CHINA SOUTHERN AIRLINES CO LTD
Form 6-K
September 02, 2005

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 6-K

REPORT OF FOREIGN PRIVATE ISSUER

PURSUANT TO RULE 13a-16 OR 15d-16 OF

THE SECURITIES EXCHANGE ACT OF 1934

For the month of September, 2005

CHINA SOUTHERN AIRLINES COMPANY LIMITED
(Translation of registrant's name into English)

Jichang Road
Guangzhou, Guangdong 510405
People's Republic of China
(Address of principal executive offices)

(Indicate by check mark whether the registrant files or will file annual reports under cover Form 20-F or Form 40-F.)

Form 20-F. [X] Form 40-F. [ ]

(Indicate by check mark whether the registrant by furnishing the information contained in this Form is also thereby furnishing the information to the Commission pursuant to Rule 12g3-2(b) under the Securities Exchange Act of 1934.)

Yes. [ ] No. [X]

(If "Yes" is marked, indicate below the file number assigned to the registrant in connection with Rule 12g3-2(b): 82-_____.)

China Southern Airlines Company Limited (the "Company") on or around September 2, 2005 distributed its Interim Report for the six months ended June 30, 2005, in English and Chinese to its shareholders. A copy of the Interim Report (in English) is included in this Form 6-K of the Company.

[PICTURE]

CHINA SOUTHERN AIRLINES COMPANY LIMITED 2005 INTERIM REPORT 1

All Shareholders:

The Board of Directors of China Southern Airlines Company Limited (the "Company") hereby announces the unaudited operating results of the Company and its subsidiaries (collectively, the "Group") for the six months ended 30 June 2005.

INTRODUCTION

The Group is one of the largest airlines in the People's Republic of China ("PRC") in terms of volume of passenger traffic, number of scheduled flights per week, number of hours flown, route networks and size of aircraft fleet. The Group operates the most extensive route network among all PRC airlines. As of 30 June 2005, the Group operated a total of 498 routes, of which 399 were domestic, 26 were Hong Kong regional and 73 were international. For the six months ended 30 June 2005, the Group operated an average of 7,929 scheduled flights per week, serving 134 cities. As of 30 June 2005, the Group operated a fleet of 242 aircraft, of which 136 were Boeing aircraft and 56 were Airbus aircraft. The average age of the fleet was 8.68 years as of 30 June 2005.

BUSINESS OVERVIEW

With the continuous and steady growth of the PRC economy and the nation's "Go West" and "Revitalising the Old Industrial Bases in the North-eastern Region" strategies, coupled with the effects of joint restructuring of domestic airlines, the Company is faced with new challenges under a market environment which is full of opportunities. On 31 December 2004, the acquisition of the airline operations and certain related assets of China Northern Airlines Company ("CNA") and Xinjiang Airlines Company ("XJA") ("CNA/XJA Acquisition") was approved at an extraordinary general meeting of the Company, which completed the restructuring exercise. The Group has benefited from this acquisition through increased economies of scale and transportation capacity.

However, escalating oil prices continued to drive up the jet fuel prices, which directly increased the operating costs of the Company significantly. In addition, the competition in the domestic civil aviation market was very intensive, leading to an unstable yield. Furthermore, after the restructuring of the Group, it would take a period of time for the benefits of business integration to materialise and for business synergy to take effect. As a result, the Company recorded a net loss of RMB907 million during the first half of the year.

During the first half year of 2005, the Group managed to maintain a consistently high level of flight safety standard to further implement the integration of management of the Group and to complete a stable transition. Notwithstanding challenges like the period required for reorganisation of the management and personnel of the Group after the CNA/XJA Acquisition, the enlarged scale of management and difficulties associated therewith, and the increasingly intensive competition in the aviation and air freight market, the Company has handled these challenges with care and plan, and further implemented the development strategies of the Company.

With the approval of the Board, the Company and Centergate Securities Co., Ltd mutually agreed to the early termination of the assets management agreement. As of 30 May 2005, the Company recovered the full investment principal sum of RMB500,000,000 and the investment return of RMB12,904,110.

For the period under review, the Group's total traffic revenue was RMB17,443 million, an increase of RMB6,609 million or 61.0% from the same period last year. Meanwhile, the Group's total traffic volume increased by 52.9% to 3,343 million RTKs. The aggregate utilisation rate of the Group's Boeing and Airbus aircraft was 9.87 hours per day for the period under review, an increase of 0.47 hours or 5.0% from the same period last year.

Passenger revenue for the period under review was RMB15,967 million, up 63.3% from the same period last year, representing 91.5% of the Group's total traffic revenue. Passenger traffic volume increased by 65.2% to 28,478 million RPKs.

Domestic passenger revenue was RMB12,956 million, up 64.4% from the same period last year. Domestic passenger revenue accounted for 81.1% of overall passenger revenue. Passenger capacity, in terms of ASKs, increased by 68.0% while passenger traffic volume, in terms of RPKs, increased by 72.1% from the same period last year, resulting in an increase in passenger load factor of 1.7 percentage points to 69.4%. The passenger yield per RPK decreased by 5.2% from RMB0.58 to RMB0.55, resulting from intensive competition in the domestic market.

On Hong Kong regional routes, the Group recorded passenger revenue of RMB599 million, up 12.0% from the same period last year. Hong Kong regional passenger revenue accounted for 3.8% of total passenger revenue. Passenger capacity, in terms of ASKs, increased by 22.9% while passenger traffic volume, in terms of RPKs increased by 21.3% from the same period last year, resulting in a decrease in passenger load factor of 0.8 percentage points to 61.1%. The passenger yield per RPK decreased by 7.5% to RMB0.86 as more chartered flights were rendered during the period under review.

Passenger revenue for the Group's international routes amounted to RMB2,412 million, an increase of 77.5% from the same period last year. International passenger revenue accounted for 15.1% of total passenger revenue. Passenger capacity, in terms of ASKs, increased by 39.5% while passenger traffic volume, in terms of RPKs, increased by 42.3% from the same period last year, resulting in an increase in passenger load factor of 1.3 percentage points to 63.5%. The passenger yield per RPK increased by 24.4% to RMB0.56 mainly due to upward fare adjustment on certain routes during the period under review.

Cargo and mail revenue was RMB1,476 million, an increase of 39.5% from the same period last year. Cargo and mail revenue accounted for 8.5% of total traffic revenue. Cargo and mail volume grew by 24.5% to 804 million RTKs from the same period last year, mainly due to the increase in traffic volume. The overall yield per cargo and mail tonne kilometre increased by 12.2% to RMB1.84, mainly due to an increase in fares during the period under review.

The Group's other revenue amounted to RMB401 million, an increase of 54.2% from the same period last year, primarily due to increases in ground service income of RMB72 million, as a result of the increase in traffic volume.

Total operating expenses increased by 76.6% to RMB18,260 million from the same period last year, primarily due to the general increases in fuel cost, aircraft repairs and maintenance expenses, landing and navigation fees and commission expenses resulting from the increase in traffic volume during the period under review.

Flight operations expenses increased by 92.4% to RMB9,084 million from the same period last year. Of these expenses, fuel cost was RMB5,549 million, up 104.6% from the same period last year, mainly as a result of increases in fuel consumption and fuel prices. Aircraft insurance costs increased by 48.2% to RMB126 million, primarily resulted from the fleet expansion subsequent to the CNA/XJA Acquisition. Operating lease payments increased by 43.0% to RMB1,184 million, mainly attributable to additional rental payments for new aircraft under operating leases. Air catering expenses increased by 72.4% to RMB538 million, primarily as a result of an increase in number of passengers carried during the period under review. Labour costs for flight personnel increased by 65.8% to RMB814 million, largely due to an increase in flying hours.

Maintenance expenses increased by 64.5% to RMB2,320 million, due mainly to increases in aircraft overhaul charges and routine maintenance costs resulting from the increase in flying hours during the period under review.

Aircraft and traffic servicing expenses increased by 51.6% to RMB2,560 million from the same period last year, reflecting primarily an increase in number of landing and takeoffs.

Promotion and sales expenses increased by 39.6% to RMB1,220 million from the same period last year, primarily as a result of an increase in traffic volume.

General and administrative expenses increased by 65.2% to RMB912 million from the same period last year, due mainly to an increase in the scale of operations.

As compared with the same period last year, depreciation and amortisation expenses increased by 93.4% to RMB2,094 million, reflecting primarily the effect of the fleet expansion through the CNA/XJA Acquisition and scheduled aircraft delivered during the second half of 2004 and the period under review.

Interest expense increased by 118.0% to RMB750 million in the period under review, primarily reflecting an increase in the balance of loan borrowings and the increase in LIBOR rate, while 46.5% of the Group total borrowings are subject to LIBOR rate.

The Group recorded a net exchange gain of RMB197 million, predominantly relating to its Japanese yen denominated borrowings as a result of the depreciation of Japanese Yen during the period under review. The major part of such amount represented unrealised translation gain.

As a result of the aforementioned factors, for the six months ended 30 June 2005, the Group recorded a net loss attributable to equity holders of the parent of RMB907 million, as compared to a net profit attributable to equity holders of the parent of RMB266 million for the same period last year.

LIQUIDITY, FINANCIAL RESOURCES AND CAPITAL STRUCTURE

As of 30 June 2005, the Group's borrowings totalled RMB42,933 million, an increase of RMB7,601 million from RMB35,332 million as of 31 December 2004. The majority of such borrowings were denominated in United States dollars and, to a smaller extent, in Japanese yen and Hong Kong dollars, with a significant portion being fixed interest rate borrowings. As of 30 June 2005, cash and cash equivalents of the Group totalled RMB5,632 million, an increase of RMB2,549 million from RMB3,083 million as of 31 December 2004. Of such balance, 30.8% was denominated in foreign currencies. Net debts (total borrowings net of cash and cash equivalents) increased by 15.7% to RMB37,301 million from RMB32,249 million as of 31 December 2004.

As of 30 June 2005, the equity attributable to equity holders of the parent amounted to RMB10,941 million, a decrease of RMB907 million from RMB11,848 million as of 31 December 2004, reflecting the net loss recorded for the period under review.

Net debt/equity ratio of the Group as of 30 June 2005 was 3.41 times, as compared to 2.72 times as of 31 December 2004.

FINANCIAL RISK MANAGEMENT POLICY

In the normal course of business, the Group is exposed to fluctuations in foreign currencies and jet fuel prices. The Group's exposure to foreign currencies is mainly attributable to its debts denominated in foreign currencies. Depreciation or appreciation of the Renminbi against foreign currencies could affect the Group's results and financial position significantly, as the Group's foreign currency payments generally exceed its foreign currency receipts. The Group is not able to hedge its foreign currency exposure effectively other than by retaining its foreign currency denominated earnings and receipts to the extent permitted by the State Administration of Foreign Exchange, or subject to certain restrictive conditions, by entering into forward foreign exchange contracts with authorised PRC banks.

On 21 July 2005, the People's Bank of China ("PBOC") announced that the PRC government reformed the exchange rate regime by moving into a managed floating exchange rate regime based on market supply and demand with reference to a basket of foreign currencies. In particular, the exchange rate of US dollar against Renminbi was adjusted upward to RMB8.11 per US dollar with effect from the close of business on 21 July 2005. The Group considers that the above appreciation of Renminbi would not have adverse financial impacts to its operation.

The Group is required to procure a majority of its jet fuel domestically at PRC spot market prices. There are currently no effective means available to the Group for managing its exposure associated with the fluctuations in domestic jet fuel prices.

CHARGES ON ASSETS

As of 30 June 2005, certain aircraft of the Group with an aggregate carrying value of approximately RMB25,268 million (as of 31 December 2004: RMB23,562 million) were mortgaged under certain loan and lease agreements.

CAPITAL AND INVESTING COMMITMENTS

As of 30 June 2005, the Group had capital commitments of approximately RMB40,605 million. Of such amounts, RMB37,429 million was related to the acquisition of aircraft and related flight equipment and RMB820 million was related to the Group's facilities and equipment to be constructed and installed at the new Guangzhou Baiyun International Airport. The remaining amount of RMB2,356 million was related to the Group's other airports and office facilities and equipment, overhaul and maintenance bases and training facilities.

As of 30 June 2005, the Group was committed to making a capital contribution of approximately RMB61 million and RMB83 million to its subsidiaries and jointly controlled entities respectively.

CONTINGENT LIABILITIES

There have been no material adverse changes in the contingent liabilities of the Group since 31 December 2004.

RECENT ECONOMIC DEVELOPMENT

Upon approval from the Board, the Company will set up its Beijing branch in Tianzhu Airport Industrial Zone, Beijing. The Company believes that with the integration of the Group's core business, the Company's business development in Beijing Capital International Airport will provide a better hub base for the Group's existing Azure Big Delta (Guangzhou, Shenyang and Urumqi) network services. Meanwhile, the Group can also take an active role in and share the opportunities arising from the Beijing Olympics Games 2008.

Following the announcement by the PBOC on the changes in the Renminbi foreign exchange rate system on 21 July 2005, the Company will benefit from the Renminbi appreciation as it finances its aircraft acquisitions and conducts other transactions in US dollar e.g. jet fuel, lease of aviation equipment, acquisition and major repair, and it still has a substantial amount of debt in US dollar. In addition, landing fees for international flights are denominated in foreign currencies making the Company a beneficiary of the appreciation of Renminbi. Reminbi appreciation will also bring a one-off exchange gain to the Group and reduce its operating costs which are denominated in foreign currencies. On the other hand, the Group faces greater challenge from international routes.

