Emergent BioSolutions Inc.
Form 10-Q
November 05, 2007

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2007

OR

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

For the transition period from ___ to ____

Commission file number: **001-33137**

EMERGENT BIOSOLUTIONS INC.

(Exact Name of Registrant as Specified in Its Charter)

Delaware	**14-1902018**
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)
2273 Research Boulevard, Suite 400	
Rockville, Maryland	**20850**
(Address of Principal Executive Offices)	(Zip Code)

(301) 795-1800

(Registrant s Telephone Number, Including Area Code)

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

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

o Large Accelerated Filer o Accelerated Filer x Non-Accelerated Filer

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

As of October 26, 2007, the registrant had 29,750,237 shares of common stock outstanding.

Emergent BioSolutions Inc.

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SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

This quarterly report on Form 10-Q and the documents incorporated by reference herein contain 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 exp to identify forward-looking statements, although not all forward-looking statements contain these identifying words.

These forward-looking statements include, among other things, statements about:

our ability to obtain new contracts with the U.S. government for sales of BioThrax® (Anthrax Vaccine Adsorbed), our FDA-approved anthrax vaccine, and our performance under those contracts, including the timing of deliveries;

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; and

our estimates regarding expenses, future revenues, capital requirements and needs for additional financing.

We may not actually achieve the plans, intentions or expectations disclosed in our forward-looking statements, and you should not place undue reliance on our forward-looking statements. Actual results or events could differ materially from the plans, intentions and expectations disclosed in the forward-looking statements we make. We have included important factors in the cautionary statements included in this quarterly report, particularly in the Risk Factors section, that we believe could cause actual results or events to differ materially from the forward-looking statements that we make. Our forward-looking statements do not reflect the potential impact of any future acquisitions, mergers, dispositions, joint ventures or investments we may make.

You should read this quarterly report, including the documents that we have incorporated by reference herein and filed as exhibits hereto, completely and with the understanding that our actual future results may be materially different from what we expect. We do not assume any obligation to update any forward-looking statements.

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

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

	September 30, 2007 (unaudited)	December 31, 2006
ASSETS		
Current assets:		
Cash and cash equivalents	$ 24,266	$ 76,418
Accounts receivable	42,013	43,331
Inventories	25,623	24,721
Income taxes receivable	12,986	869
Deferred tax assets	-	295
Prepaid expenses and other current assets	2,475	1,703
Total current assets	107,363	147,337
Property, plant and equipment, net	103,479	78,174
Deferred tax assets, net of current	9,305	11,477
Restricted cash	5,192	192
Other assets	1,412	1,075
Total assets	$ 226,751	$ 238,255
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 19,383	$ 27,366
Accrued expenses and other current liabilities	4,055	3,253
Accrued compensation	7,616	7,190
Indebtedness under lines of credit	-	8,930
Long-term indebtedness, current portion	3,485	2,473
Income taxes payable	-	13,703
Deferred tax liability	243	-
Deferred revenue, current portion	729	1,432
Total current liabilities	35,511	64,347
Long-term indebtedness, net of current portion	43,488	31,368
Deferred revenue, net of current portion	2,685	2,997
Other liabilities	1,574	1,071
Total liabilities	83,258	99,783
Commitments and contingencies	-	-
Stockholders equity:		
Preferred Stock $0.001 par value; 15,000,000 shares authorized, 0 shares issued and outstanding at September 30, 2007 and December 31, 2006	-	-
Common Stock, $0.001 par value; 100,000,000 shares authorized, 29,750,237 and 27,596,249 shares issued and outstanding at September 30, 2007 and December 31, 2006, respectively	30	28
Additional paid-in capital	101,992	90,920
Accumulated other comprehensive loss	(1,117)	(473)
Retained earnings	42,588	47,997
Total stockholders equity	143,493	138,472
Total liabilities and stockholders equity	$ 226,751	$ 238,255

