intangible assets in the value of our intellectual property. In accordance with generally accepted accounting principles, we have not capitalized the value of this intellectual property on our balance sheet. Due to the nature of this intellectual property, we believe that these intangible assets are not affected by inflation. Because we intend to retain and continue to use our equipment, furniture and fixtures and leasehold improvements, we believe that the incremental inflation related to replacement costs of such items will not materially affect our operations. However, the rate of inflation affects our expenses, such as those for employee compensation and contract services, which could increase our level of expenses and the rate at which we use our resources.

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,

We 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 we have not made a final determination of the effect the adoption of FIN 48 will have on our financial position and results of operations, it is expected that the cumulative adjustment to retained earnings will not have a material effect on our 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 SFAS 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. We have not yet determined the impact of the adoption of this statement on our financial statements.

In September 2006, the SEC issued Staff Accounting Bulletin (SAB 108), *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements.* 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 SFAS 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. We have not yet determined the impact of the adoption of this statement on our financial statements.

QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Our exposure to market risk is currently confined to our cash and cash equivalents and restricted cash that have maturities of less than three months. We currently do not hedge interest rate exposure or foreign currency exchange exposure. We have not used derivative financial instruments for speculation or trading purposes. Because of the short-term maturities of our cash and cash equivalents, we do not believe that an increase in market rates would have a significant impact on the realized value of our investments, but would likely increase the interest expense associated with our debt.

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.

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	December 31, 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.

CONSOLIDATED STATEMENTS OF OPERATIONS

	2004	2005	2006
(in thousands, except share and per share data)			
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.

CONSOLIDATED STATEMENTS OF CASH FLOWS

	Year Ended December 31,		
	2004	2005	2006
(in thousands)			
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.

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

	Class A No-Par Common Stock		Class B No-Par Common Stock		Class A $0.001 Par Value Common Stock	
	Shares	Amount	Shares	Amount	Shares	Amount
(in thousands, except share and per share data)						
Balance at December 31, 2003	18,017,994	$ 2,940	1,099,223	$101	—	$ —
Redemption of common stock	—	—	(573,322)	(53)	—	—
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
Conversion of class B no-par common stock to class A $.01 par value common stock	—	—	(648,485)	(60)	648,485	1
Stock-based compensation expense	—	—	—	—	—	—
Tax benefit related to the disqualifying disposition	—	—	—	—	—	—
Net Income	—	—	—	—	—	—
Balance at December 31, 2004	—	$ —	—	$ —	18,666,479	$ 19
Issuance of common stock to acquire Microscience Limited	—	—	—	—	3,636,801	3
Exercise of stock options	—	—	—	—	—	—
Redemption of common stock	—	—	—	—	—	—
Forfeiture of stock options	—	—	—	—	—	—
Payment of dividend	—	—	—	—	—	—
Net income	—	—	—	—	—	—
Foreign currency translation	—	—	—	—	—	—
Comprehensive income	—	—	—	—	—	—
Balance at December 31, 2005	—	$ —	—	$ —	22,303,280	$ 22
Exercise of stock options	—	—	—	—	—	—
Redemption of common stock	—	—	—	—	—	—
Conversion of class A $0.001 and class B par value $0.01 to $0.001 par value common stock	—	—	—	—	(22,303,280)	(22)
Issuance of common stock in initial public offering (net of issuance cost)	—	—	—	—	—	—
Stock-based compensation expense	—	—	—	—	—	—
Excess tax benefits from exercises of non-qualified stock options	—	—	—	—	—	—
Net income	—	—	—	—	—	—
Foreign currency translation	—	—	—	—	—	—
Comprehensive income	—	—	—	—	—	—
Balance at December 31, 2006	—	$ —	—	$ —	—	$ —

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

Class B $0.01 Par Value Common Stock		$0.001 Par Value Common Stock		Additional Paid-In Capital	Accumulated Other Comprehensive Loss	Retained Earnings	Total Stock-holders' Equity
Shares	Amount	Shares	Amount				
—	$—	—	$—	$ —	$ —	$ 5,407	$ 8,448
—	—	—	—	—	—	(1,559)	(1,612)
—	—	—	—	—	—	—	12
—	—	—	—	2,922	—	—	—
—	—	—	—	59	—	—	—
—	—	—	—	4,310	—	—	4,310
—	—	—	—	319	—	—	319
—	—	—	—	—	—	11,472	11,472
—	$—	—	$—	$ 7,610	$ —	$15,320	$ 22,949
—	—	—	—	26,998	—	—	27,001
133,451	1	—	—	32	—	—	33
(112,168)	(1)	—	—	(28)	—	(308)	(337)
—	—	—	—	(17)	—	—	(17)
—	—	—	—	—	—	(5,400)	(5,400)
—	—	—	—	—	—	15,784	15,784
—	—	—	—	—	(276)	—	(276)
—	—	—	—	—	—	—	15,508
21,283	$—	—	$—	$34,595	$(276)	$25,396	$ 59,737
95,858	1	175,828	—	589	—	—	590
—	—	—	—	—	—	(192)	(192)
(117,141)	(1)	22,420,421	23	—	—		
—	—	5,000,000	5	54,224	—	—	54,229
—	—	—	—	723	—	—	723
—	—	—	—	789	—	—	789
—	—	—	—	—	—	22,793	22,793
—	—	—	—	—	(197)	—	(197)
—	—	—	—	—	—	—	22,596
—	$—	27,596,249	$28	$90,920	$(473)	$47,997	$138,472