According to "Notice of the National Development and Reform Commission (NDRC) and the General Administration of Civil Aviation of China (CAAC) Concerning the Relevant Questions on Collecting Fuel Surcharge to Domestic Routes", effective from 1 August 2005 (flight time), airlines are allowed to impose fuel surcharge on all domestic routes (other than routes between Mainland to Hong Kong and Macau). The resumption of fuel surcharge collection will ease the Group's burden due to the jet fuel cost.

PROSPECTS FOR THE SECOND HALF

Global airline industry has been badly hit by soaring jet fuel prices. As a result of the three times increases in domestic jet fuel prices, the Group's jet fuel cost has accounted for 30% of total costs. The Group intends to meet the challenges by using its economies of scale operation and strict control over operating costs increase, so as to reduce the impact brought by the persistently high oil prices.

The enlarged scale of the Group due to its joint restructuring will provide more opportunities for the development of the Company's business and operations. The Group will adjust its flight network by increasing traffic capacity to fill in any deficiencies in its routes, and will maintain or increase domestic and regional market shares. The Group believes that its leading position in the civil aviation industry can be assured by speeding up integration of flight networks and capacity to realize the objectives of network operation, and also through innovation, refinement and enhancement of incentive mechanism.

The Company will continue to implement strict costs control and raise its overall synergy benefits.

DIVIDENDS

The Board of Directors does not propose to declare an interim dividend for the year 2005.

STRUCTURE OF SHARE CAPITAL

As of 30 June 2005, the share capital of the Company comprised 4,374,178,000 shares, of which approximately 50.30% or 2,200,000,000 State-owned Shares were held by China Southern Air Holding Company ("CSAHC"), approximately 22.86% or 1,000,000,000 A Shares were held by the PRC investors and approximately 26.84% or 1,174,178,000 H Shares were held by Hong Kong and overseas investors.

CATEGORY OF SHARES	NUMBER OF SHARES HELD	PERCENTAGE TO THE TOTAL SHARE CAPITAL (%)
State-owned Shares (held by CSAHC)	2,200,000,000	50.30%
H Shares	1,174,178,000	26.84%
A Shares	1,000,000,000	22.86%
Total share capital	4,374,178,000	100.00%

SUBSTANTIAL SHAREHOLDERS

As of 30 June 2005, to the knowledge of the directors, chief executive and supervisors of the Company, the interests and short positions of the following persons other than the directors, chief executives or supervisors in the shares and underlying shares of the Company as recorded in the register of the Company required to be kept under section 336 of the Securities and Futures Ordinance (the "SFO") or otherwise persons who have an interest of 10% or more in the Company's shares are as follows:

NAME OF SHAREHOLDER	TYPE OF SHAREHOLDING	TYPE OF SHARE	NUMBER OF SHARES HELD	% OF THE TOTAL ISSUED H SHARES OF THE COMPANY
CSAHC	Direct holding	Domestic share	2,200,000,000	-
HKSCC Nominees Limited	Direct holding	H share	1,150,918,998	98.0%

Notes:

Based on the information available to the directors, chief executive and supervisors of the Company (including such information as was available on the website of the Stock Exchange) and so far as the directors, chief executive and supervisors are aware, as at 30 June 2005:

1. Among the 1,150,918,998 H Shares held by HKSCC Nominees Limited, Li Ka-Shing Unity Trustcorp Limited had an interest in an aggregate of 193,877,000 H Shares of the Company (representing approximately 16.51% of its then total issued H Shares) in the capacity as beneficiary of a trust.

2. Among the 1,150,918,998 H Shares held by HKSCC Nominees Limited, J.P. Morgan Chase & Co. had an interest in an aggregate of 164,098,800 H Shares of the Company (representing approximately 13.98% of its then total issued H Shares). Out of the 164,098,800 H Shares, J.P. Morgan Chase & Co. had an interest in a lending pool comprising 76,962,000 H Shares of the Company (representing approximately 6.55% of its then total issued H Shares). According to the information as disclosed in the website of the Stock Exchange and so far as the directors, chief executive and supervisors are

aware, J.P. Morgan Chase & Co. held its interest in the Company in the following manners:

(a) 76,962,000 H Shares in a lending pool, representing approximately 6.55% of the Company's then total issued H Shares, were held by J.P. Morgan Chase Bank N.A., which was 100% held by J.P. Morgan Chase & Co.;

(b) 1,064,800 H Shares, representing approximately 0.09% of the Company's then total issued H Shares, were held in the capacity as beneficial owner by J.P. Morgan Whitefriars Inc., which was ultimately 100% held by J.P. Morgan Chase & Co.;

(c) 83,512,000 H Shares, representing approximately 7.11% of the Company's then total issued H Shares, were held in the capacity as investment manager by JF Asset Management Limited, which was approximately 99.99% held by J.P. Morgan Fleming Asset Management (Asia) Inc., which was ultimately 100% held by J.P. Morgan Chase & Co.; and

(d) 2,560,000 H Shares, representing approximately 0.22% of the Company's then total issued H Shares, were held in the capacity as beneficial owner by JF International Management Inc., which was ultimately 100% held by J.P. Morgan Chase & Co..

3. Among the 1,150,918,998 H Shares held by HKSCC Nominees Limited, Morgan Stanley International Incorporated had an interest in an aggregate of 111,121,932 H Shares of the Company (representing approximately 9.46% of its then total issued H Shares). According to the information as disclosed on the website of the Stock Exchange and so far as the directors, chief executive and supervisors are aware, Morgan Stanley International Incorporated which was (or its directors were) accustomed to act in accordance with the directors of Morgan Stanley, held its indirect interest in the Company in the manner as follows:

(a) 743,332 H Shares, representing approximately 0.06% of the Company's then total issued H Shares, were held by Morgan Stanley Dean Witter Hong Kong Securities Limited, which was ultimately 100% held by Morgan Stanley Asia Pacific (Holdings) Limited, which, in turn, was 90% held by Morgan Stanley International Incorporated;

(b) 108,670,000 H Shares, representing approximately 9.25% of the Company's then total issued H Shares, were held by Morgan Stanley Investment Management Company, which was ultimately 100% held by Morgan Stanley Asia Pacific (Holdings) Limited, which, in turn, was 90% held by Morgan Stanley International Incorporated;

(c) 292,600 H Shares, representing approximately 0.02% of the Company's then total issued H Shares, were held by Morgan Stanley Asset & Investment Trust Management Co. Limited, which was 100% held by Morgan Stanley International Incorporated;

(d) 714,000 H Shares, representing approximately 0.06% of the Company's then total issue H Shares, were held by Morgan Stanley & Co International Limited, which was ultimately 100% held by Morgan Stanley Group (Europe), which, in turn, was approximately 98.30% held by Morgan Stanley International Limited, in which Morgan Stanley International Incorporated held 100% control; and

(e) 702,000 H Shares, representing approximately 0.06% of the Company's then total issued H Shares, were held by Morgan Stanley Capital (Luxembourg) S.A., which was approximately 93.75% held by Morgan

Stanley International Incorporated.

According to the information as disclosed on the website of the Stock Exchange and so far as the directors, chief executive and supervisors are aware, Morgan Stanley Dean Witter Hong Kong Securities Limited also had a short position in 616,000 H Shares of the Company (representing approximately 0.05% of its then total issued H Shares).

4. Among the 1,150,918,998 H Shares held by HKSCC Nominees Limited, 96,938,500 H Shares, representing approximately 8.26% of the Company's then total issued H Shares, were held by Space Dragon Limited as beneficial owner, which was 100% held by Cheung Kong Investment Company Limited.

5. Among the 1,150,918,998 H Shares held by HKSCC Nominees Limited, 96,938,500 H Shares, representing approximately 8.26% of the Company's then total issued H Shares, were held by Choicewell Limited as beneficial owner, which was ultimately 100% held by Hutchison Whampoa Limited.

Save as disclosed above, as at 30 June 2005, to the knowledge of the directors, chief executive and supervisors of the Company, no other person (other than the directors, chief executives or supervisors) had an interest or short positions in the shares or underlying shares of the Company as recorded in the register of the Company required to be kept under section 336 of the SFO or otherwise had an interest of 10% or more in the Company's shares.

PURCHASE, SALE OR REDEMPTION OF SHARES

Neither the Company nor any of its subsidiaries purchased, sold or redeemed any shares of the Company during the first half of 2005.

INTERESTS OF THE DIRECTORS AND SUPERVISORS IN THE EQUITY OF THE COMPANY

As of 30 June 2005, the interests and short positions of the directors, chief executive and supervisors in the shares, underlying shares and/or debentures (as the case may be) of the Company or its associated corporations (within the meaning of Part XV of the SFO) which were required to be notified to the Company and The Stock Exchange of Hong Kong Limited (the "Stock Exchange") pursuant to SFO (including interest or short positions which are taken or deemed to have under such provisions of the SFO), or recorded in the register maintained by the Company pursuant to Section 352 of the SFO or which were required to be notified to the Company and the Stock Exchange pursuant to the "Model Code for Securities Transactions by Directors of the Listed Companies" in Schedule 10 of the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited (the "Listing Rules") are as follows:

NAME	THE COMPANY/ ASSOCIATED CORPORATION	TYPES OF INTEREST	TYPE OF SHARE	NUMBER OF SHARES HELD	% TO THE TOTAL ISSUED SHARE CAPITAL OF THE COMPANY	% TO THE TOTAL ISSUED H SHARES OF THE COMPANY	SHORT POSITION
Simon To	The Company	Interest of spouse (note 1)	H Shares	100,000	0.002%	0.009%	-

Note 1: The spouse of Mr. Simon To is the owner of these 100,000 H shares of the Company and accordingly, Mr. Simon To, is taken to be interested in these 100,000 H Shares by virtue of the SFO.

Save as disclosed above, as of 30 June 2005, none of the directors, chief executive or supervisors of the Company has interest or short position in the shares, underlying shares and/or debentures (as the case may be) of the Company or its associated corporations (within the meaning of the Part XV of the SFO) which were notified to the Company and the Stock Exchange pursuant to SFO (including interest or short positions which they are taken or deemed to have under such provisions of the SFO), or recorded in the register maintained by the Company pursuant to Section 352 of the SFO or which were notified to the Company and the Stock Exchange pursuant to the "Model Code for Securities Transactions by Directors of the Listed Companies" in Schedule 10 of the Listing Rules.

DESIGNATED DEPOSITS AND OVERDUE TIME DEPOSITS

As of 30 June 2005, the Group's deposits placed with financial institutions or other parties did not include any designated deposits or overdue time deposits against which the Group failed to receive repayments.

THE MODEL CODE

Having made specific enquiries with all the directors of the Company, the directors have for six months ended 30 June 2005 complied with the "Model Code for Securities Transactions by Directors of Listed Issuers" as set out in Appendix 10 of the Rules Governing the Listing of Securities on the Hong Kong Stock Exchange (the "Listing Rules"). The Company has not adopted a code of conduct less stringent than the "Model Code for Securities Transactions by Directors of Listed Issuers" regarding securities transactions of the directors.

THE CODE OF CORPORATE GOVERNANCE PRACTICES

The Directors of the Company consider that, in the six months ended 30 June 2005, the Group was in compliance with the Code of Corporate Governance Practices set out in Appendix 14 of the Listing Rules.

MATERIAL LITIGATION

The Company was involved in a civil litigation (Hong Kong High Court Action No. 515 of 2001) ("Litigation"). According to the writ of summons for the Litigation, New Link Consultants Limited, the plaintiff, claimed against the Group (as one of the defendants to the Litigation) on the basis of certain evidence proving that United Aero-Supplies System of China, Limited ("UASSC") entered into an agreement with the defendants for exclusive purchase of aviation equipment consigned to UASSC for sale. As the defendants failed to perform the agreement, UASSC should have the right to compensation. Since UASSC was in the course of its winding up proceedings, all the rights and benefits of UASSC in connection with the claim had been transferred to the plaintiff. The Company, as one of the defendants to the Litigation was claimed for unspecified damages for breach of the agreement. The Company filed an objection in respect of the jurisdiction of the court, and has requested the court to transfer the case to the PRC for trial. On 3 May 2004, the court made an award in favour of the Company for the transfer to the PRC, against which the plaintiff has filed an appeal.

In August 2005, the parties to the Litigation reached an out of court settlement, pursuant to which the plaintiff will waive all its rights or possible rights to commence proceedings, claims or appeals against the Company in respect of the same matter.

By order of the Board of Directors
LIU SHAO YONG
Chairman of the Board of Directors

Guangzhou, the PRC
26 August 2005

DOCUMENTS AVAILABLE FOR INSPECTION AND ADDRESS FOR INSPECTION

DOCUMENT AVAILABLE FOR INSPECTION: Original copy of the Company's 2005 interim report signed by the Chairman of the Board.

ADDRESS FOR INSPECTION: The Company Secretary Office of the China Southern Airlines Company Limited, No. 278, Ji Chang Lu, Guangzhou, the People's Republic of China.

