

BIOQUAL, INC. AND SUBSIDIARY

**AUDITED CONSOLIDATED
FINANCIAL STATEMENTS**

MAY 31, 2009 AND 2008

Bioqual, Inc. and Subsidiary

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805 King Farm Boulevard
Suite 300
Rockville, Maryland 20850
301.231.6200 Main
301.231.7630 Fax



Independent Auditor's Report

Board of Directors
Bioqual, Inc.
Rockville, Maryland

We have audited the accompanying Consolidated Balance Sheets of **Bioqual, Inc. and Subsidiary** as of May 31, 2009 and 2008, and the related Consolidated Statements of Income, Stockholders' Equity and Cash Flows for the years then ended. 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 auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as 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 **Bioqual, Inc. and Subsidiary** as of May 31, 2009 and 2008, and the consolidated results of their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Rockville, Maryland
August 31, 2009

<i>May 31,</i>	2009	2008
Assets		
Current assets		
Cash and cash equivalents	\$ 2,917,774	\$ 1,823,935
Accounts receivable - contracts, net	4,742,415	4,711,851
Prepaid income taxes	171,721	-
Prepaid expenses	67,441	145,074
Deferred income tax asset	90,000	103,600
Total current assets	7,989,351	6,784,460
Property and equipment		
Leasehold improvements	2,893,746	2,761,785
Furniture, fixtures and equipment	8,361,376	7,904,418
Total property and equipment	11,255,122	10,666,203
Less: Accumulated depreciation and amortization	(7,762,332)	(7,033,318)
Net property and equipment	3,492,790	3,632,885
Other assets		
Cash surrender value of officers' life insurance	748,002	702,741
Total assets	\$ 12,230,143	\$ 11,120,086

Bioqual, Inc. and Subsidiary

Consolidated Balance Sheets

	2009	2008
Liabilities and Stockholders' Equity		
Current liabilities		
Accounts payable	\$ 328,599	\$ 609,072
Accrued compensation and related liabilities	1,213,146	1,035,225
Reserve for overapplied indirect rates	135,987	250,000
Income taxes payable	-	65,236
Total current liabilities	1,677,732	1,959,533
Long term liabilities		
Deferred rent	421,670	315,614
Deferred income taxes	206,800	111,600
Total long term liabilities	628,470	427,214
Total liabilities	2,306,202	2,386,747
Commitments and contingencies		
Stockholders' equity		
Preferred stock - par value \$1.00 per share; 500,000 shares authorized; no shares issued and outstanding	-	-
Common stock - par value \$0.01 per share, 25,000,000 shares authorized, 1,600,408 shares issued; 904,872 and 896,538 shares outstanding, respectively	16,004	16,004
Treasury stock, at cost	(946,466)	(953,928)
Additional paid-in capital	7,325,799	7,320,222
Retained earnings	3,528,604	2,351,041
Total stockholders' equity	9,923,941	8,733,339
Total liabilities and stockholders' equity	\$ 12,230,143	\$ 11,120,086

The accompanying Notes to Consolidated Financial Statements are an integral part of these financial statements.

Bioqual, Inc. and Subsidiary

Consolidated Statements of Income

<i>Years Ended May 31,</i>	2009	2008
Contract revenue	\$ 28,247,895	\$ 24,868,256
Operating expenses		
Contract	22,119,547	19,249,296
General and administrative	3,940,769	3,702,898
Total operating expenses	26,060,316	22,952,194
Operating income	2,187,579	1,916,062
Other income (expense)		
Interest income	31,747	50,449
Interest expense	(274)	(4,574)
Total other income (expense)	31,473	45,875
Income before income taxes	2,219,052	1,961,937
Provision for income taxes	896,843	754,007
Net income	\$ 1,322,209	\$ 1,207,930
Basic earnings per share	\$ 1.46	\$ 1.35
Diluted earnings per share	\$ 1.46	\$ 1.34
Weighted average number of shares outstanding for basic earnings per share	903,428	896,538
Effect of dilutive securities - stock options	918	7,337
Weighted average number of shares outstanding for diluted earnings per share	904,346	903,875

The accompanying Notes to Consolidated Financial Statements are an integral part of these financial statements.