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

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	**2006**	**2007**	**2006**
	(Unaudited)		**(Unaudited)**	
Revenues:				
Product sales	$ 41,786	$ 40,855	$ 89,750	$ 61,263
Contracts and grants	1,858	1,319	3,528	4,580
Total revenues	43,644	42,174	93,278	65,843
Operating expense:				
Cost of product sales	11,407	7,275	22,765	11,645
Research and development	12,777	13,544	41,689	29,240
Purchased in-process research and development	-	477	-	477
Selling, general and administrative	15,038	11,157	38,889	30,352
Income (loss) from operations	4,422	9,721	(10,065)	(5,871)
Other income (expense):				
Interest income	472	79	1,945	405
Interest expense	(7)	(546)	(54)	(778)
Other income (expense), net	(14)	167	164	291
Total other income (expense)	451	(300)	2,055	(82)
Income (loss) before provision for (benefit from) income taxes	4,873	9,421	(8,010)	(5,953)
Provision for (benefit from) income taxes	2,028	5,067	(3,205)	(2,617)
Net income (loss)	$ 2,845	$ 4,354	$ (4,805)	$ (3,336)
Earnings (loss) per share - basic	$ 0.10	$ 0.19	$ (0.17)	$ (0.15)
Earnings (loss) per share - diluted	$ 0.10	$ 0.18	$ (0.17)	$ (0.15)
Weighted-average number of shares - basic	29,739,797	22,389,620	28,741,380	22,370,191
Weighted-average number of shares - diluted	29,900,571	23,704,751	28,741,380	22,370,191

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

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

	Nine Months Ended September 30,	
	2007	**2006**
	(Unaudited)	
Cash flows from operating activities:		
Net loss	$ (4,805)	$ (3,336)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Stock-based compensation expense	1,895	442
Depreciation and amortization	3,597	3,265
Deferred income taxes	9,418	933
Excess tax benefits from stock-based compensation	(6,708)	-
Loss on disposal of property and equipment	-	82
Purchased in-process research and development	-	477
Changes in operating assets and liabilities:		
Accounts receivable	1,318	(744)
Inventories	(901)	(11,627)
Income taxes	(25,820)	(4,913)
Prepaid expenses and other assets	(1,109)	(3,653)
Accounts payable	(688)	(475)
Accrued expenses and other liabilities	697	1,442
Accrued compensation	426	(1,279)
Deferred revenue	(1,015)	4,639
Net cash used in operating activities	(23,695)	(14,747)
Cash flows from investing activities:		
Purchases of property, plant and equipment	(36,197)	(25,712)
Acquisitions, net of cash received	-	(218)
Restricted cash deposits	(5,000)	(190)
Net cash used in investing activities	(41,197)	(26,120)
Cash flows from financing activities:		
Proceeds from borrowings on long term indebtedness and lines of credit	15,333	35,853
Issuance of common stock subject to exercise of stock options	2,474	43
Redemption of Class B common stock	-	(221)
Principal payments on long term indebtedness, notes payable to employees, and lines of credit	(11,131)	(11,290)
Excess tax benefits from stock-based compensation	6,708	-
Net cash provided by financing activities	13,384	24,385
Effect of exchange rate changes on cash and cash equivalents	(644)	94
Net decrease in cash and cash equivalents	(52,152)	(16,388)
Cash and cash equivalents at beginning of period	76,418	36,294
Cash and cash equivalents at end of period	24,266	19,906
Supplemental disclosure of cash flow information:		
Cash paid during the period for interest	$ 2,217	$ 665
Cash paid during the period for income taxes	$ 14,329	$ 1,470
Supplemental information on non-cash investing and financing activities:		
Purchases of property, plant and equipment unpaid at period end	$ 7,295	$ 6,621

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

EMERGENT BIOSOLUTIONS INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

(dollars in thousands, except per share data)

1. Summary of significant accounting policies

Basis of presentation and consolidation

The accompanying unaudited consolidated financial statements include the accounts of Emergent BioSolutions Inc. (the Company or Emergent) and its wholly owned subsidiaries. All significant inter-company accounts and transactions have been eliminated in consolidation.