WEBSITE: www.cs-air.com

OPERATING DATA SUMMARY

	FOR THE SIX MONTHS ENDED 30 JUNE		2005 VS 2004 INCREASE/	
	2005	2004	(DECREASE)	(%)
CAPACITY				
Available seat kilometres (ASKs) (million)				
- Domestic	33,833	20,141	13,692	68.0
- Hong Kong regional	1,138	926	212	22.9
- International	6,782	4,861	1,921	39.5
Total	41,753	25,928	15,825	61.0
Available tonne kilometres (ATKs) (million)				
- Domestic	3,885	2,333	1,552	66.5
- Hong Kong regional	127	103	24	23.3
- International	1,402	1,139	263	23.1
Total	5,414	3,575	1,839	51.4
Kilometres flown (thousand)	254,547	156,041	98,506	63.1
Hours flown (thousand)	400	242	158	65.3

Number of flight sectors				
– Domestic	184,974	117,919	67,055	56.9
– Hong Kong regional	8,364	7,549	815	10.8
– International	12,826	7,548	5,278	69.9
Total	206,164	133,016	73,148	55.0

	FOR THE SIX MONTHS ENDED 30 JUNE		2005 VS 2004 INCREASE/	
	2005	2004	(DECREASE)	(%)
TRAFFIC				
Revenue passenger kilometres (RPKs) (million)				
– Domestic	23,479	13,644	9,835	72.1
– Hong Kong regional	695	573	122	21.3
– International	4,304	3,025	1,279	42.3
Total	28,478	17,242	11,236	65.2
Revenue tonne kilometres (RTKs) (million)				
– Domestic	2,524	1,518	1,006	66.3
– Hong Kong regional	69	57	12	21.1
– International	750	611	139	22.7
Total	3,343	2,186	1,157	52.9
Passenger tonne kilometres (million)				
– Domestic	2,094	1,219	875	71.8
– Hong Kong regional	62	51	11	21.6
– International	383	270	113	41.9
Total	2,539	1,540	999	64.9
Cargo and mail tonne kilometres (million)				
– Domestic	430	299	131	43.8
– Hong Kong regional	7	6	1	16.7
– International	367	341	26	7.6
Total	804	646	158	24.5

Passengers carried (thousand)				
- Domestic	18,115	11,825	6,290	53.2
- Hong Kong regional	739	671	68	10.1
- International	1,405	819	586	71.6
Total	20,259	13,315	6,944	52.2

	FOR THE SIX MONTHS ENDED 30 JUNE		2005 VS 2004 INCREASE/	
	2005	2004	(DECREASE)	(%)
Cargo and mail carried (thousand tonne)				
- Domestic	285	218	67	30.7
- Hong Kong regional	8	7	1	14.3
- International	55	42	13	31.0
Total	348	267	81	30.3
LOAD FACTORS				
Passenger load factor (RPK/ASK) (%)				
- Domestic	69.4	67.7	1.7	2.5
- Hong Kong regional	61.1	61.9	(0.8)	(1.3)
- International	63.5	62.2	1.3	2.1
Total	68.2	66.5	1.7	2.6
Average load factor (RTK/ATK) (%)				
- Domestic	65.0	65.1	(0.1)	(0.2)
- Hong Kong regional	54.3	55.3	(1.0)	(1.8)
- International	53.5	53.6	(0.1)	(0.2)
Total	61.7	61.1	0.6	1.0
Breakeven load factor (%)	64.6	58.3	6.3	10.8
YIELD				
Yield per RPK (RMB)				
- Domestic	0.55	0.58	(0.03)	(5.2)
- Hong Kong regional	0.86	0.93	(0.07)	(7.5)
- International	0.56	0.45	0.11	24.4
Total	0.56	0.57	(0.01)	(1.8)

Yield per cargo and mail tonne kilometre (RMB)	1.84	1.64	0.20	12.2
Yield per RTK (RMB)				
- Domestic	5.39	5.49	(0.10)	(1.8)
- Hong Kong regional	9.29	9.98	(0.69)	(6.9)
- International	4.28	3.15	1.13	35.9
Total	5.22	4.96	0.26	5.2

	FOR THE SIX MONTHS ENDED 30 JUNE		2005 VS 2004 INCREASE/	
	2005	2004	(DECREASE)	(%)
FLEET				
Number of aircraft in service at period end				
- Boeing	136	113	23	20.4
- Airbus	56	24	32	133.3
- McDonnell Douglas	36	-	36	100.0
- Embraer	6	2	4	200.0
- Others	8	-	8	100.0
Total	242	139	103	74.1
Aircraft utilisation rate (hours per day)				
- Boeing	10.30	9.60	0.70	7.3
- Airbus	9.34	9.27	0.07	0.8
Total	9.87	9.40	0.47	5.0
FINANCIAL				
Operating cost per ASK (RMB)	0.44	0.40	0.04	10.0
Operating cost per ATK (RMB)	3.37	2.89	0.48	16.6

The Board of Directors of the Company hereby announces the unaudited consolidated interim results of the Group for the six months ended 30 June, 2005, together with the comparative figures for the corresponding period of 2004 as follows:

A. PREPARED IN ACCORDANCE WITH INTERNATIONAL FINANCIAL REPORTING STANDARDS ("IFRS")

CONSOLIDATED INCOME STATEMENT

For the six months ended 30 June 2005 - unaudited
(Expressed in Renminbi)

	Note	FOR THE SIX MONTHS ENDED 30 JUNE 2005 RMB MILLION	2004 RMB millio (Note 2)
Operating revenue			
Traffic revenue		17,443	10,834
Other operating revenue		401	260
Total operating revenue	3	17,844	11,094
Operating expenses			
Flight operations		9,084	4,722
Maintenance		2,320	1,410
Aircraft and traffic servicing		2,560	1,689
Promotion and sales		1,220	874
General and administrative		912	552
Depreciation and amortisation		2,094	1,083
Other		70	8
Total operating expenses		18,260	10,338
Operating (loss)/profit		(416)	756
Non-operating income/(expenses)			
Interest income		17	9
Interest expense	4	(750)	(344)
Share of associates' results		(28)	21
Share of jointly controlled entities' results		24	4
(Loss)/profit on sale of property, plant and equipment		(35)	3
Exchange gain, net		197	15
Other, net		(34)	5
Total net non-operating expenses		(609)	(287)
(Loss)/profit before taxation	4	(1,025)	469
Taxation credit/(expense)	5	61	(95)
(Loss)/profit for the period		(964)	374
Attributable to			
Equity holders of the parent		(907)	266
Minority interests	2	(57)	108
(Loss)/profit for the period		(964)	374

Basic (loss)/earnings per share	7	(RMB0.21)	RMB0.06

The notes on pages 19 to 27 form part of this interim financial report.

CONSOLIDATED BALANCE SHEET
As at 30 June 2005 – unaudited
(Expressed in Renminbi)

	Note	AS AT 30 JUNE 2005 RMB MILLION	As at 31 December 2004 RMB million (Note 2)
NON-CURRENT ASSETS			
Property, plant and equipment, net	8	50,478	46,841
Construction in progress		773	565
Lease prepayments		371	346
Interest in associates		402	429
Interest in jointly controlled entities		809	782
Other investments		290	272
Lease and equipment deposits		4,699	5,397
Deferred tax assets		68	–
Other assets		299	331
		58,189	54,963
CURRENT ASSETS			
Short term investments		–	683
Inventories		1,505	1,302
Taxes recoverable		40	–
Trade receivables	9	1,271	1,203
Other receivables		976	616
Prepaid expenses and other current assets		418	378
Cash and cash equivalents		5,632	3,083
		9,842	7,265
CURRENT LIABILITIES			
Bank and other loans		13,282	11,518
Obligations under finance leases		2,397	2,144
Trade payables	10	2,334	1,554
Bills payable		2,760	136
Sales in advance of carriage		899	874
Taxes payable		–	39
Amounts due to related companies		106	2,330
Accrued expenses		4,590	4,551
Other liabilities		3,246	2,974

	29,614	26,120
NET CURRENT LIABILITIES	(19,772)	(18,855)
TOTAL ASSETS LESS CURRENT LIABILITIES	38,417	36,108
NON-CURRENT LIABILITIES AND DEFERRED ITEMS		
Bank and other loans	12,782	11,935
Obligations under finance leases	11,712	9,599
Provision for major overhauls	275	284
Deferred credits	370	100
Deferred tax liabilities	336	287
	25,475	22,205
NET ASSETS	12,942	13,903

The notes on pages 19 to 27 form part of this interim financial report.

CONSOLIDATED BALANCE SHEET (continued)
As at 30 June 2005 – unaudited
(Expressed in Renminbi)

	Note	AS AT 30 JUNE 2005 RMB MILLION	As a 31 Dece 200 RMB mil (Note
CAPITAL AND RESERVES			
Share capital		4,374	4,37
Reserves	11	6,567	7,47
TOTAL EQUITY ATTRIBUTABLE TO EQUITY HOLDERS OF THE PARENT		10,941	11,84
MINORITY INTERESTS	2	2,001	2,05
TOTAL EQUITY		12,942	13,90

Approved and authorised for issue by the Board of Directors on 26 August 2005.

LIU SHAO YONG	SI XIAN MIN	XU JIE BO
Director	Director	Director

The notes on pages 19 to 27 form part of this interim financial report.

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY
For the six months ended 30 June 2005 – unaudited
(Expressed in Renminbi)

		ATTRIBUTABLE TO EQUITY HOLDERS OF THE PARENT				
	Note	SHARE CAPITAL RMB million	SHARE PREMIUM RMB million	OTHER RESERVES RMB million	RETAINED EARNINGS RMB million	TOT RMB m
At 1 January 2004	2	4,374	5,325	611	1,586	11,
Profit for the period		–	–	–	266	
Dividends		–	–	–	–	
Issue of share capital		–	–	–	–	
At 30 June 2004	2	4,374	5,325	611	1,852	12,
At 1 January 2005	2	4,374	5,325	672	1,477	11,
Loss for the period		–	–	–	(907)	(
Dividends		–	–	–	–	
Issue of share capital		–	–	–	–	
AT 30 JUNE 2005		4,374	5,325	672	570	10,

The notes on pages 19 to 27 form part of this interim financial report.

CONDENSED CONSOLIDATED CASH FLOW STATEMENT
For the six months ended 30 June 2005 – unaudited
(Expressed in Renminbi)

	FOR THE SIX MONTHS ENDED 30 JUNE 2005 RMB MILLION	200 RMB mil
Net cash inflows from operating activities	1,662	1,21
Net cash used in investing activities	(692)	(4,05

Net cash inflow/(outflow) before financing activities	970	(2,83
Net cash inflows from financing activities	1,579	3,68
Increase in cash and cash equivalents	2,549	85
Cash and cash equivalents as at 1 January	3,083	2,08
Cash and cash equivalents as at 30 June	5,632	2,93

The notes on pages 19 to 27 form part of this interim financial report.

NOTES:

1 BASIS OF PREPARATION

This interim financial report of China Southern Airlines Company Limited (the "Company") and its subsidiaries (the "Group") has been prepared in accordance with the applicable disclosure provisions of the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited, including compliance with International Accounting Standard 34 "Interim Financial Reporting" ("IAS 34") adopted by the International Accounting Standards Board ("IASB"). It was authorised for issuance on 26 August 2005.

The interim financial report has been prepared in accordance with the same accounting policies adopted in the 2004 annual financial statements, except for the change in presentation of financial statements arising from the changes of International Financial Reporting Standards ("IFRS") that is expected to be reflected in the 2005 annual financial statements. Details of the changes are set out in note 2.

The preparation of an interim financial report in conformity with IAS 34 requires management to make judgements, estimates and assumptions that affect the application of policies and reported amounts of assets and liabilities, income and expenses on a year to date basis. Actual results may differ from these estimates.

The interim financial report contains condensed consolidated financial statements and selected explanatory notes. The notes include an explanation of events and transactions that are significant to an understanding of the changes in financial position and performance of the Group since the 2004 annual financial statements. The condensed consolidated interim financial statements and notes thereon do not include all of the information required for full set of financial statements prepared in accordance with IFRS. IFRS includes IAS and interpretations.

The interim financial report is unaudited, but has been reviewed by KPMG in accordance with Statement of Auditing Standards 700, Engagements to review interim financial reports, issued by the Hong Kong Institute of Certified Public Accountants. KPMG's independent review report to the Board of Directors is included on page 28.

The financial information relating to the financial year ended 31 December 2004 that is included in the interim financial report as being previously reported information does not constitute the Group's annual financial statements prepared under IFRS for that financial year but is derived from those financial statements. The Group's annual financial statements for the year ended 31 December 2004 are available at the Company's registered office. The auditors have expressed an unqualified opinion on those financial statements in their report dated 25 April 2005.

2 NEW AND REVISED IFRS

The IASB has issued a number of new and revised IFRS that are effective or available for early adoption for accounting periods beginning on or after 1 January 2005. The Board of Directors has determined the accounting policies to be adopted in the preparation of the Group's annual financial statements prepared under IFRS for the year ending 31 December 2005, on the basis of IFRS currently in issue.

The IFRS that will be effective or are available for voluntary early adoption in the annual financial statements prepared under IFRS for the year ending 31 December 2005 may be affected by the issue of additional interpretation(s) or other changes announced by the IASB subsequent to the date of issuance of this interim report. Therefore the policies that will be applied in the Group's financial statements for that period cannot be determined with certainty at the date of issuance of this interim financial report.

2 NEW AND REVISED IFRS (continued)

The adoption of revised IAS 1, Presentation of financial statements and IAS 27, Consolidated and separate financial statements, has resulted in a change in presentation of minority interests in the financial statements:

In prior years, minority interests at the balance sheet date were presented in the consolidated balance sheet separately from liabilities and as deduction from net assets. Minority interests in the results of the Group for the year were also separately presented in the consolidated income statement as a deduction before arriving at the profit attributable to shareholders.

With effect from 1 January 2005, in order to comply with IAS 1 and IAS 27, minority interests at the balance sheet date are presented in the consolidated balance sheet within equity, separately from the equity attributable to the equity holders of the parent, and minority interests in the results of the Group for the period are presented on the face of the consolidated income statement as an allocation of the total profit or loss for the period between the minority interests and the equity holders of the parent.