Bioqual, Inc. and Subsidiary

Consolidated Statements of Stockholders' Equity

	Common Stock		Treasury Stock		Additional Paid-In Capital	Retained Earnings	Total
	Shares	Amount	Shares	Amount			
Balance, June 1, 2007	1,600,408	\$ 16,004	703,870	\$ (953,928)	\$ 7,320,222	\$ 1,259,661	\$ 7,641,959
Dividends declared - \$0.13 per share	-	-	-	-	-	(116,550)	(116,550)
Net income	-	-	-	-	-	1,207,930	1,207,930
Balance, May 31, 2008	1,600,408	16,004	703,870	(953,928)	7,320,222	2,351,041	8,733,339
Exercise of stock options	-	-	(8,334)	7,462	5,577	-	13,039
Dividends declared - \$0.16 per share	-	-	-	-	-	(144,646)	(144,646)
Net income	-	-	-	-	-	1,322,209	1,322,209
Balance, May 31, 2009	1,600,408	\$ 16,004	695,536	\$ (946,466)	\$ 7,325,799	\$ 3,528,604	\$ 9,923,941

The accompanying Notes to Consolidated Financial Statements are an integral part of these financial statements.

Bioqual, Inc. and Subsidiary

Consolidated Statements of Cash Flows

<i>Years Ended May 31,</i>	2009	2008
Cash flows from operating activities		
Net income	\$ 1,322,209	\$ 1,207,930
Adjustments to reconcile net income to net cash provided by operating activities		
Depreciation and amortization	815,513	785,356
Deferred income taxes	108,800	(120,300)
Provision for doubtful accounts	-	76,750
Change in cash surrender value of officers' life insurance	17,003	15,545
(Increase) decrease in		
Accounts receivable - contracts	(30,564)	(1,894,349)
Prepaid expenses	77,633	242,387
Increase (decrease) in		
Accounts payable	(280,472)	199,698
Accrued compensation and related liabilities	177,921	79,476
Reserve for overapplied indirect rates	(114,013)	(421,054)
Income taxes payable	(65,236)	(79,206)
Deferred rent	(65,665)	191,116
Net cash provided by operating activities	1,963,129	283,349
Cash flows from investing activities		
Purchases of property and equipment	(675,419)	(1,074,542)
Payment on officers' life insurance	(62,264)	(62,264)
Net cash used by investing activities	(737,683)	(1,136,806)
Cash flows from financing activities		
Proceeds from line of credit	-	1,818,206
Payments on line of credit	-	(1,818,206)
Dividends paid	(144,646)	(116,550)
Proceeds from exercise of stock options	13,039	-
Net cash used by financing activities	(131,607)	(116,550)

The accompanying Notes to Consolidated Financial Statements are an integral part of these financial statements.

Bioqual, Inc. and Subsidiary

Consolidated Statements of Cash Flows (Continued)

<i>Years Ended May 31,</i>	2009	2008
Net change in cash and cash equivalents	1,093,839	(970,007)
Cash and cash equivalents at beginning of year	1,823,935	2,793,942
Cash and cash equivalents at end of year	\$ 2,917,774	\$ 1,823,935
Supplemental information:		
Interest paid	\$ 274	\$ 4,574
Income taxes paid	\$ 1,025,000	\$ 954,000

The accompanying Notes to Consolidated Financial Statements are an integral part of these financial statements.

Bioqual, Inc. and Subsidiary

Notes to Consolidated Financial Statements

1. **Organization and significant accounting policies** **Organization:** Bioqual, Inc., a Delaware Corporation, was founded in 1981. The Company supports the National Institutes of Health by providing research services in the following research areas: cancer, AIDS, hepatitis, influenza, immunology, transgenics, contraception, breeding and development of genetically defined animals, and neurobiology and behavior.

Principles of consolidation: The accompanying consolidated financial statements include the accounts of Bioqual, Inc. and its wholly-owned subsidiary, Enhanced Therapeutics, Inc. (collectively, the "Company"). All significant intercompany balances and transactions have been eliminated in consolidation.