The unaudited consolidated financial statements included herein have been prepared in accordance with U.S. generally accepted accounting principles for interim financial information and in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X of the Securities and Exchange Commission. Certain information and footnote disclosures normally included in consolidated financial statements prepared in accordance with U.S. generally accepted accounting principles have been condensed or omitted pursuant to such rules and regulations. These consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto contained in the Company s Annual Report on Form 10-K for the year ended December 31, 2006, as filed with the Securities and Exchange Commission.

In the opinion of the Company s management, any adjustments contained in the accompanying unaudited consolidated financial statements are of a normal recurring nature, and are necessary to present fairly the financial position of the Company as of September 30, 2007, results of operations for the three and nine month periods ended September 30, 2007 and 2006, and cash flows for the nine month periods ended September 30, 2007 and 2006. Interim results are not necessarily indicative of results that may be expected for any other interim period or for an entire year.

Significant customers and accounts receivable

The Company s primary customers are the U.S. Department of Defense (the DoD) and the U.S. Department of Health and Human Services (HHS). For the three months ended September 30, 2007 and 2006, sales of BioThrax to the DoD and HHS comprised 96% and 97% of total revenues, respectively. For the nine months ended September 30, 2007 and 2006, sales of BioThrax to the DoD and HHS comprised 96% and 92% of total revenues, respectively. As of September 30, 2007, 100% of the Company s accounts receivable balance was comprised of amounts due from these customers. Accounts receivable are stated at invoice amounts and generally consist 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.

Capitalized interest

The Company capitalizes interest expense in accordance with Statement of Financial Accounting Standards ("SFAS") No. 34, *Capitalization of Interest Cost*, based on the cost of major ongoing capital projects which have not yet been placed in service. For the three months ended September 30, 2007 and 2006, the Company capitalized $890 and $42 of interest, respectively. For the nine months ended September 30, 2007 and 2006, the Company capitalized $2,226 and $149 of interest, respectively.

Earnings per share

Basic net income (loss) per share of common stock excludes dilution for potential common stock issuances and is computed by dividing net income (loss) 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 during the period. For the nine months ended September 30, 2007 and 2006, diluted net loss per share is equal to basic net loss per share, as the inclusion of outstanding stock options would be anti-dilutive.

Accounting for stock-based compensation

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 2007 and 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).

The Company accounts for equity instruments issued to non-employees in accordance with SFAS No. 123, *Accounting for Stock-Based Compensation* (SFAS No. 123), and Emerging Issues Task Force (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).

Based on options granted to employees as of September 30, 2007, total compensation expense not yet recognized related to unvested options is approximately $3,075, after tax. The Company expects to recognize that expense over a weighted average period of 3.0 years.

The Company utilizes 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:

	Three Months ended		**Nine Months ended**	
	September 30, 2007	**September 30, 2006**	**September 30, 2007**	**September 30, 2006**
Expected dividend yield	0%	0%	0%	0%
Expected volatility	50%	50%	50%	50%
Risk-free interest rate	4.01%-4.95%	4.69%	4.01%-5.09%	4.69%-5.21%
Expected average life of options	3.0 years	2.7 years	3.0 years	2.9 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 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 range of U.S. Treasury rates with a term that most closely resembles the expected life of the option as of the date the option was granted; and

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 employee 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.

Comprehensive income (loss)

SFAS No. 130, *Reporting Comprehensive Income* (SFAS No. 130), requires the presentation of the comprehensive income (loss) and its components as part of the financial statements. Comprehensive income (loss) is comprised of net income (loss) and other changes in equity that are excluded from net income (loss). The Company includes gains and losses on inter-company 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). Comprehensive income for the three months ended September 30, 2007 and 2006 was $2,683 and $4,485, respectively. Comprehensive loss for the nine months ended September 30, 2007 and 2006 was $5,449 and $3,242, respectively.

Reclassifications

Certain prior period balances have been reclassified to conform to current period presentation.