The presentation of minority interests in the consolidated balance sheet, income statement and statement of changes in equity for the comparative period has been restated accordingly.

3 TURNOVER

The Group is principally engaged in the provision of domestic, Hong Kong regional and international passenger, cargo and mail airline services,

with flights operating primarily from the Guangzhou Baiyun International Airport in the People's Republic of China ("PRC"), which is both the main hub of the Group's route network and the location of its corporate headquarters.

Turnover comprises revenues from airline and airline-related businesses and is stated net of sales tax.

Geographic information about the Group's turnover and operating (loss)/profit are analysed as follows:

	FOR THE SIX MONTHS ENDED 30 JUNE			
	DOMESTIC RMB million	HONG KONG REGIONAL RMB million	INTERNATIONAL RMB million	TOTAL RMB million
2005				
Traffic revenue	13,592	641	3,210	17,443
Other operating revenue	401	–	–	401
Turnover	13,993	641	3,210	17,844
Operating (loss)/profit	(228)	28	(216)	(416)
2004				
Traffic revenue	8,341	569	1,924	10,834
Other operating revenue	260	–	–	260
Turnover	8,601	569	1,924	11,094
Operating profit	605	39	112	756

4 (LOSS)/PROFIT BEFORE TAXATION

	FOR THE SIX MONT ENDED 30 JUNE 2005 RMB MILLION	20 RMB mi
(Loss)/profit before taxation is arrived at after charging:		
Depreciation		
– owned assets	1,603	8
– assets acquired under finance leases	491	2
Amortisation of deferred expenditure	30	
Operating lease charges		

- aircraft and flight equipment	1,184	8
Staff costs	1,776	1,0
Interest expense		
Interest on bank and other loans	493	1
Finance charges on obligations under finance leases	302	1
Less: borrowing costs capitalised	(45)	(
Net interest expense	750	3
	=====	===
and after crediting:		
Net realised and unrealised gain on equity securities held for trading	1	
	=====	===

5 TAXATION (CREDIT)/EXPENSE

	FOR THE SIX MONTHS ENDED 30 JUNE	
	2005	2004
	RMB MILLION	RMB million
PRC income tax	5	28
Share of taxation of associates	(1)	4
Share of taxation of jointly controlled entities	(3)	5
	---	--
	1	37
Deferred taxation	(62)	58
	---	--
	(61)	95
	===	==

The statutory income tax rate in the PRC is 33%. Pursuant to approval documents issued by the relevant tax authorities, the Company and certain airline subsidiaries of the Company are entitled to enjoy a preferential tax rate of 15%.

In respect of the Group's overseas airline activities, the Group has either obtained exemptions from overseas taxation pursuant to the bilateral aviation agreements between the overseas governments and the PRC government, or has sustained tax losses in these overseas jurisdictions. Accordingly, no provision for overseas tax has been made for the periods presented.

6 DIVIDENDS

The Board of Directors of the Company does not recommend the payment of an interim dividend for the six months ended 30 June 2005 (six months ended 30 June 2004: Nil).

7 BASIC (LOSS)/EARNINGS PER SHARE

The calculation of basic (loss)/earnings per share is based on the

consolidated loss attributable to equity holders of the parent of RMB907 million (six months ended 30 June 2004: profit of RMB266 million) and the weighted average number of shares in issue during the period of 4,374 million (six months ended 30 June 2004: 4,374 million).

The amount of diluted (loss)/earnings per share is not presented as there were no dilutive potential ordinary shares in existence during the six months ended 30 June 2004 and 2005.

8 PROPERTY, PLANT AND EQUIPMENT, NET

During the six months ended 30 June 2005, the Group acquired aircraft with an aggregate cost of RMB5,168 million (six months ended 30 June 2004: RMB1,382 million).

9 TRADE RECEIVABLES

Credit terms granted by the Group to sales agents and other customers generally range from one to three months. An ageing analysis of trade receivables, net of provision for doubtful accounts, is set out below:

	AS AT 30 JUNE 2005 RMB MILLION	As at 31 December 2004 RMB million
Within 1 month	1,113	998
More than 1 month but less than 3 months	123	163
More than 3 months but less than 12 months	35	42
	1,271	1,203

10 TRADE PAYABLES

An ageing analysis of trade payables is as follows:

	AS AT 30 JUNE 2005 RMB MILLION	As at 31 December 2004 RMB million
Due within 1 month or on demand	917	599
Due after 1 month but within 3 months	582	430
Due after 3 months but within 6 months	835	525
	2,334	1,554

11 RESERVES

No transfer to statutory surplus reserve, statutory public welfare fund and discretionary surplus reserve has been made during the six months ended 30 June 2005 (six months ended 30 June 2004: Nil).

12 COMMITMENTS

(a) Capital commitments

As at 30 June 2005, the Group had capital commitments as follows:

	AS AT 30 JUNE 2005 RMB MILLION	As at 31 December 2004 RMB million
Commitments in respect of aircraft and related equipment		
- authorised and contracted for	37,429	11,776
- authorised but not contracted for	-	13,571
	37,429	25,347
Commitments in respect of investments in the Guangzhou new airport		
- authorised and contracted for	79	110
- authorised but not contracted for	741	714
	820	824
Other commitments		
- authorised and contracted for	57	132
- authorised but not contracted for	2,299	568
	2,356	700
	40,605	26,871

(b) Investing commitments

As at 30 June 2005, the Group committed to make capital contributions in respect of:

	AS AT 30 JUNE 2005 RMB MILLION	As at 31 December 2004 RMB million
Subsidiaries	61	181
Jointly controlled entities	83	83

144	264

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13 RELATED PARTY TRANSACTIONS

The Group obtained various operational and financial services provided by China Southern Air Holding Company ("CSAHC"), the ultimate holding company, and its subsidiaries, and the Group's associates and jointly controlled entities during the normal course of its business.

(a) Significant transactions with related companies

The following is a summary of significant transactions carried out in the normal course of business between the Group, CSAHC and its subsidiaries, and the Group's associates and jointly controlled entities:

	FOR THE SIX MONTHS ENDED 30 JUNE	
	2005	2004
	RMB MILLION	RMB million
EXPENSES		
Paid to CSAHC and its subsidiaries		
Handling charges	23	19
Sundry aviation supplies	35	26
Commission expenses	18	–
Housing benefits	–	43
Lease charges for land and buildings	28	8
Lease charges for aircraft	5	–
Paid to associates and jointly controlled entities		
Repairing charges	506	431
Flight simulation service charges	59	46
Interest expense	29	4
INCOME		
Received from associates and jointly controlled entities		
Interest income	3	1
Rental income	15	15

In addition to the above, certain subsidiaries of CSAHC also provided hotel and other services to the Group during the periods presented. The total amounts involved are not material to the results of the Group for the periods.

13 RELATED PARTY TRANSACTIONS (continued)

(b) Amounts due to related companies

		AS AT 30 JUNE 2005 RMB MILLION	As at 31 December 2004 RMB million
Jointly controlled entities	(i)	13	340
CSAHC	(ii)	93	1,990

(i) Amounts due to jointly controlled entities

Amounts due to jointly controlled entities mainly represent amounts payable for repairing charges and other services. The payable balances are unsecured, interest free and have no fixed terms of repayment.

(ii) Amount due to CSAHC

The balance mainly represents remaining consideration payable to CSAHC in respect of the Group's acquisition of the airline operations and certain related assets of China Northern Airlines Company and Xinjiang Airlines Company.

Amount due to CSAHC is unsecured, interest free and is repayable within 6 months.

(c) Loans from Southern Airlines Group Finance Company Limited

Loans to the Group from Southern Airlines Group Finance Company Limited, a PRC authorised financial institution controlled by CSAHC and an associate of the Group, are unsecured and have the following terms:

INTEREST RATE	AS AT 30 JUNE 2005 RMB MILLION	As at 31 December 2004 RMB million	GUARANTEE
Floating interest rates at 90% of interest rates as published by the People' s Bank of China ("PBOC"), repayable within 1 year	-	76	No guarantee
Floating interest rates at 90% of interest rates as published by the PBOC, repayable within 1 year	300	180	Guaranteed by CSAHC
	300	256	

13 RELATED PARTY TRANSACTIONS (continued)

(d) Credit facilities provided by Southern Airlines Group Finance Company Limited

As at 30 June 2005, bills payable arranged by Southern Airlines Group Finance Company Limited amounted to RMB854 million (as at 31 December 2004: Nil).

(e) Bank balances and deposits placed with Southern Airlines Group Finance Company Limited

As at 30 June 2005, the Group had bank balances and deposits placed with Southern Airlines Group Finance Company Limited amounted to RMB591 million (as at 31 December 2004: RMB406 million). The applicable interest rates were determined in accordance with the rates published by the PBOC.

(f) Key management personnel compensations

The key management personnel compensations are as follows:

	FOR THE SIX MONTHS ENDED 30 JUNE	
	2005	2004
	RMB MILLION	RMB million
Short-term employee benefits	2.3	1.8
Post-employment benefits	0.5	0.4
	2.8	2.2
Directors and supervisors	1.6	1.6
Senior management	1.2	0.6
	2.8	2.2

(g) Transactions with other state-owned enterprises

The Company is part of a larger group of companies under CSAHC, which itself is owned by the PRC government. Other than the transactions with CSAHC and its subsidiaries, the Group also conducts business with other enterprises directly or indirectly owned or controlled by the PRC government ("State-owned enterprises"). The Group considers that the transactions with these State-owned enterprises are conducted in the ordinary course of business and under normal commercial terms and as such the Group has not disclosed such activities as related party transactions.

14 CONTINGENT LIABILITIES

There have been no material adverse changes in contingent liabilities of the Group subsequent to 31 December 2004, details of which are disclosed in its 2004 annual financial statements.

15 POST BALANCE SHEET EVENTS

(a) Aircraft transactions

On 8 August 2005, the Group's subsidiary, Xiamen Airlines Company Limited, entered into a purchase agreement with Boeing Company for the purchase of 3 Boeing 787 aircraft, scheduled for deliveries in 2008 to 2010.

(b) Appreciation of Renminbi

On 21 July 2005, the PBOC announced that the PRC government reformed the exchange rate regime by moving into a managed floating exchange rate regime based on market supply and demand with reference to a basket of foreign currencies. In particular, the exchange rate of US dollar against Renminbi was adjusted upward to RMB8.11 per US dollar with effect from the close of business on 21 July 2005. The directors are of the opinion that the above appreciation of Renminbi would not have adverse financial impacts to the Group for the year ending 31 December 2005.

INDEPENDENT REVIEW REPORT TO THE BOARD OF DIRECTORS OF CHINA SOUTHERN AIRLINES COMPANY LIMITED

INTRODUCTION

We have been instructed by the company to review the interim financial report as set out on pages 14 to 27.

RESPECTIVE RESPONSIBILITIES OF DIRECTORS AND AUDITORS

The Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited require the preparation of an interim financial report to be in compliance with the relevant provisions thereof and International Accounting Standard 34 "Interim Financial Reporting" adopted by the International Accounting Standards Board. The interim financial report is the responsibility of, and has been approved by, the directors.

It is our responsibility to form an independent conclusion, based on our review, on the interim financial report and to report our conclusion solely to you, as a body, in accordance with our agreed terms of engagement, and for no other purpose. We do not assume responsibility towards or accept liability to any other person for the contents of this report.

REVIEW WORK PERFORMED

We conducted our review in accordance with Statement of Auditing Standards 700 "Engagements to review interim financial reports" issued by the Hong Kong Institute of Certified Public Accountants. A review consists principally of making enquiries of group management and applying analytical procedures to the

interim financial report and based thereon, assessing whether the accounting policies and presentation have been consistently applied unless otherwise disclosed. A review excludes audit procedures such as tests of controls and verification of assets, liabilities and transactions. It is substantially less in scope than an audit and therefore provides a lower level of assurance than an audit. Accordingly, we do not express an audit opinion on the interim financial report.

REVIEW CONCLUSION

On the basis of our review which does not constitute an audit, we are not aware of any material modifications that should be made to the interim financial report for the six months ended 30 June 2005.