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 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 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 item(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.

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

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.

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		Emergent 2006 Plan	
	Number of Shares	Weighted-Average Exercise Price	Number of Shares	Weighted-Average Exercise 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 $91,000 for state jurisdictions and $77,000 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:

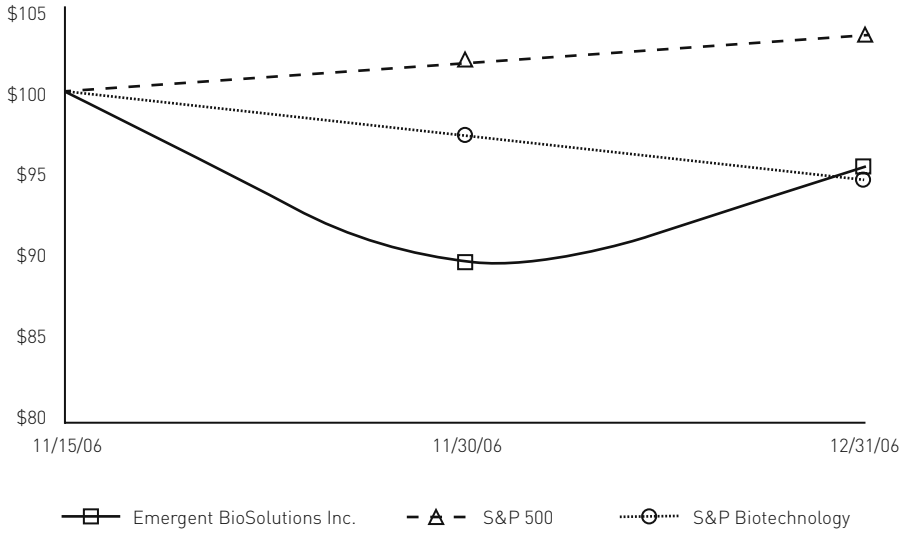
	Three months ended			
	March 31,	**June 30,**	**September 30,**	**December 31,**
Fiscal year 2006				
Revenue	$12,223	$11,446	$42,174	$86,889
Income (loss) from operations	(9,398)	(6,194)	9,720	43,900
Net income (loss)	(4,636)	(3,054)	4,354	26,129
Net income (loss) per share, basic	(0.21)	(0.14)	0.19	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

COMMON STOCK INFORMATION

STOCK PERFORMANCE GRAPH

The stock performance graph below compares the cumulative total stockholder return for our common stock between November 15, 2006, the date our common stock was first publicly traded, and December 31, 2006 with the cumulative total return of the S&P 500 Index and the S&P Biotechnology Index. The comparison assumes the investment of $100.00 on November 15, 2006 in each of our common stock, the S&P 500 Index and the S&P Biotechnology Index and assumes the reinvestment of dividends. The graph below assumes that the initial value of our common stock on November 15, 2006 was the closing sales price of $11.70 per share.

COMPARISON OF CUMULATIVE TOTAL RETURN
Among Emergent BioSolutions Inc., the S&P 500 Index and the S&P Biotechnology Index



	11/15/06	11/30/06	12/31/06
Emergent BioSolutions Inc.	$100.00	$ 89.66	$ 95.38
S&P 500 Index	100.00	101.90	103.33
S&P Biotechnology Index	100.00	97.29	94.65

For the period from November 15, 2006 to December 31, 2006, our common stock had a high sales price of $12.72 per share and a low sales price of $9.75 per share. As of March 15, 2007, we had 57 holders of record of our common stock. This number does not include beneficial owners whose shares are held by nominees in street name.

DIVIDEND POLICY

We currently intend to retain all of our future earnings to finance the growth and development of our business. We do not intend to pay cash dividends to our stockholders in the foreseeable future.