Recent accounting pronouncements

In September 2006, the Financial Accounting Standards Board (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. The Company is currently evaluating the impact of the adoption of this statement on its financial statements.

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. The Company is currently evaluating the impact of adoption of this statement on its financial statements.

In June 2007, the FASB issued EITF No. 07-3, *Accounting for Nonrefundable Advance Payments for Goods or Services Received for Use in Future Research and Development Activities* (EITF No. 07-3). EITF No. 07-3 states that nonrefundable advance payments for goods or services that will be used or rendered for future research and development activities should be deferred and capitalized. Such amounts should be recognized as an expense as the related goods are delivered or the related services are performed. The provisions of EITF No. 07-3 are effective for fiscal years beginning after December 15, 2007. The Company is currently evaluating the impact of adoption of this statement on its financial statements.

2. Acquisitions
ViVacs GmbH

On July 14, 2006, the Company 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 14, 2006 by and between the Company and ViVacs. The Company 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 provided 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 September 30, 2007, 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.

3. Inventories

Inventories consist of the following:

		September 30, 2007		**December 31, 2006**
Raw materials and supplies	$	2,372	$	2,133
Work-in-process		17,420		22,239
Finished goods		5,831		349
Total inventories	$	25,623	$	24,721

4. Property, plant and equipment

Property, plant and equipment consist of the following:

		September 30, 2007		**December 31, 2006**
Land and improvements	$	4,922	$	4,922
Buildings and leasehold improvements		25,924		25,325
Furniture and equipment		18,587		15,401
Software		4,703		4,499
Construction-in-progress		66,269		41,563
		120,405		91,710
Less: Accumulated depreciation and amortization		(16,926)		(13,536)
Total property, plant and equipment, net	$	103,479	$	78,174

5. 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 September 30, 2007, no Preferred Stock has been issued.

Common stock

The Company currently has one class of common stock, $0.001 par value per share (Common Stock), authorized and outstanding. The Company is authorized to issue up to 100,000,000 shares of 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 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, reclassified the Company s previously outstanding class A common stock, $0.01 par value per share, as Common Stock, increased the number of authorized shares of Common Stock to 100,000,000 shares and adjusted 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 the Common Stock, in the form of a dividend of shares of Common Stock, and the Company s previously outstanding class B common stock, $0.01 par value per share (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 Common Stock and Class B Common Stock effective as of October 27, 2006.

Each share of Class B Common Stock automatically converted into one share of Common Stock immediately prior to the closing of the Company s initial public offering on November 20, 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, the stock split and the conversion of the Class B Common Stock into Common Stock.

Stock options

As of September 30, 2007, 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) (together, the Emergent Plans), 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 2006 Plan initially authorized the issuance of up to 1,089,461 shares of Common Stock. In addition, the 2006 Plan contains an evergreen provision that allows for increases in the number of shares authorized for issuance under the 2006 Plan in the first and third quarter of each year from 2007 through 2009. Each semi-annual increase in the number of shares will be equal to the lowest of: (1) a specified number of shares stipulated in the 2006 Plan; (2) a specified percentage of the aggregate number of shares outstanding; and (3) an amount determined by the Company s Board of Directors. The maximum specified number of shares per semi-annual increases range from 428,700 to 937,900. The maximum specified percentage of outstanding shares for each semi-annual increase ranges from 1.5% to 3.0%. Accordingly, an aggregate of 1,949,362 shares of Common Stock are authorized for issuance under the 2006 Plan as of September 30, 2007. The Company has granted options to purchase a total of 1,315,161 shares of Common Stock under the 2006 Plan as of September 30, 2007. 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 a contractual life of no more than 10 years. Following the closing of the Company s initial public offering, the Company no longer grants options pursuant to the 2004 Plan.