KPMG
Certified Public Accountants

Hong Kong,
26 August 2005

B. PREPARED IN ACCORDANCE WITH THE PRC ACCOUNTING RULES AND REGULATIONS ("PRC GAAP")

CONSOLIDATED INCOME STATEMENT
For the six months ended 30 June 2005 - unaudited
(Expressed in Renminbi)

	FOR THE SIX MONTHS ENDED 30 JUNE	
	2005 RMB MILLION	2004 RMB million
REVENUE FROM PRINCIPAL OPERATIONS	18,053	11,167
Less: Cost of principal operations	15,924	8,776
Business taxes and surcharges	518	318
PROFIT FROM PRINCIPAL OPERATIONS	1,611	2,073
Add: Profit from other operations	240	95
Less: Selling expenses	1,290	870
Administrative expenses	862	478
Financial expenses	583	331
OPERATING (LOSS)/PROFIT	(884)	489
Add: Investment (loss)/income	(10)	29
Non-operating income	23	48
Less: Non-operating expenses	57	25
(LOSS)/PROFIT BEFORE INCOME TAX	(928)	541
Less: Income tax (credit)/expenses	(57)	88
Minority interests	(28)	120
NET (LOSS)/PROFIT FOR THE PERIOD	(843)	333

CONSOLIDATED BALANCE SHEET
As at 30 June 2005 – unaudited
(Expressed in Renminbi)

	AS AT 30 JUNE 2005 RMB MILLION	As at 31 December 2004 RMB million
ASSETS		
CURRENT ASSETS:		
Cash at bank and on hand	5,844	3,274
Short-term investments	–	669
Trade receivables	1,431	1,592
Other receivables	1,045	731
Advance payments	146	147
Inventories	1,639	1,398
Prepaid expenses	364	346
TOTAL CURRENT ASSETS	10,469	8,157
LONG-TERM EQUITY INVESTMENTS	726	741
FIXED ASSETS:		
Fixed assets, at cost	66,909	61,326
Less: Accumulated depreciation	15,647	13,706
Net book value of fixed assets	51,262	47,620
Construction in progress	784	626
TOTAL FIXED ASSETS	52,046	48,246
OTHER ASSETS:		
Lease and equipment deposits	4,748	5,397
Long-term deferred expenditure	113	131
Intangible assets	540	467
Long-term receivables	15	16
TOTAL OTHER ASSETS	5,416	6,011
DEFERRED TAXATION:		
Deferred tax assets	70	55
TOTAL ASSETS	68,727	63,210

CONSOLIDATED BALANCE SHEET (continued)
As at 30 June 2005 – unaudited
(Expressed in Renminbi)

	AS AT 30 JUNE 2005 RMB MILLION	As at 31 December 2004 RMB million
LIABILITIES AND SHAREHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Short-term loans	11,666	10,173
Bills payable	2,760	137
Trade payables	2,561	2,600
Receipts in advance	–	5
Sales in advance of carriage	899	874
Wages payable	123	179
Staff welfare payable	63	79
Taxes payable	271	324
Other creditors	718	495
Other payables	2,419	4,328
Accrued expenses	4,249	3,729
Dividend payable	39	–
Long-term liabilities due within one year	4,140	3,691
TOTAL CURRENT LIABILITIES	29,908	26,614
LONG-TERM LIABILITIES:		
Long-term loans	13,139	12,324
Obligations under finance leases	11,604	9,538
Provision for major overhauls	275	284
Deferred credits	494	240
TOTAL LONG-TERM LIABILITIES	25,512	22,386
DEFERRED TAXATION:		
Deferred tax liabilities	327	337
TOTAL LIABILITIES	55,747	49,337
MINORITY INTERESTS	2,158	2,220
SHAREHOLDERS' EQUITY		
Share capital	4,374	4,374
Capital reserve	5,813	5,801
Surplus reserves	672	672

Including: Statutory public welfare fund	193	193
(Accumulated loss)/ retained profits	(37)	806
TOTAL SHAREHOLDERS' EQUITY	10,822	11,653
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	68,727	63,210

NOTES:

1 SIGNIFICANT ACCOUNTING POLICIES

The significant accounting policies adopted by the Group in the preparation of the financial statements conform to the Accounting Standards for Business Enterprises and the "Accounting Regulations for Business Enterprises" and other relevant regulations issued by the Ministry of Finance ("MOF"). Pursuant to a notice Cai Kuai (2003) No. 18 from the MOF, the Group adopts the "Accounting Method for Civil Aviation Enterprises" since 1 January 2003. The significant accounting policies adopted in the preparation of these financial statements are set out below:

(a) Accounting year

The accounting year of the Group is from 1 January to 31 December.

(b) Basis of consolidation

The consolidated financial statements have been prepared in accordance with " Accounting Regulations for Business Enterprises " and Cai Kuai Zi [1995] No. 11 " Provisional regulations on consolidated financial statements " issued by the MOF.

The consolidated financial statements include the financial statements of the Company and all of its principal subsidiaries. Subsidiaries are those entities in which the Company has more than 50% equity interest or those entities controlled by the Company. The consolidated income statement of the Company only includes the results of the subsidiaries during the period when the Company has more than 50% equity interest, or when the Company does not have more than 50% equity interest, but has control over those entities. The effect of minority interests on equity and profit/loss attributable to minority interests are separately shown in the consolidated financial statements. For those subsidiaries whose assets and results of operations are not significant and have no significant effect on the Group 's consolidated financial statements, the Company does not consolidate these subsidiaries but equity accounted in long term equity investment.

Where the accounting policies adopted by subsidiaries are different from the policies adopted by the Company, the financial statements of the subsidiaries have been adjusted in accordance with the accounting policies adopted by the Company on consolidation. All significant intercompany balances and transactions, and any unrealised gains arising from inter-company transactions, have been

eliminated on consolidation.

For those jointly controlled entities which the Company has joint control with other investors under contractual arrangements, the Company consolidates their assets, liabilities, revenues, costs and expenses based on the proportionate consolidation method according to its percentage of equity interest holding in those entities in the consolidated financial statements.

(c) Basis of preparation

The financial statements have been prepared on an accrual basis under the historical costs convention, unless otherwise stated.

(d) Reporting currency

The financial statements are prepared in Renminbi.

1 SIGNIFICANT ACCOUNTING POLICIES (Continued)

(e) Translation of foreign currencies

Foreign currency transactions during the year are translated into Renminbi at the exchange rates quoted by the People's Bank of China ruling at the transaction dates. Monetary assets and liabilities denominated in foreign currencies are translated into Renminbi at the exchange rates quoted by the People's Bank of China ruling at the balance sheet date. Exchange gains and losses on foreign currency translation, except for the exchange gains and losses directly relating to the construction of fixed assets (see note 1(j)) below, are dealt with in the income statement.

(f) Cash equivalents

Cash equivalents are short-term and highly liquid investments which are readily convertible into known amounts of cash and are subject to an insignificant risk of change in value.

(g) Provision for bad and doubtful debts

Trade accounts receivable showing signs of uncollectibility are identified individually and allowance is then made based on the probability of being uncollectible. In respect of trade accounts receivable showing no sign of uncollectibility, allowance is made with reference to the ageing analysis and management's estimation based on past experience.

Allowances for other receivables are made based on the nature of the receivables and estimation of the corresponding collectibility risk.

(h) Inventories

Inventories, which consist primarily of expendable spare parts and consumables, are carried at the lower of cost and net realisable value. Inventories are measured at their actual cost upon acquisition. The cost of inventories is calculated using the weighted average method. Any excess of the cost over the net realisable value of each class of inventories is recognised as a

provision for diminution in value of inventories. Net realisable value is determined based on amount recoverable in the normal course of business after the balance sheet date or estimates made by management based on market conditions. Inventories are recorded using the perpetual stocking method.

Inventories are amortised in full when issued for use.

(i) Investments

(i) Short-term investments

Short-term investments are carried at the lower of cost and market value. The cost of a short-term investment is the total price paid on acquisition of the investment. However, it does not include cash dividends which have been declared but which are unpaid or unpaid interest on debentures which was due at the time of acquisition.

Provision for diminution in value is made on an item-by-item basis for any shortfall of the market value over the cost of material short-term investments. Provision for diminution in value is also made for any shortfall of the market value over the cost of other short-term investments on an aggregate basis by each category of the investments.

1 SIGNIFICANT ACCOUNTING POLICIES (Continued)

(i) Investments (Continued)

(i) Short-term investments (Continued)

With the exception of cash dividends which have been declared but which are unpaid at the time of acquisition and interest on debentures which is due but not yet paid at the time of acquisition, cash dividends and interest are set off against the carrying amount of the short-term investments when received by the Company. Upon the disposal of short-term investments, the difference between the carrying amount of the short-term investments and the proceeds received is recognised in the income statement for the current period.

(ii) Long-term equity investments

Where the Company has the power to control, jointly control or exercise significant influence over an investee enterprise, the investment is accounted for under the equity method of accounting whereby the investment is initially recorded at cost and adjusted thereafter for any post acquisition change in the Company's share of the investors' equity in the investee enterprise.

Equity investment difference, which is the difference between the initial investment cost and the Company's share of investors' equity in the investee enterprise, is accounted for as follows:

- Any excess of the initial investment cost over the

Company's share of the investors' equity in the investee enterprise is amortised on a straight-line basis. The amortisation period is determined according to the investment period as stipulated in the relevant agreement, or 10 years if the investment period is not specified in the agreement. The unamortised balance is included in long-term equity investments at the year end.

- Any shortfall of the initial investment cost over the Company's share of the investors' equity in the investee enterprise is amortised on a straight-line basis over 10 years if the investment was acquired before the MOF's issuance of the " Questions and Answers on Implementing Accounting Regulations for Business Enterprises and Related Accounting Standards (II) " (Cai Kuai [2003] No. 10). The unamortised balance is included in long-term equity investments at the year end. Any shortfalls are recognised in the " Capital surplus - reserve for equity investment " if the investment is acquired after the issuance of Cai Kuai [2003] No. 10.

Where the Company does not control, jointly control or exercise significant influence over an investee enterprise, the investment is accounted for under the cost method, stating it at the initial investment cost. Investment income is recognised when the investee enterprise declares a cash dividend or distributes profits.

Upon the disposal or transfer of long-term equity investments, the difference between the proceeds received and the carrying amount of the investments is recognised in the income statement.

The Group makes provision for impairment losses on long-term equity investments (see note 1(n)).

1 SIGNIFICANT ACCOUNTING POLICIES (Continued)

(j) Fixed assets and construction in progress

Fixed assets represent the assets held by the Group for rendering services and administrative purposes with useful lives over 1 year and comparatively high unit values.

Fixed assets are stated in the balance sheet at cost or revalued amount less accumulated depreciation and impairment losses (see note 1(n)). Construction in progress are stated in the balance sheet at cost less impairment losses (see note 1(n)). Valuation is carried out in accordance with the relevant rules and regulations in the PRC and the assets are adjusted to the revalued amounts accordingly.

All direct and indirect costs related to the acquisition or construction of fixed assets, incurred before the assets are ready for their intended uses, are capitalised as construction in progress. Those costs include borrowing costs, which include foreign exchange differences, on specific borrowings for the construction of the fixed assets during the construction period.

Construction in progress is transferred to fixed assets when the asset is ready for its intended use. No depreciation is provided on construction in progress.

Pursuant to an approval document Cai Kuai Han [2004] No. 39 issued by the MOF, the Group accounts for high value rotables as fixed assets.

Depreciation is provided to write off the cost of fixed assets over their estimated useful lives on a straight-line basis, after taking into account their estimated residual values. The respective annual depreciation rates for fixed assets are as follows:

	ANNUAL DEPRECIATION RATE
Owned and leased aircraft	4.75%-6.33%
Other flight equipment:	
- Jet engines	6.47%-12.13%
- Others, including high value rotables	6.67%-12.5%
Buildings	2.5%-6.67%
Machinery and equipment	9.7%-19.4%
Motor vehicles	16.17%

Land use rights are stated in the balance sheet at cost or revalued amount less accumulated depreciation and impairment losses (see note 1(n)), and are amortised on a straight-line basis over the period for land use rights.

1 SIGNIFICANT ACCOUNTING POLICIES (Continued)

(k) Leased assets

Leases are classified into finance leases and operating leases. A finance lease is a lease that transfers substantially all the risks and rewards incidental to ownership of a leased asset to the lessee, whether or not the legal title to the asset is eventually transferred. An operating lease is a lease other than a finance lease.

(i) Assets acquired under finance leases

Fixed assets acquired by way of finance leases are stated under fixed assets at an amount equal to the lower of their original carrying amount in the books of the legal owner (the lessor) and the present value of the minimum lease payments at the inception of the lease. Depreciation of leased assets is calculated using the straight-line method. Subsequent to the revaluation, which was based on depreciated replacement costs, assets acquired under finance lease are carried at revalued amount, being the fair value at the date of the revaluation less any subsequent accumulated depreciation and impairment losses.

If there is no reasonable certainty that the Group will obtain

ownership of the leased assets at the end of the lease term, the leased assets are depreciated over the shorter of the lease term or their estimated useful lives. If there is reasonable certainty that the Group will obtain ownership of the leased assets at the end of the lease term, the leased assets are depreciated over their estimated useful lives.

At the inception of the lease, the minimum lease payments are recorded as payables under finance leases. The difference between the value of the leased assets and the minimum lease payments is recognised as unrecognised finance charges under finance leases. At the year end, payables under finance leases are netted against the unrecognised finance charges under finance leases and included in long-term payables in the balance sheet.

Unrecognised finance charges under finance leases are amortised using the effective interest rate method over the lease term.

The Group makes provision for impairment losses on assets acquired under finance leases (see note 1(n)).

(ii) Operating lease charges

Rental payments under operating leases are recognised as expenses on a straight-line basis over the lease term. Contingent rental payments are recognised as expenses in the accounting period in which they are incurred.

(l) Intangible assets

Intangible assets are stated in the balance sheet at cost less accumulated amortisation and impairment losses (see note 1(n)). The cost of the intangible assets is amortised on a straight-line basis over the contracted beneficial period or the effective period stipulated by law, whichever is shorter. Where the useful life is not stipulated by the contract or law, the amortisation is over a period of 10 years.

(m) Long-term deferred expenses

Custom duties and other direct costs incurred in relation to modifying, introducing and certifying certain operating leased aircraft are deferred and amortised on a straight-line basis over the terms of the related leases.

1 SIGNIFICANT ACCOUNTING POLICIES (Continued)

(n) Provision for impairment

The carrying amounts of assets (including long-term investments, fixed assets, construction in progress, intangible assets, assets acquired under finance leases and other assets) are reviewed regularly at each balance sheet date to determine whether their recoverable amounts have declined below their carrying amounts. Assets are tested for impairment whenever events or changes in circumstances indicate that their recorded carrying amounts may not

be recoverable. When such a decline has occurred, the carrying amount is reduced to the recoverable amount. The amount by which the carrying amount is reduced is the impairment loss.