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

Revenue: Revenue from cost-type contracts is recognized as costs are incurred on the basis of direct costs plus allowable indirect costs and an allocable portion of the fixed fee. Revenue from fixed-price type contracts is recognized under the percentage-of-completion method of accounting, with costs and estimated profits included in contract revenue as work is performed. If actual and estimated costs to complete a contract indicate a loss, provision is made currently for the loss anticipated on the contract. Revenue from time and materials contracts is recognized as costs are incurred at amounts represented by the agreed-upon billing amounts. As soon as it is determined that it is probable a contract will result in a loss and the loss can be reasonably estimated, the entire loss is charged to operations.

Cash and cash equivalents: Cash and cash equivalents consist of financial instruments with original maturities of less than three months. At times, the Company's cash balances may exceed Federally insured limits. The Company does not believe that this results in any significant risk.

Government contracts: Substantially all of the Company's revenue is from U.S. Government contracts (primarily the National Institutes of Health). The indirect rates used in cost-plus-fixed-fee contracts are subject to final negotiated settlements for each fiscal year. In management's opinion, final settlement of indirect rates will not have a material effect on the Company's financial position or results of operations when settled. The Company does not require collateral for its government billings and does not consider its accounts receivable to be a significant risk.

Bioqual, Inc. and Subsidiary

Notes to Consolidated Financial Statements

Accounts receivable: Accounts receivable consist mainly of billed and unbilled receivables under contracts in progress with governmental agencies and commercial entities. The Company provides for an allowance for doubtful accounts based on management's best estimate of possible losses determined principally on the basis of historical experience and specific allowances for known troubled accounts, if needed. All accounts, or portions thereof that are deemed to be uncollectible or that require an excessive collection cost are written off to the allowance for doubtful accounts.

Property and equipment: Property and equipment are recorded at the original cost and are being depreciated on a straight-line basis over estimated lives of three to ten years. Leasehold improvements are amortized over the life of the assets or the remaining period of the lease, whichever is shorter.

Income taxes: Current income tax expense is the amount of income taxes expected to be payable for the current year. Deferred income taxes are recognized for the tax consequences in future years of differences between the tax bases of assets and liabilities and their financial reporting amounts at each year end based on enacted tax laws and statutory tax rates applicable to the periods in which the differences are expected to affect taxable earnings. Valuation allowances are established when necessary to reduce deferred tax assets to the amount more likely than not to be realized.

The Company evaluates uncertainty in income tax positions based on a more-likely-than-not recognition standard, effective June 1, 2007. If that threshold is met, the tax position is then measured at the largest amount that is greater than 50% likely of being realized upon ultimate settlement. Prior to June 1, 2007, the Company evaluated uncertain tax positions such that the effects of tax positions were generally recognized in the financial statements consistent with amounts reflected in returns filed, or expected to be filed, with taxing authorities. For tax positions that the Company considered to be uncertain, current and deferred tax liabilities were recognized, or assets derecognized, when it was probable that an income tax liability had been incurred and the amount of the liability was reasonably estimable, or when it was probable that a tax benefit, such as a tax credit or loss carryforward, would be disallowed by a taxing authority.

There was no impact on the financial statements of the adoption of the revised standard for uncertain tax positions. As of May 31, 2009, there are no accruals for uncertain tax positions. If applicable, the Company records interest and penalty as a component of income tax expense. Tax years from May 31, 2006 through the current year remain open for examination by Federal and state tax authorities.

Bioqual, Inc. and Subsidiary

Notes to Consolidated Financial Statements

Fair value of financial instruments: The carrying amounts of obligations approximate their fair value due to the short-term nature or their underlying terms.

Earnings per share: The Company follows Statement of Financial Accounting Standard No. 128 ("SFAS 128") "Earnings Per Share" for the calculation of basic and diluted earnings per share. Basic earnings per share is calculated using the weighted-average number of common shares outstanding during the period. Diluted earnings per share is calculated using the weighted-average number of common shares plus dilutive potential common shares outstanding during the period. Potential common shares consist of stock options.