The following is a summary of stock option activity:

	2004 Plan			2006 Plan			
	Number of Shares		Weighted-Average Exercise Price	Number of Shares		Weighted-Average Exercise Price	Aggregate Intrinsic Value
Outstanding at December 31, 2006	2,936,389	$	2.53	1,030,500	$	10.13	
Granted	-		-	466,561		10.22	
Exercised	(2,153,988)		1.15	-		-	
Forfeited	(57,923)		5.77	(181,900)		10.48	
Cancelled	(5,214)		1.49	-		-	
Outstanding at September 30, 2007	719,264	$	6.41	1,315,161	$	10.11	$ 2,469,682
Exercisable at September 30, 2007	401,828	$	5.39	-	$	-	$ 1,593,956

The weighted average remaining contractual term of options outstanding as of September 30, 2007 and December 31, 2006 was 5.7 and 3.2 years, respectively. The weighted average remaining contractual term of options exercisable as of September 30, 2007 and December 31, 2006 was 4.5 and 1.1 years, respectively.

The weighted average grant date fair value of options granted during the three and nine months ended September 30, 2007 was $3.41 and $3.90, respectively. The total intrinsic value of options exercised during the three and nine months ended September 30, 2007 was $110 and $20,468, respectively. The total fair value of shares vested during the three and nine months ended September 30, 2007 was $96 and $479, respectively.

Stock-based compensation expense was recorded in the following financial statement line items:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
Cost of sales	$ 19	$ -	$ 53	$ -
Research and development	97	21	272	63
General and administrative	619	132	1,570	379
Total share-based compensation expense	$ 735	$ 153	$ 1,895	$ 442

A summary of the activity of the Company s non-vested stock options at September 30, 2007 is presented below:

	2004 Plan Number of Shares	Weighted-Average Price	2006 Plan Number of Shares	Weighted-Average Price
Non-vested at December 31, 2006	537,532	$ 7.45	1,030,500	$ 10.13
Granted	-	-	466,561	10.22
Exercised	-	-	-	-
Vested	(167,829)	7.68	-	-
Forfeited	(52,267)	5.15	(181,900)	10.48
Non-vested at September 30, 2007	317,436	$ 7.70	1,315,161	$ 10.11

During the three and nine months ended September 30, 2007, the Company received a tax benefit from stock options exercised of approximately $0 and $6,700, respectively.

6. Income taxes

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
Current				
Federal	$ 1,931	$ 3,299	$ (6,025)	$ (3,650)
State	214	-	317	100
Total current	2,145	3,299	(5,708)	(3,550)
Deferred				
Federal	(114)	1,665	2,229	833
State	(3)	103	274	100
Total deferred	(117)	1,768	- 2,503	933
Total provision for (benefit from) income taxes	$ 2,028	$ 5,067	$ (3,205)	$ (2,617)

The estimated effective annual tax rate for the nine months ended September 30, 2007 and 2006 was 40% and 44%, respectively. The estimated effective tax rate differs from statutory rates due primarily to the impact of foreign and state net operating losses and permanent differences, including incentive stock options.

In September 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 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 to be 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 Company adopted the provisions of FIN 48 on January 1, 2007. As a result of the implementation of FIN 48, the Company recognized, as a cumulative effect of change in accounting principle, a $607 increase in tax-related liabilities for unrecognized tax benefits and a $607 reduction to beginning retained earnings. The Company recognizes interest in interest expense and recognizes potential penalties related to unrecognized tax benefits in selling, general and administrative expense. The Company accrued approximately $62 for the payment of interest and penalties as of September 30, 2007.

As of January 1, 2007, the Company recorded approximately $607 for unrecognized tax benefits, including accrued interest and penalties, related to prior years. During the three months ended September 30, 2007, the Company recorded a decrease in unrecognized tax benefits, including accrued interest and penalties, of $493. Of this $493, $426 represents a reduction in unrecognized tax benefits as a result of a lapse of the applicable statue of limitations during the quarter ended September 30, 2007, and $7 represents a reduction related to the 2005 federal income tax audit. During the three and nine months ended September 30, 2007, unrecognized tax benefits, including accrued interest and penalties, increased by $219 and $256, respectively. During the nine months ended September 30, 2007, the Company accrued $39 of interest expense related to unrecognized tax benefits of prior years. Substantially all of these reserves would impact the effective tax rate if released into income. Of the total unrecognized tax benefits recorded at September 30, 2007, $139 is classified as a current liability and $231 is classified as a non-current liability on the balance sheet. As of September 30, 2007, $37 of unrecognized tax benefits will reverse within the next twelve months.