The recoverable amount is the higher of the net selling price and the present value of the estimated future cash flows arising from the continuous use of the asset and from the disposal of the asset at the end of its useful life.

Provision for impairment loss is calculated on an item by item basis and recognised as an expense in the income statement. However, when a shortfall of the initial investment cost over the Group's share of the investors' equity of the investee enterprise has been credited to the capital reserve, any impairment losses for long-term equity investment are firstly set off against the difference initially recognised in the capital reserve relating to the investment and any excess impairment losses are then recognised in the income statement.

If there is an indication that there has been a favourable change in the estimates used to determine the recoverable amount and as a result the estimated recoverable amount is greater than the carrying amount of the asset, the impairment loss recognised in prior years is reversed. Reversals of impairment losses are recognised in the income statement. Impairment losses are reversed to the extent of the asset's carrying amount that would have been determined had no impairment loss been recognised in prior years. In respect of the reversal of an impairment loss for a long-term equity investment, the reversal starts with the impairment losses that had previously been recognised in the income statement and then the impairment losses that had been charged to the capital reserve.

(o) Income tax

Income tax is recognised using the tax effect accounting method. Income tax for the year comprises current tax paid and payable and movement of deferred tax assets and liabilities.

Current tax is calculated at the applicable tax rate on taxable income.

Deferred tax is provided using the liability method for the differences between the accounting profits and the taxable profits arising from the timing differences in recognising income, expenses or losses between the accounting and tax regulations. When the tax rate changes or a new type of tax is levied, adjustments are made to the amounts originally recognised for the timing differences under the liability method. The current tax rates are used in arriving at the reversal amounts when the timing differences are reversed.

Deferred tax assets arising from tax losses, which are expected to be utilised against future taxable profits, are set off against the deferred tax liabilities (only for the same taxpayer within the same jurisdiction). When it is not probable that the tax benefits of deferred tax assets will be realised, the deferred tax assets are reduced to the extent that the related tax benefits are expected to be realised.

1 SIGNIFICANT ACCOUNTING POLICIES (Continued)

(p) Provisions and contingent liabilities

Provisions are recognised when the Group has a present obligation as a result of a past event, it is probable that an outflow of economic benefits will be required to settle the obligations and a reliable estimate can be made.

Where it is not probable that the settlement of the above obligation will cause an outflow of economic benefits, or the amount of the outflow cannot be estimated reliably, the obligation is disclosed as a contingent liability.

(q) Revenue recognition

Provided it is probable that the economic benefits will flow to the Group and the revenue and costs can be measured reliably, revenue is recognised in the income statement as follows:

(i) Passenger, cargo and mail revenues are recognised when the transportation is provided. Ticket sales for transportation not yet provided are included in current liabilities as sales in advance of carriage;

(ii) Revenues from airline-related businesses are recognised when the relevant services are rendered;

(iii) Interest income is recognised on a time proportion basis according to the principal outstanding and the applicable rate; and

(iv) Dividend income is recognised when the Group's right to receive the dividend is established.

(r) Traffic commissions

Traffic commissions are expensed when the transportation is provided and the related revenue is recognised. Traffic commissions for transportation not yet provided are recorded on the balance sheet as a prepaid expense.

(s) Borrowing costs

Borrowing costs incurred on specific borrowings for the construction of fixed assets are capitalised into the cost of the fixed assets during the construction period until the fixed assets are ready for their intended uses.

Except for the above borrowing costs, other borrowing costs are recognised as financial expenses in the income statement when incurred.

(t) Repairs and maintenance expenses

Routine maintenance and repairs and overhauls in respect of owned aircraft and aircraft held under finance leases are expensed as and when incurred. In respect of aircraft held under operating leases, a provision is made over the lease term for the estimated cost of overhauls that are required to be performed on the related aircraft prior to their return to the lessors.

(u) Dividends

Dividends appropriated to shareholders are recognised in the income statement and profit appropriation statement when approved. Dividends proposed or approved after the balance sheet date but before the date on which the financial statements are authorised for issue are separately disclosed under shareholders' equity in the balance sheet.

1 SIGNIFICANT ACCOUNTING POLICIES (Continued)

(v) Retirement benefits

Pursuant to the relevant laws and regulations in the PRC, the Group has joined certain defined contribution retirement schemes for the employees arranged by the governmental organisations. The Group makes contributions to the retirement schemes at the applicable rates based on the employees' salaries. The required contributions under the retirement schemes are charged to the income statement when they are due.

(w) Frequent flyer award programmes

The Group maintains two frequent flyer award programmes, namely, the China Southern Airlines Sky Pearl Club and Egret Mileage Plus, which provide travel awards to members based on accumulated mileage. The estimated incremental cost of providing free travel is recognised as an expense and accrued as a current liability as members accumulate mileage. As members redeem awards or their entitlements expire, the incremental cost liability is reduced accordingly, to reflect the acquittal of the outstanding obligations.

Revenue from mileage sales to third parties under the frequent flyer award programmes is recognised when the related transportation services are provided.

(x) Related parties

If the Group has the power, directly or indirectly, to control, jointly control or exercise significant influence over another party, or vice versa, or where the Group and one or more parties are subject to common control from another party, they are considered to be related parties. Related parties may be individuals or enterprises.

2 SIGNIFICANT DIFFERENCES BETWEEN PRC GAAP AND IFRS

Effect of significant differences between PRC GAAP and IFRS on net (loss)/profit are analysed as follows:

		FOR THE SIX MONTHS ENDED 30 JUNE	
		2005	2004
	Note	RMB MILLION	RMB million
Net (loss)/profit under PRC GAAP		(843)	333
Adjustments:			

Gains on aircraft sales and leaseback transactions	(a)	(15)	(15)
Losses on staff housing allocations	(b)	(13)	(56)
Adjustment for revaluation of land use rights	(c)	2	2
Adjustment for investment in associates	(d)	(52)	–
Donation	(f)	12	–
Effect of the above adjustments on taxation		2	2
Net loss/(profit) attributable to equity holders of parent under IFRS		(907)	266

2 SIGNIFICANT DIFFERENCES BETWEEN PRC GAAP AND IFRS (Continued)

Effect of significant differences between PRC GAAP and IFRS on shareholders' equity are analysed as follows:

	Note	AS AT 30 JUNE 2005 RMB MILLION	As at 31 December 2004 RMB million
Total shareholders' equity under PRC GAAP		10,822	11,653
Adjustments:			
Gains on aircraft sales and leaseback transactions	(a)	165	180
Losses on staff housing allocations	(b)	184	197
Adjustment for revaluation of land use rights	(c)	(160)	(162)
Adjustment for investment in associates	(d)	(78)	(26)
Interest capitalisation	(e)	11	11
Effect of the above adjustments on taxation		(3)	(5)
Total equity attributable to equity holders of parent under IFRS		10,941	11,848

Notes:

(a) In accordance with PRC accounting rules and regulations, gains on aircraft sale and leaseback transactions are recorded as deferred credits and amortised over the lease terms on a straight line basis. Under IFRS, gains on sale and leaseback transactions where the subsequent lease is an operating lease are recognised as income immediately, if the transactions are established at fair value. Differences between the sale price and fair value are deferred and amortised over the lease term.

(b) In accordance with PRC accounting rules and regulations, losses on staff housing allocation executed by CSAHC on the Company's behalf are charged to retained profits as and when incurred. In addition, lump sum housing benefits are charged to retained profits as of 1 January 2001 pursuant to the relevant regulations. Under IFRS, losses on staff housing allocations and lump sum housing benefits are charged to the income statement in the obligatory periods stipulated by the relevant contracts.

(c) In accordance with PRC accounting rules and regulations, land use rights are carried at revalued amounts. Under IFRS, land use rights are carried at cost with effect from 1 January 2002. Accordingly, the unamortised surplus on revaluation of the land use rights was reversed against shareholders' equity.

(d) In the PRC GAAP financial statements, the investment in associates have been equity accounted for based on the PRC GAAP financial statements of these companies. The accounting policies of these companies differ in certain aspects from those of the Group. In the IFRS financial statements, the differences arising from the different accounting policies of the associates have been adjusted to conform with the accounting policies of the Group.

(e) In the PRC GAAP financial statements, interest incurred on specific borrowings obtained for the construction of fixed assets is capitalised. In the IFRS financial statements, interest incurred on specific and other borrowings which are directly attributable to the construction of fixed assets is capitalised.

(f) In the PRC GAAP financial statements, all donations received are recognised as movement in capital reserve as and when incurred. Under IFRS, donations are recognised in the income statements when received.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

CHINA SOUTHERN AIRLINES COMPANY LIMITED

By /s/ Su Liang

Name: Su Liang
Title: Company Secretary

Date: September 2, 2005

vertible preferred stock and common stock financings. On April 1, 2001, we issued 137,300 shares of common stock in consideration for payment in full of the approximate $500,000 payable to the University of Medicine and Dentistry of New Jersey due through March, 2001. At December 31, 2001, we had cash and cash equivalents totaling approximately $76,000. At March 31, 2002, we had cash and cash equivalents totalling approximately $0. In 2001, the National Institutes of Health awarded us a Small Business Innovation Research Grant, which will be utilized in our research and development efforts. NIH has formally awarded us a 2001 grant of $884,000, of which we have received approximately $627,000 through March 31, 2002 and expect to receive 29 the remainder through June 2002. Additionally, this award refers to funding levels of $814,398 and $989,352 that we expect to be awarded in 2002 and 2003, respectively, subject to availability and satisfactory progress of the project in NIH's opinion. Therefore, we expect to receive a total of approximately $2.7 million related to our initial application for the grant through June 2004 assuming that we continue to achieve positive results from the research. Our initial application was for approximately $3.0 million. However, due to our proposed purchase of certain materials from sources outside the United States, the funding was accordingly reduced because NIH grants require materials to be purchased from U.S. based entities. The grant is subject to provisions for monitoring set forth in NIH Guide for Grants and Contracts dated February 24, 2000. If NIH believes that satisfactory progress is not achieved in its opinion, the 2002 and 2003 amounts noted above may be reduced or eliminated in its sole discretion. On a pro forma basis (our results combined with BioDelivery Sciences, Inc.) we used $253,000 of cash for operations in 2000 compared to $1.6 million of cash used for operations in 2001.

On a pro forma basis (BioDelivery Sciences, Inc. combined with us) we have used $1.6 million of cash for operations since inception through March 31, 2002, net of sponsored research proceeds received since inception of $8.1 million. We have paid limited compensation to certain executive employees, including the CEO and chairman of the board. While members of the board of directors and other executive officers have received compensation in the form of stock options, we expect that increases in their compensation will occur in future periods commensurate with the level of services rendered. Since our inception through March 31, 2002, we have incurred approximately $2.0 million of research and development expenses. Additionally, during the period March 28, 1995 (date of BioDelivery Sciences, Inc.'s incorporation) through the acquisition of a controlling interest in BioDelivery Sciences, Inc. in October 2000, we incurred approximately $6.8 million of research and development expenses. We have also obtained a $1,050,000 line of credit personally guaranteed by Dr. Francis O'Donnell, our President and CEO and Donald Ferguson, our Senior Executive Vice President, at a rate of prime plus 2% of which $850,000 matured in May 2002 but is currently deferred until the completion of this offering and $200,000 will mature in June 2002. At March 31, 2002, $619,000 was outstanding under the credit line. We have incurred significant net losses and negative cash flows from operations since our inception. As of March 31, 2002, we had an accumulated deficit of approximately $5.4 million and our working capital deficit at March 31, 2002 was $1.7 million. We anticipate that cash used in operations and our investment in facilities will increase significantly in the future as we research, develop, and, potentially, manufacture our proposed drugs. While we believe further application of our Bioral cochleate technology to other drugs will result in license agreements with manufacturers of generic and over-the-counter drugs, our plan of operations in the next 18 months is focused on our further development of the Bioral cochleate technology itself and its use in a limited number of applications, and not on the marketing, production or sale of FDA approved products. We believe that our existing cash and cash equivalents, together with available equipment financing and the net proceeds of this offering will be sufficient to finance our planned operations and capital expenditures through at least the next 12 months. While we plan to manage our expenditures for development in accordance with the prior statement, we are currently unable to estimate the costs to complete or the completion dates of our current projects. Accordingly, we may be required to raise additional capital through a variety of sources, including: - the public equity market; - private equity financing; - collaborative arrangements; - grants; - public or private debt; and 30 - redemption and exercise of warrants. There can be no assurance that additional capital will be available on favorable terms, if at all. If adequate funds are not available, we may be required to significantly reduce or refocus our operations or to obtain funds through arrangements that may require us to relinquish rights to certain of our technologies, drugs or potential markets, either of which could have a material adverse effect on our business, financial condition and results of operations. To the extent that additional capital is raised through the sale of equity or convertible debt securities, the issuance of such securities would result in ownership dilution to our existing stockholders including investors in this offering. NEW ACCOUNTING PRONOUNCEMENTS. In July 2001, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) 141, Business Combinations, and SFAS 142, Goodwill and Intangible Assets. SFAS 141 is effective for all business combinations completed after June 30, 2001. SFAS 142 is effective for the year beginning January 1, 2002; however, certain provisions of that Statement applied to goodwill and other intangible assets acquired between July 1, 2001 and the effective date of SFAS 142. We are in the process of evaluating the effect, if any, of adopting SFAS 142, but do not believe that this standard will have any material effect on our financial statements. In July 2001, the FASB issued SFAS No. 143, Accounting for Asset Retirement Obligations. This statement addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. This Statement applies to all entities. It applies to legal obligations associated with the retirement of long-lived assets that result from the acquisition, construction, development and (or) the normal operation of a long-lived asset, except for certain obligations of lessees. This Statement is effective for financial statements issued for fiscal years beginning after June 15, 2002. The Company is evaluating the impact of the adoption of this standard and has not yet determined the effect of adoption on its financial position and results of operations. In August 2001, the FASB issued SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. This statement address financial accounting and reporting for the impairment or disposal of long-lived assets and supersedes FASB Statement No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of. The provisions of the statement are effective for financial statements issued for fiscal years beginning after December 15, 2001. We adopted this standard effective January 1, 2002, which did not have any material effect on our financial statements. 31 DESCRIPTION OF BUSINESS