Stock options: Effective June 1, 2006, the Company measures compensation expense for its employee stock-based compensation plans under the modified prospective method established by Statement of Financial Accounting Standards (SFAS) No. 123(R), *Share-Based Payment*, which requires that compensation expense be recorded in operations for all grants issued after June 1, 2006, and for the portion of awards granted prior to June 1, 2006, for which the requisite service had not been rendered at June 1, 2006. Prior to June 1, 2006, stock-based compensation was determined using the intrinsic value method prescribed by Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*. Under APB No. 25, compensation expense is only recognized for the excess of fair market value of the Company's stock, over the exercise price of the option. Since the Company generally issued options with an exercise price equal to fair market value, no compensation expense for options granted to employees was reflected in income prior to June 1, 2006.

All options were fully vested in periods prior to the year ended May 31, 2006, and no options were issued in 2009 or 2008. Therefore, there is no stock compensation expense or pro forma compensation expense after June 1, 2006.

Reclassifications: Certain 2008 balances have been reclassified to conform with the 2009 presentation. The Company reclassified \$250,000 from accounts receivable-contracts to reserve for overapplied indirect rates on the 2008 consolidated balance sheet. This resulted in an increase to both line items. This change had no effect on net income.

Bioqual, Inc. and Subsidiary

Notes to Consolidated Financial Statements

2. **Accounts receivable** Accounts receivable at May 31, 2009 and 2008, consist of amounts due under contracts in progress with Federal government agencies, primarily the National Institutes of Health. The components of accounts receivable are:

	2009	2008
Billed receivables	\$ 3,893,478	\$ 4,162,113
Unbilled receivables	848,937	626,488
Total	4,742,415	4,788,601
Less: Allowance for doubtful accounts	-	(76,750)
Total	\$ 4,742,415	\$ 4,711,851

3. **Note payable - line of credit** The Company has a line of credit arrangement with a bank in the amount of \$1,200,000 which is due on demand. At May 31, 2009 and 2008, the Company had no outstanding balance under the agreement. The line bears interest at the bank's prime rate plus .25% (3.5% at May 31, 2009) and is collateralized by all assets of the Company. The line of credit contains various financial covenants which include maintaining certain ratios of cash flow to required debt service and debt to tangible net worth as well as maintaining minimum tangible net worth. The Company was in compliance with the financial covenants as of May 31, 2009 and 2008.

4. **Income taxes** For the years ended May 31, 2009 and 2008, the components of the provision for income taxes consisted of:

	2009	2008
Current tax expense	\$ 788,043	\$ 874,307
Deferred tax expense (benefit)	108,800	(120,300)
Provision for income taxes	\$ 896,843	\$ 754,007

Bioqual, Inc. and Subsidiary

Notes to Consolidated Financial Statements

The provision for income taxes for the years ended May 31, 2009 and 2008 reflected in the accompanying consolidated Statements of Income varies from the amount which would have been computed using statutory rates as follows:

	2009	2008
Federal taxes at statutory rate	\$ 754,000	\$ 667,000
State taxes at statutory rate, net of federal tax benefit	121,000	91,000
Permanent differences and other	21,843	(3,993)
Provision for income taxes	\$ 896,843	\$ 754,007

The net deferred income tax liability represents an estimate of the income tax that will be due in future periods from the cumulative temporary differences recognized for financial reporting purposes from that recognized for income tax reporting purposes. At May 31, 2009 and 2008, the components of these temporary differences and the deferred tax liability were as follows:

	2009	2008
Financial statement accruals	\$ 90,000	\$ 72,900
Allowance for doubtful accounts	-	30,700
Different methods of depreciation of fixed assets for tax purposes	(208,100)	(120,800)
Research and development costs deferred for tax purposes	1,300	9,200
Total deferred income taxes	\$ (116,800)	\$ (8,000)
Current deferred income tax asset	\$ 90,000	\$ 103,600
Long-term deferred income tax liability	(206,800)	(111,600)
Net deferred tax liability	\$ (116,800)	\$ (8,000)

5. Operating leases

The Company is obligated, as lessee, under non-cancelable operating leases covering its facilities and certain equipment and vehicles expiring at various dates through 2014. One of the three facility leases provides an option to renew for five years. Another facility lease provides for two successive five-year renewal options. Some of the leases provide for annual increases. A deferred rent liability is recorded for the difference between the pro-rata expense recognized and the total amounts paid to date under the leases.