The Company s federal and state income tax returns for the tax years 2004, 2005 and 2006 remain open to examination. The Company s tax returns in the United Kingdom remain open to examination for the tax years 2001, 2002, 2003, 2004, 2005 and 2006, and tax returns in Germany remain open indefinitely. A federal income tax audit of the Company's tax return for the 2004 tax year was completed in March 2007. As a result of this audit, the Company paid an assessment of $722, including $96 of interest. The Company is the subject of an ongoing federal income tax audit for the tax year ended December 31, 2005. The financial statement impact of the audit has been estimated at approximately $469, including $49 of interest. This amount has been accrued as of September 30, 2007.

7. Litigation

From time to time, the Company is involved in product liability litigation and other lawsuits that arise in the ordinary course of its business. The Company does not believe that any pending proceedings will have a material, adverse effect on the results of its operations. With respect to claims filed against the Company arising out of the use of BioThrax by the U.S. government, the Company relies on a combination of contractual indemnification provisions, the government contractor defense, statutory protections and product liability insurance to limit its potential liability.

8. Segment information

The Company operates in two business segments: biodefense and commercial. In the biodefense business, the Company develops, manufactures and commercializes immunobiotics, consisting of vaccines and therapeutics, for use against biological agents that are potential weapons of bioterrorism and biowarfare. Revenues in this segment relate to the Company s FDA-approved product, BioThrax. In the commercial business, the Company develops immunobiotics for use against infectious diseases that have resulted in significant unmet or underserved public health 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 that are not allocated to the other segments. The assets in this segment consist primarily of cash and fixed assets.

	Reportable Segments			
	Biodefense	**Commercial**	**All Other**	**Total**
Nine Months Ended September 30, 2007				
External revenue	$ 90,643	$ 2,635	$ -	$ 93,278
Inter-segment revenue (expense)	-	-	-	-
Research and development	20,716	19,411	1,562	41,689
Interest income	-	-	1,945	1,945
Interest expense	-	-	(54)	(54)
Depreciation and amortization	2,599	685	313	3,597
Net income (loss)	26,120	(24,124)	(6,801)	(4,805)
Assets	156,695	19,738	50,318	226,751
Expenditures for long-lived assets	34,081	617	1,499	36,197
Nine Months Ended September 30, 2006				

External revenue	$ 61,260	$ 4,583	$ -	$ 65,843
Inter-segment revenue	-	-	-	-
Research and development	13,980	14,674	586	29,240
Interest income	-	-	405	405
Interest expense	-	-	(778)	(778)
Depreciation and amortization	2,530	559	176	3,265
Net income (loss)	15,920	(14,586)	(4,670)	(3,336)
Assets	74,655	14,761	41,415	130,831
Expenditures for long-lived assets	14,657	1,665	9,390	25,712

The accounting policies of the segments are the same as those described in Note 1 Summary of significant accounting policies. There are no inter-segment transactions.

9. Related party transactions

The Company has engaged Wilmer Cutler Pickering Hale and Dorr LLP ("WilmerHale") to provide certain legal services to the Company. The Company's Senior Vice President Legal Affairs and General Counsel is married to a partner at WilmerHale, who has not participated in providing legal services to the Company. The Company has incurred fees for legal services rendered by WilmerHale of approximately $760 in 2007. Of this amount, approximately $318 was in accounts payable at September 30, 2007.