OVERVIEW We are a development-stage biotechnology company that is developing and seeking to commercialize a drug delivery technology designed for a potentially broad base of prescription drugs, vaccines, and over-the-counter drugs. Our proposed drug delivery technology encapsulates the selected drug in a jellyroll-like structure termed a "cochleate" cylinder. All of the components of the cochleate cylinder are naturally occurring substances. We believe that the cochleate cylinder provides an effective delivery mechanism without forming a chemical bond, or otherwise chemically altering, the drug. Our drug delivery technology is being developed in collaboration with the University of Medicine and Dentistry of New Jersey and the Albany Medical College which have granted us the exclusive worldwide licenses under applicable patents. When wrapped in our cochleate cylinders, we anticipate that these drugs may be marketed under our brand name, "Bioral". We believe that our drug delivery technology is potentially applicable with a broad base of existing and new drugs, vaccine, and over-the-counter drugs. Once we have established our technology, we intend to seek commercialization through a combination of marketing approaches which, we anticipate may include marketing drugs no longer under patent protection under our brand name Bioral, licensing our drug delivery technology to other pharmaceutical companies with regard to certain patented, proprietary, or branded drugs and entering into various types of agreements with other bio-technology or pharmaceutical companies. In addition to completing development of our drug delivery technology and initial Bioral products, we are also preparing an application seeking to begin Phase I clinical trials with the FDA with regard to our HIV therapy. This technology is being developed as a patient specific (autologous) therapy for treatment following HIV infection. Our autologous HIV therapy is based upon a patented proteoliposome technology which we believe facilitates uptake by cells responsible for stimulating immune responses. We believe that the ongoing research and development of this technology will require significant time and resources and we intend to primarily rely upon the availability of grants and corporate support to largely finance further development of this technology. Investors should be aware that we do not develop any new drugs. Our business is to license drugs from third parties and to encapsulate them in our delivery system. This requires that we enter into numerous license or development agreements with third parties. OVERVIEW OF THE DRUG DELIVERY INDUSTRY The drug delivery industry develops technologies for the improved administration of certain drugs. These technologies have focused primarily on safety, efficacy, ease of patient use and patient compliance. Pharmaceutical and biotechnology companies view new and improved delivery technology as a way to gain competitive advantage through enhanced safety, efficacy, convenience and patient compliance of their drugs. Drug delivery technologies can provide pharmaceutical and biotechnology companies with an avenue for developing new drugs, as well as extending existing drug patent protections. Drug delivery companies can also apply their technologies to drugs no longer patent protected. We believe that focusing our drug delivery technology for use with existing FDA approved drugs to be less risky than attempting to discover new drugs. When management believes that the market opportunity exists and given the right circumstances however, we may consider devoting resources to discovering new drugs. We intend to primarily target drugs that have large established markets for which there is an established medical need and therefore doctors are familiar with the drug compounds and are accustomed to prescribing them. We anticipate that many of the drug candidates we target will have been through the regulatory process and therefore the safety and efficacy of the drug has been previously established. Consequently, we believe that our clinical trials would primarily need to show that our encapsulation technology delivers the drug without harming the patient or changing the clinical attributes of the drug. Focusing on drug delivery 32 compared to drug discovery should allow us to potentially form a number of collaborations to deliver a wide variety of medicines without limiting rights to utilize our proprietary technology with additional drug opportunities. DESCRIPTION OF OUR DRUG DELIVERY TECHNOLOGY Overview Our drug delivery technology is based upon encapsulating drugs to potentially deliver the drug safely and effectively. Over the years, biochemists and biophysicists have studied artificial membrane systems to understand their properties and potential applications, as well as to gain insight into the workings of more complex biological membrane systems. In the late 1960's, scientists began investigating the interactions of divalent cations with negatively charged lipid bilayers. They reported that the addition of calcium ions to small phosphatidylserine vesicles induced their collapse into discs which fused into large sheets of lipid. In order to minimize their interaction with water, these lipid sheets rolled up into jellyroll-like structures, termed "cochleate" cylinders, after the Greek name for a snail with a spiral shell. Bioral cochleate technology is based upon components which are believed to be non-toxic. The primary chemical components of our Bioral cochleate technology are phosphatidylserine (PS) and calcium. Phosphatidylserine is a natural component of essentially all biological membranes, and is most concentrated in the brain. Clinical studies by other investigators (more than 30 have been

published that we are aware of), to evaluate the potential of phosphatidylserine as a nutrient supplement indicate that PS is safe and may play a role in the support of mental functions in the aging brain. As an indication of its nontoxic nature, today phosphatidylserine isolated from soybeans is sold in health food stores as a nutritional supplement. Research and development of cochleates has been conducted at the University of Medicine and Dentistry of New Jersey and Albany Medical College ("the Universities") for a number of years. Our scientists, some of whom were former researchers and others who still hold teaching positions with these Universities, supervised their cochleate research programs. As a result of the relationship between our scientists and the Universities, we became the exclusive worldwide licensee to develop this cochleate technology and in some cases co-own the patents with them. See "Description of Business -- Relationship with the University of Medicine and Dentistry of New Jersey and Albany Medical College." Potential Advantages We believe that our drug delivery technology represents a potentially important new delivery mechanism. While the characteristics and benefits of our drug delivery technology will ultimately be established through FDA clinical trials, our research, based upon pre-clinical studies indicates that our drug delivery technology may have the following characteristics: - Oral Availability. Our drug delivery technology is being developed to enable oral availability of a broad spectrum of compounds, such as those with poor water solubility, and protein and peptide biopharmaceuticals, which have been difficult to administer. - Encapsulation. Our drug delivery encapsulates, rather than chemically bond, with the included drug. - Minimizing Side Effects. Our drug delivery technology may reduce toxicity, stomach irritation and other side effects of the encapsulated drug. - Stability. Our drug delivery technology employs cochleate cylinders which consists of unique multi-layered structures of large, continuous, solid, lipid bilayer sheets rolled up in a spiral, with no internal aqueous space. We believe that our cochleate preparations can be stored in cation-containing buffer, or lyophilized to a powder, stored at room temperature, and reconstituted with liquid prior to administration. Our cochleate preparations have been shown to be stable for more than two years at 4(LOGO) C in a cation-containing buffer, and at least one year as a lyophilized powder at room temperature. - Cellular Delivery. Our drug delivery technology is being developed as membrane fusion intermediates. We believe that, when drugs encapsulated in our drug delivery technology come into close 33 approximation to a target membrane, a fusion event between the outer layer of the cochleate cylinder and the cell membrane may occur. This fusion may result in the delivery of a small amount of the encochleated material into the cytoplasm of the target cell. Further, we believe that drugs encapsulated in our drug delivery technology may slowly fuse or break free of the cell and be available for another fusion event, either with this or another cell. - Resistance to Environmental Attack. Our drug delivery technology is being developed to provide protection from degradation of the encochleated drug. Traditionally, many drugs can be damaged from exposure to adverse environmental conditions such as sunlight, oxygen, water and temperature. Since the cylinder structure consists of a series of solid layers, we believe that components within the interior of the cochleate structure remain intact, even though the outer layers of the cochleate may be exposed to these conditions. - Patient Compliance. We believe that a potential benefit of our cochleate cylinders may include reducing unpleasant taste, unpleasant intestinal irritation, and in some cases providing oral availability. - Release Characteristics. Our cochleate technology may offer the potential to be tailored to control the release of the drug depending on desired application. Initial Bioral Products in Development We plan a diverse pipeline of products to be developed by applying our drug delivery technology to a potentially broad array of established and promising pharmaceuticals. Each intended Bioral product (i.e. drug and neutraceutical encapsulated with our drug delivery technology) will, upon completion of development, require separate FDA regulatory approval, and accordingly, will be subject to the uncertainty, time and expense generally associated with the FDA regulatory process. Even though we are targeting FDA approved, market-accepted drugs for encapsulation, each of the products currently in development face, development hurdles, regulatory requirements and uncertainty before market introduction. As summarized below, we have initially targeted three potential Bioral products for development.

PRE-CLINICAL INDICATION	DRUGS	CATEGORY	DEVELOPMENT	FDA STATUS
Systemic fungal infection	Amphotericin B	Antifungal	Bioral Formulation development in process.	Pre-clinical In vitro and animal studies in process
Tuberculosis and bacterial infections	Clofazimine	Antimicrobial	Bioral Formulation development in process.	Pre-clinical In vitro and animal studies in process
Inflammatory disease	Anti-inflammatory (such as aspirin or ibuprofen)	Bioral Anti-inflammatory	OTC Formulation development	Pre-clinical and in vitro studies in process
Antibacterial	Amphotericin B	Antimicrobial	Bioral Formulation development	Submission of IND being prepared, GMP manufacturing initiated.
Antifungal	Amphotericin B	Antimicrobial	Bioral Formulation development	Phase I completed. In vitro and in vivo efficacy data completed

We are currently developing a Bioral product for treatment of fungal infection which we plan to submit to the FDA for a Phase I Investigational New Drug Application

(IND). Our IND has not been completed and assuming that the funding is available, we estimate the filing will be made in the first quarter of 2003. Systemic fungal infections continue to be a major domestic and international health care problem. In the mid-1990s, Amphotericin B was the most commonly used drug to treat these infections in the United States. 34 The major types of systemic fungal infections are normally controlled and disposed of by the body's immune system. However, patients whose immune systems have been suppressed by therapies for cancer, bone marrow transplants or diseases such as AIDS can lose the ability to combat these infections. Systemic Candidiasis, the most common type of invasive fungal infection, represents the majority of all such infections, with fatality rates between 30 and 40 percent. Aspergillosis, while occurring less frequently, is a significant threat as fatality rates for this infection range as high as 90 percent. Cryptococcal meningitis is a disease that frequently strikes patients with AIDS. The use of conventional Amphotericin B to treat these infections is often limited by its propensity to cause kidney damage which we believe our Bioral products may minimize. Amphotericin B is an established drug which is delivered intravenously. The primary advantage which we are seeking for our proposed Bioral Amphotericin B product is an oral form of the drug. Additional potential advantages include improved safety, extended shelf life, improved cellular uptake and reduced dosage. Assuming that we complete development of our proposed Bioral Amphotericin B and that we obtain FDA approval, we believe that Bioral Amphotericin B (a Bioral encapsulation of Amphotericin B) may provide an effective orally administered version of Amphotericin B which may be more effective and less toxic. In the development of this drug, we are collaborating with the National Institutes of Health, the Public Health Research Institute of New York and the University of Texas. Further, we have been awarded a grant totaling approximately $0.9 million, with an additional $1.8 million which could be awarded from the National Institutes of Health to support the further development of this drug if it believes in its judgment that progress continues to be made. Bioral Clofazimine. We are currently developing a Bioral product to target tuberculosis. The bacillus is suspected to reside latently in a large population of people, and remains viable for infection in those people for many years past the initial infection stage. We are targeting clofazimine, an off-patent oral drug, and may target other drugs no longer under patent protection which treat tuberculosis, for potential encapsulation in our drug delivery technology. The primary advantages which we are seeking for our proposed Bioral Clofazimine product include increased oral bio-availability, reduce required dosage and decrease side effects. Assuming that we complete development of this Bioral drug and that we obtain FDA approval, we believe that it may provide an effective, orally administered version of a tuberculosis agent such as clofazimine. This Bioral product in development may be administered orally, be more effective and have fewer side effects. We are currently in pre-clinical development of a Bioral encapsulated clofazimine in collaboration with the University of Chicago. Our development for the proposed Bioral Clofazamine has not been completed. We estimate that the preparation of an IND will be completed in the first quarter of 2003 assuming the data in pre-clinical trials are favorable and the funding is available. Bioral Anti-Inflammatory -- We have targeted inflammation disorders, such as arthritis, for development of Bioral products, based upon accepted, unpatented, over-the-counter, anti-inflammatory drugs such as generic aspirin or ibuprofen. Various types of over-the-counter anti-inflammatory compounds are currently available. Nonsteroidal anti-inflammatory drugs significantly decrease inflammation at higher dosages. We believe that our drug delivery technology can be used to effectively deliver anti-inflammatory drugs with reduced side effects. The primary advantages which we are seeking for our proposed Bioral anti-inflammatory products include reduced gastrointestinal side effects, reduce required dosage and improve cellular uptake. Anti-inflammatories formulated within cochleates are inside a multi-layered solid particle which we believe may enhance the safety and efficacy profiles and could potentially transform the compounds into an entirely new class of improved anti-inflammatory drugs. As part of our pre-clinical development, initial formulations have been tested in vitro. We are in the process of preparing formulations as part of our preparation to commence pre-clinical development. Our IND for our proposed Bioral Anti-Inflammatories has not been completed and we believe that the earliest that we may begin the preparation of an IND would be the second quarter of 2003 assuming the data in pre-clinical trials are favorable and the funding is available. 35 OUR AUTOLOGOUS HIV THERAPY As part of our research and development activities, we have developed and are investigating our patented autologous (patient-specific) HIV therapy for AIDS which uses a cochleate related (proteoliposone) delivery vehicle. This immunotherapeutic is autologous meaning that it contains the specific patient's virus or membrane protein. Our autologous HIV therapy is intended to boost or alter the immune response in patients already infected with HIV. We are preparing a submission to the FDA seeking to begin Phase I clinical trials as a follow-up to our initial clinical trials which were conducted pursuant to an Institutional Review