Bioqual, Inc. and Subsidiary

Notes to Consolidated Financial Statements

The following is a schedule by years of future minimum rental payments required under the operating leases that have an initial or remaining non-cancelable lease term in excess of one year as of May 31, 2009:

Year Ending May 31	Total
2010	\$ 3,097,342
2011	3,173,930
2012	3,238,474
2013	1,114,257
2014	1,145,833
Total	\$ 11,769,836

Total rent expense for the years ended May 31, 2009 and 2008 was approximately \$2,975,000 and \$3,061,000, respectively.

6. **Contract status** **Provisional indirect cost rates:** Billings under cost-based government contracts are calculated using provisional rates which permit recovery of indirect costs. These rates are subject to audit on an annual basis by the government agencies' cognizant audit agency. The cost audits will result in the negotiation and determination of the final indirect cost rates which the Company may use for the years audited. The final rates, if different from the provisional rates, may create a receivable or a liability.

As of May 31, 2009, the Company had negotiated final settlements on indirect cost rates through 2007. The Company periodically reviews its cost estimates and experience rates, and adjustments, if needed, are made and reflected in the period in which the estimates are revised. In the opinion of management, redetermination of any cost-based contracts for the open years will not have any material effect on the Company's financial position or results of operations.

The Company has authorized but uncompleted contracts in progress at May 31, 2009, approximately as follows:

Total contract price of initial contract awards including modifications, exercised options, and approved change orders	\$ 68,020,000
Completed to date	(54,667,000)
Authorized backlog	\$ 13,353,000

Bioqual, Inc. and Subsidiary

Notes to Consolidated Financial Statements

The foregoing contracts contain unexercised options and unfunded amounts not reflected in the above amounts totaling approximately \$37,729,000 at May 31, 2009.

7. **Retirement plan** The Company sponsors a tax deferred savings plan to provide retirement benefits for all eligible employees under the Internal Revenue Code. The Company's annual contribution to the plan is based on eligible employee participation. Participating employees may voluntarily contribute a percentage of their annual salaries, not to exceed certain limits provided by the Code. The Company may make discretionary matches of each participant's contribution. Rights to benefits provided by the Company's contributions vest 20% each year after the second year of service. Participants are fully vested in their voluntary contributions. The Company's contributions for the years ended May 31, 2009 and 2008, were \$120,003 and \$109,648, respectively.
8. **Stock options** The Company grants options to purchase shares of its common stock under its 1988 and 1998 stock option plans. The 1998 stock option plan is authorized to grant options to purchase up to 83,333 shares of common stock. The options expire ten years from the date of grant under the plan, or upon the optionee's separation from the Company and are granted at the average of the closing bid and ask price of the Company's common stock at the date of the grant. Both the 1988 and 1998 plan were terminated in accordance with their terms and conditions.

Options exercised during the year ended May 31, 2009, have an aggregate intrinsic value (fair value less option exercise price) of \$100,594. The Company received cash of \$13,039 related to the exercise of the options in 2009. There was no tax benefit recognized as the options qualified as incentive stock options. The Company issues shares from treasury upon the exercise of stock options.

Bioqual, Inc. and Subsidiary

Notes to Consolidated Financial Statements

The following table summarizes activity in the stock option plans for the years ended May 31, 2009 and 2008:

	Number of Options	Weighted Average Option Price Per Share
Options outstanding, June 1, 2007	8,334	\$ 1.56
Options outstanding, May 31, 2008	8,334	\$ 1.56
Options exercised	(8,334)	1.56
Options outstanding as of May 31, 2009	-	\$ -
Options exercisable as of May 31, 2009	-	\$ -

- 9. Commitments and contingencies** The Company has an employment agreement with its President which provides for a base compensation and additional incentive compensation dependent upon annual operations. On July 10, 2007, the agreement was renewed for an additional five years.
- 10. Major customers** Of the total receivables as of May 31, 2009 and 2008, approximately 71% and 82% are due from three and four customers, respectively. Additionally, the Company has four and three customers, respectively, under contracts that generated approximately 82% and 78% of total contract revenues for the years ended May 31, 2009 and 2008.