For the nine months ended September 30, 2007 and 2006, the Company paid approximately $178 and $383, respectively, for consulting, lease and transportation agreements with various persons or entities affiliated with the Chief Executive Officer or members of the Board of Directors. Of these amounts, $15 and $0 was in accounts payable at September 30, 2007 and 2006, respectively. The Company currently has an agreement with a director to perform corporate strategic issues consultation and direct project support to the marketing and communications group, and an agreement with a company owned by the Chief Executive Officer to provide transportation and logistical support.

10. Indebtedness

On June 8, 2007, the Company entered into a loan agreement with Fifth Third Bank, whereby Fifth Third Bank agreed to extend to the Company a revolving line of credit up to $15,000. Collateral for this loan consists of accounts receivable under supply contracts with the DoD and HHS. The Company can borrow under this line of credit through May 2008, at which time the agreement expires. No borrowings under this revolving line of credit were outstanding as of September 30, 2007.

On June 29, 2007, the Company entered into a loan agreement with HSBC Realty Credit Corporation (USA) ("HSBC"), under which HSBC provided the Company with a term loan of $30,000. This loan replaced a prior loan arrangement with HSBC under which HSBC agreed to loan the Company $15,000, consisting of a $10,000 term loan and a $5,000 revolving line of credit. Under the new loan agreement, the Company is required to maintain a minimum balance of $5,000 in a deposit account pledged to HSBC and to make monthly payments in the amount of $250 in principal plus accrued interest beginning in August 2007, with a residual principal payment due upon maturity in September 2012. Interest on the loan accrues at an annual rate of LIBOR plus 2.75%. Payment of the loan is secured by substantially all of the assets of Emergent BioDefense Operations, other than accounts receivable under BioThrax supply contracts with the DoD and HHS that are pledged as collateral to secure the $15,000 revolving line of credit with Fifth Third Bank.

11. HHS Contract

On September 25, 2007 the Company entered into an agreement with HHS to supply 18.75 million doses of BioThrax for placement into the Strategic National Stockpile (SNS). The term of the agreement is from September 25, 2007 through September 24, 2010. The first 5.5 million doses to be delivered under this contract are being sold to HHS at a discounted price, as specified in the contract, due to the limited remaining shelf life for those specific doses. This discounted price will not apply to the remaining 13.25 million doses that will be sold to HHS under the contract. The firm fixed price for the 18.75 million doses, including the discount, is $400,000 in the aggregate. If the Company receives FDA approval of an application to extend the shelf life of BioThrax from three years to four years, HHS has agreed to increase the price per dose for the remaining 13.25 million doses under the agreement. In that event, HHS would make a lump sum payment reflecting a price per dose increase for certain of these doses delivered prior to approval and an increase in the price per dose to be paid for doses delivered following the date of such approval. The aggregate value of such price increase is $34,000. If the Company does not receive FDA approval of four-year expiry dating during the term of the agreement there will be no adjustment in the price per dose, or lump sum payment, under the agreement. Under the agreement, the Company has also agreed to provide all shipping services related to delivery of doses into the SNS over the term of the agreement, for which HHS has agreed to pay approximately $2,200. HHS will be invoiced for each delivery upon acceptance of BioThrax doses delivered into the SNS. The agreement also provides for HHS to pay up to $11,500 in milestone payments in connection with the Company advancing a program to obtain a post-exposure prophylaxis indication for BioThrax. These funds are payable upon achievement of specific program milestones.

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ITEM 2. 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 quarterly report on Form 10-Q. Some of the information contained in this discussion and analysis or set forth elsewhere in this quarterly report on Form 10-Q, 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 and the Risk Factors section of this quarterly 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, consisting of vaccines and therapeutics that assist the body's immune system to prevent or treat disease. We operate in two business segments: biodefense and commercial. Our biodefense business focuses on immunobiotics for use against biological agents that are potential weapons of bioterrorism and biowarfare. Our marketed product, BioThrax® (Anthrax Vaccine Adsorbed), or BioThrax, is the only vaccine approved by the U.S. Food and Drug Administration, or FDA, for the prevention of anthrax infection. Our commercial business focuses on immunobiotics for use against infectious diseases and other medical conditions that have resulted in significant unmet or underserved public health needs. 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 not received any 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