On June 15, 2005, our board of directors declared a special cash dividend to the holders of our outstanding shares of common stock in an aggregate amount of approximately $5.4 million. Our board of directors declared this special dividend in order to distribute the net proceeds of a payment that we received as a result of the settlement of litigation that we initiated against Elan Pharmaceuticals, Inc., Athena Neurosciences, Inc. and Solstice Neurosciences, Inc. We paid the special cash dividend on July 13, 2005 to stockholders of record as of June 15, 2005. Prior to this special cash dividend, we had never declared or paid any cash dividends on our common stock.

CORPORATE INFORMATION

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The information in this annual report is a summary and should be considered along with the company's Annual Report on Form 10-K for the year ended December 31, 2006.

A copy of the company's Form 10-K for the year ended December 31, 2006, filed with the Securities and Exchange Commission, is available without charge upon written request to Investor Relations, Emergent BioSolutions, 2273 Research Blvd, Suite 400, Rockville, MD 20850, by calling (301) 795-1800 or by accessing the company's website at www.emergentbiosolutions.com.

Independent Registered Public Accounting Firm
Ernst & Young LLP
McLean, VA
United States

Stock Transfer Agent and Registrar
Investors with questions concerning account information, new certificate issuances, lost or stolen certificate replacement, securities transfers, or the processing of a change of address should contact:

American Stock Transfer &
Trust Company
59 Maiden Lane, 1st Floor
New York, NY 10038
United States
Tel: 800-937-5449 or 212-936-5100
www.amstock.com

Corporate Counsel
Wilmer Cutler Pickering Hale
and Dorr LLP
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United States

Annual Meeting
Thursday, June 14, 2007
10 a.m. Eastern Time
Hyatt Regency Bethesda
1 Bethesda Metro Center
Bethesda, MD 20814
United States

Investor Relations
Mr. Robert Burrows
Vice President,
Corporate Communications
E-mail: burrowsr@ebsi.com
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Fax: 301-795-1899

Market Information
Emergent BioSolutions Inc. common stock has traded on the New York Stock Exchange under the trading symbol **EBS** since November 15, 2006.

Corporate Governance
Our Chief Executive Officer and Chief Financial Officer have provided the certifications required by Rule 13a-14(a) under the Securities Exchange Act of 1934, copies of which are filed as exhibits to our Annual Report on Form 10-K. In addition, our Chief Executive Officer intends to submit his initial annual chief executive officer certification to the New York Stock Exchange within 30 days of the date of our Annual Meeting of Stockholders in accordance with the New York Stock Exchange listing requirements.

Emergent BioSolutions Inc. is strongly committed to the highest standards of ethical conduct and corporate governance. Our Board of Directors has adopted Corporate Governance Guidelines, along with the charters of the Board Committees and a Code of Conduct and Business Ethics for directors, officers and employees, all of which are available on the company's website at www.emergentbiosolutions.com.

Important Note About Forward-Looking Statements
This annual report contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 and Section 21E of the Securities Exchange Act of 1934, as amended, that involve substantial risks and uncertainties. All statements, other than statements of historical fact, including statements regarding our strategy, future operations, future financial position, future revenues, projected costs, prospects, plans and objectives of management, are forward-looking statements. The words "anticipate," "believe," "estimate," "expect," "intend," "may," "plan," "predict," "project," "will," "would" and similar expressions are intended to identify forward-looking statements, although not all forward-looking statements contain these identifying words.

There are a number of important factors that could cause the company's actual results to differ materially from those indicated by such forward-looking statements, including our performance under existing BioThrax sales contracts with the U.S. government, including the timing of deliveries under these contracts; our ability to obtain new BioThrax sales contracts with the U.S. government; our plans for future sales of BioThrax; our plans to pursue label expansions and improvements for BioThrax; our plans to expand our manufacturing facilities and capabilities; the rate and degree of market acceptance and clinical utility of our products; our ongoing and planned development programs, preclinical studies and clinical trials; our ability to identify and acquire or in license products and product candidates that satisfy our selection criteria; the potential benefits of our existing collaboration agreements and our ability to enter into selective additional collaboration arrangements; the timing of and our ability to obtain and maintain regulatory approvals for our product candidates; our commercialization, marketing and manufacturing capabilities and strategy; our intellectual property portfolio; our estimates regarding expenses, future revenue, capital requirements and needs for additional financing; and other factors identified in the company's Annual Report on Form 10-K for the year ended December 31, 2006 and subsequent reports filed with the SEC. The company disclaims any intention or obligation to update any forward-looking statements as a result of developments occurring after the date of this annual report. Our forward-looking statements do not reflect the potential impact of any future acquisitions, mergers, dispositions, joint ventures or investments we may make.

Corporate Headquarters

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