We have derived and expect for the foreseeable future to continue to derive substantially all of our revenues from BioThrax sales to the U.S. Department of Defense, or the DoD, and the U.S. Department of Health and Human Services, or HHS. Our total revenues from BioThrax sales were $127.3 million in 2005, $148.0 million in 2006 and $89.8 million for the nine months ended September 30, 2007. 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 multiple biodefense product candidates. We are developing an anthrax immune globulin candidate, in part with funding from the National Institute of Allergy and Infectious Diseases, or the NIAID, and the BioMedical Advanced Research and Development Authority, or BARDA. We have entered into collaboration agreements with the U.K. Health Protection Agency, or HPA, for the development of a recombinant botulinum vaccine candidate and 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

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.

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 the Phase I and Phase II clinical trials of our typhoid vaccine candidate. In addition, the NIAID is conducting and funding the Phase I clinical trial of our group B streptococcus vaccine candidate.

Manufacturing Infrastructure

We operate vaccine manufacturing facilities at a multi-building campus on approximately 12.5 acres in Lansing, Michigan. To augment our existing manufacturing capabilities, we are constructing a new 50,000 square foot manufacturing facility on our Lansing campus. We expect the facility to cost approximately $75 million when complete, 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 have incurred costs of approximately $58 million for these purposes through September 2007.

We substantially completed construction of this facility in 2006, and are conducting installation, validation and qualification activities required for regulatory approval. This new facility is a large scale manufacturing plant that we can use to produce multiple vaccine products, subject to complying with appropriate change-over procedures. We also own two buildings in Frederick, Maryland that are available to support our future manufacturing requirements. We have incurred costs of approximately $3 million through September 2007 related to initial engineering design and preliminary utility build out of these facilities. Because we are in the preliminary planning stages of our Frederick build out, we cannot reasonably estimate the timing and costs that would 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, or sell, 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 value of 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 have generated BioThrax sales revenues under U.S. government contracts with the DoD and HHS. Under previous DoD contracts, we invoiced the DoD for progress payments upon reaching contractually specified stages in the manufacture of BioThrax. We recorded as deferred revenue the full amount of each progress payment invoice that we submitted to the DoD.

Title to the product passed to the DoD upon submission of the first invoice. The earnings process was considered complete upon FDA release of the product for sale and distribution. Following FDA release of the product, we segregated the product for later shipment and recognized 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 invoiced the DoD for the final progress payment and recognized the amount of that invoice as period revenue. Under previous contracts with HHS, we invoiced HHS and recognized the related revenues upon delivery of the product to the government carrier, at which time title to the product passed to HHS. Under our current contract with HHS, we invoice HHS and recognize the related revenues upon acceptance by the government at the delivery site, at which time title to the product passes to HHS.

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 evaluated the various components of the 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 units of accounting 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 on behalf of 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 and as services are completed, recognize the amount of the related deferred revenue as period revenues. 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 revenues 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.

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.

Income Taxes

We account for income taxes in accordance with Statement of Financial Accounting Standards, or SFAS No. 109, *Accounting for Income Taxes,* or SFAS No. 109. 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 Limited, or Microscience, and Antex Biologics, Inc., or 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.

We account for uncertainty in income taxes in accordance with Financial Accounting Standards Board, or FASB, Interpretation 48, *Accounting for Uncertainty in Income Taxes An Interpretation of FASB Statement No. 109, Accounting for Income Taxes*or FIN 48. 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. Under FIN 48, the Company recognizes 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.

Stock-based Compensation

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 grant date fair values.

We value our share-based payment transactions using the 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. We measure the amount of compensation cost based on the fair value of the underlying equity award on the date of grant. We recognize compensation cost over the period that an employee provides service in exchange for the award.

The effect of adopting SFAS No. 123(R) on net income (loss) and net income (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.

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, *Ac*