Board process. Our development for this proposed Autologous HIV Therapy has not been completed. We estimate that the preparation of an IND will begin in the first quarter of 2003 assuming the data in pre-clinical trials are favorable and the funding is available. We believe that the time, expense and risk to market is substantial and uncertain particularly when compared to that which we anticipate for the potentially broad-base of pharmaceuticals, vaccines which may ultimately be encapsulated in our drug delivery technology. Accordingly, we intend to primarily rely upon the availability of grants and corporate partners to largely finance the further research and development of this technology. RELATIONSHIP WITH THE UNIVERSITY OF MEDICINE AND DENTISTRY OF NEW JERSEY AND ALBANY MEDICAL COLLEGE We have had and continue to have critical relationships with the University of Medicine and Dentistry of New Jersey and Albany Medical College. Some of our scientists were former researchers and educators at these Universities researching cochleate technology. All of our current research and development is done using facilities provided to us on the campus of the University of Medicine and Dentistry of New Jersey, pursuant to a lease, or at the facilities of our contractors or collaborators. Both of these Universities are stockholders in our company and have a substantial financial interest in our business. In September 1995, we entered into a license agreement with the Universities to be the exclusive worldwide developer of the cochleate technology. Under the license agreement, we and the Universities have also jointly patented certain aspects of the cochleate technology and co-own such patents with them. Pursuant to the license agreement, we agreed that each university would be issued an equity interest in our capital stock, originally equal to 2% of our outstanding capital stock. As of the date of this prospectus, the University of Medicine and Dentistry of New Jersey owns 139,522 shares (including shares issued under a research agreement) and warrants to purchase 9,952 shares of our common stock and the Albany Medical College owns 2,222 shares and warrants to purchase 9,952 shares of our common stock. There are no further requirements to provide either university any additional equity interest. The license agreement grants us an exclusive license to the technology owned by these Universities and obligates us to pay a royalty fee structure as follows: (a) For commercial sales made by us or our affiliates, we shall pay to the Universities a royalty equal to 3% of our net sales; and (b) For commercial sales made by any of our sublicensee, we shall pay to the Universities royalties up to 25% of our revenues received from the sublicensee from the sale of the product. Our royalty payments to the Universities will be divided equally among them. The Universities have reserved the right to use and permit the use of our licensed technology and licensed patents by non-profit organizations for educational and research purposes on a non-commercial basis. In April 2001, we entered into a research agreement with the University of Medicine and Dentistry of New Jersey whereby we and the university agree to share the rights to new research and development that jointly takes place at the university's facilities until December 31, 2005. We also agreed to provide the university with progress and data updates and allow its researchers to publish certain projects. We lease our research facilities totaling approximately 8,000 square feet located on their campus pursuant a lease agreement ending December 31, 2005. The monthly rent is $3,340 for the first year; $3,840 for the second year; $4,340 for the third year; $4,840 for the fourth year and $5,340 for the fifth year. In addition to our rent payments, we have also agreed to pay for certain other services provided by the university totaling approximately $99,187 annually. These include employing three graduate students from the 36 university for a total of $51,840, a budget to purchase chemicals totaling approximately $40,000 (adjusted to exact cost), and an indirect cost factor constituting 8% for 2001 (12% in 2002, 16% in 2003, 20% for 2004 and 24% for 2005) of the direct costs of the graduate students and chemicals totaling $7,347. Research assistants and personnel provided to us are university employees and they belong to various unions on campus. COLLABORATIVE AND SUPPLY RELATIONSHIPS We are a party to collaborative agreements with universities, government agencies, corporate partners, and contractors. Research collaboration may result in new inventions which are generally considered joint intellectual property. Our collaboration arrangements are intended to provide us with access to greater resources and scientific expertise in addition to our in-house capabilities. We also have supply arrangements with a few of the key component producers of our delivery technology. Our relationships include: - National Institutes of Health. To investigate the properties of new antifungal and anti-staphylococcal cochleate formulations. Grants totaling approximately $2.7 million have been or could be awarded to us by NIH for the development of our proposed Amphotericin B product of which we have been awarded $0.9 million. Additionally, we are conducting anti-fungal studies using our drug delivery technology through NIH selected and paid contractors. The NIH has reserved broad and subjective authority over future disbursements under the grant. While no objective or specific milestones for future disbursements have been established by the NIH, we must generally demonstrate to the satisfaction of the NIH that our research and use of proceeds are consistent with the goal of developing a formulation

for the oral delivery of Amphotericin B. Furthermore, we are required to submit to the NIH an annual report of activities under the grant. To date we have received all expected disbursements under the NIH grant and anticipate that future disbursements will be made by the NIH under the terms of the grant. - Public Health Research Institute of New York. To investigate our proposed Amphotericin B product and other anti-fungal and anti-staphylococcal applications of our drug delivery technology. This relationship may involve shared expense reimbursement and shared intellectual property with regard to joint inventions. - Institute for Tuberculosis Research, University of Illinois at Chicago. To support our development of Bioral Clafozimine product and other anti-tuberculosis cochleate formulations. This relationship may involve shared intellectual property with regard to joint inventions. - University of Utrecht. To study and quantify pursuant to a Material Transfer Agreement, the various aspects of drug delivery using our technology. This relationship may involve expense reimbursement and shared intellectual property with regard to joint inventions. - Erasmus University of Rotterdam. To develop the cochleate as a delivery system for glycopeptides. - Avanti Polar Lipids, Inc. To supply lipids which is a required material for the manufacture of our drug delivery technology. - Octo Plus Pharmaceutical Development, B.V. To supply Amphotericin cochleates under Good Manufacturing Practice for our anticipated Phase I clinical trials. We also have agreements with entities that are affiliated with and partially-owned by key members of our board of directors and management to conduct research and license certain proposed drugs. See "Certain Transactions" for affiliations with our management. As of March 6, 2002, our board of directors appointed an audit committee consisting of independent directors to review all agreements and transactions which have been entered into with related parties, as well as all future related party transactions. At the meeting the independent board members, with Dr. O'Donnell abstaining, and after seeking and reviewing advice from an independent valuation firm and inquiring about the details of the various transactions, ratified all prior related party transactions. Subsequent to this meeting, the audit committee independently ratified these agreements. The following are the related-party agreements: - RetinaPharma International, Inc. We have entered into a license agreement with this development-stage biotechnology company to use our delivery technology in connection with their proposed neutraceutical product with potential application for macular degeneration and retinitus pigmentosa, a 37 disease affecting the retina. This exclusive worldwide right to use our drug delivery technology in conjunction with their effort to develop, commercialize and manufacture their proposed product, or to sublicense to a third party, is only for the purpose of treating antiapoptotic pharmaceutical and nutriceutical treatment of retinal disease and glaucoma. This license shall remain in effect as long as RetinaPharma International, Inc. remains in compliance with the terms of the agreement. - Tatton Technologies, LLC. We have entered into a license agreement with this development-stage biotechnology company to use our delivery technology in connection with their proposed neutraceuticals product with potential application to various neuro-degenerative diseases. Tatton Technologies, LLC is developing and plans to commercialize technology regarding certain apoptotic drugs and apoptotic naturally occurring substances to treat certain neuro-degenerative diseases. We have entered into exclusive worldwide licenses allowing Tatton Technologies, LLC to incorporate our drug delivery technology into their effort to develop and potentially commercialize their drug. Tatton Technologies, LLC may sublicense our drug delivery technology to third parties to incorporate into their proposed product and this license shall remain in effect as long as both parties remain in compliance with the terms of the agreement. - BioKeys Pharmaceuticals, Inc. We have entered into a letter of intent to seek a license agreement with this development-stage biotechnology company to use our delivery technology in connection with the development of its proposed vaccine technology. BioKeys Pharmaceuticals, Inc. in conjunction with a third party will conduct research to develop their EradicAids Vaccine Project. This proposed license shall remain in effect as long as BioKey remains in compliance with the terms of the agreement. - Biotech Specialty Partners, LLC. We have entered into a non-exclusive distribution agreement with this development-stage distribution company to market and distribute our proposed products once we have completed the commercialization of our products. Our financial arrangement with Biotech Specialty Partners, LLC requires us to sell to Biotech Specialty Partners, LLC all of our proposed products, as and when purchased by with Biotech Specialty Partners, LLC at a cost which is the lesser of: (i) ten percent (10%) below the lowest wholesale acquisition cost, inclusive of rebates, quantity discounts, etc.; and (ii) the lowest cost at which we are then selling the product(s) to any other purchaser. The term of the agreement shall be for a term of five years once a product becomes available for distribution. Biotech Specialty Partners, LLC is a start-up enterprise, which to date has not distributed any pharmaceutical products. These agreements generally provide that, except for on-going development costs related to our drug delivery technology, we are not required to share in the costs of the development of the pharmaceutical

product or technologies of these companies. We are entitled to receive the following royalty payments: - RetinaPharma International, Inc. We are entitled to 10% of all net revenue from the sale for the authorized use of our technology incorporated into the product. The planned RetinaPharma product is in its early stage of development and no sales of such product or royalty revenue therefrom is anticipated in the foreseeable future. - Tatton Technologies, LLC. We are entitled to 10% of all net revenue from the sale for the authorized use of our technology incorporated into their proposed product with potential application to various neuro-degenerative diseases. The planned Tatton Technologies product is in its early stage of development and no sales of such product or royalty revenue therefrom is anticipated in the foreseeable future. - BioKeys Pharmaceuticals, Inc. We are in the process of negotiating a royalty on net revenue from the license of our drug delivery technology. The letter of intent provides for license payments in the amount of $341,000. We have also received a $35,000 loan from BioKeys Pharmaceuticals, Inc. to begin research on BioKeys Pharmaceuticals, Inc. products incorporating our technology. The loan is in the form of a demand note with an interest rate of 1% plus prime. The planned BioKeys Pharmaceuticals, 38 Inc. product is in its early stage of development and no sales of such product or royalty revenue therefrom is anticipated in the foreseeable future. In pursuing potential commercial opportunities, we intend to seek and rely upon additional collaborative relationships with corporate partners. Such relationships may include initial funding, milestone payments, licensing payments, royalties, access to proprietary drugs or potential "nano-encapsulation" with our drug delivery technology or other relationships. While we have not, to date, entered into any such arrangements, we are currently in discussion with a number of pharmaceutical companies. COLLABORATIVE AGREEMENTS IN NEGOTIATION We are currently in the beginning stages of negotiations to potentially establish one or more license agreements with PPDI, regarding the use of our drug delivery technology. No letter of intent has been negotiated or executed and no formal or legally binding license agreement has been reached and we cannot predict whether we and PPDI will be able to reach any agreement with regard to any such licensing agreement. The proposed sale of Units to PPDI in connection with this offering is not conditioned upon the consummation of any licensing arrangement between the parties. LICENSES, PATENTS AND PROPRIETARY INFORMATION We are the exclusive licensee of eight issued United States patents and three foreign issued patents owned by the parties listed in the chart below.(1) We believe that our licenses to this intellectual property will enable us to develop this new drug delivery technology based upon cochleate and cochleate related technology. Our intellectual property strategy is intended to maximize our potential patent portfolio, license agreements, proprietary rights and any future licensing opportunities we might pursue. With regard to our Bioral cochleate technology, we intend to seek patent protection for not only our delivery technology, but also potentially for the combination of our delivery technology with various drugs no longer under patent protection. Below is a table summarizing patents we believe are currently important to our business and technology position.

PATENT NUMBER	ISSUED	EXPIRES	TITLE	PATENT OWNER
EUR0722338	7/25/2001	9/30/2014	Protein- and peptide- vaccines and methods of immunizing using the same	The University of Medicine and Dentistry of New Jersey and Albany Medical College
US06,165,502	12/26/2000	9/11/2016	Protein-lipid vesicles and autogenous immunotherapeutic comprising the same	The University of Medicine and Dentistry of New Jersey and Albany Medical College
US06,153,217	11/28/2000	1/22/2019	Nanocochleate formulations, process of preparation and method of using the same	BioDelivery Sciences International, Inc., University of Medicine and Dentistry of New Jersey and Albany Medical College
AUS722647	11/23/2000	9/02/2017	Protein-lipid vesicles and autogenous immunotherapeutic comprising the same	The University of Medicine and Dentistry of New Jersey and Albany Medical College
US05,994,318	11/30/1999	11/24/2015	Cochleate delivery vehicles	The University of Medicine and Dentistry of New Jersey and Albany Medical College
US05,840,707	11/24/1998	11/24/2015	Stabilizing and delivery of biological molecules	The University of Medicine and Dentistry of New Jersey and Albany Medical College

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PATENT NUMBER	ISSUED	EXPIRES	TITLE	PATENT OWNER
US05,834,015	11/10/1998	9/11/2016	Protein-lipid vesicles and autogenous immunotherapeutic comprising the same	The University of Medicine and Dentistry of New Jersey and Albany Medical College
AUS689505	2/2/1998	9/30/2014	Protein- or peptide- immunotherapeutics and methods of immunizing using the same	The University of Medicine and Dentistry of New Jersey and Albany Medical College
US05,643,574	07/01/1997	7/01/2014	Protein- or peptide- immunotherapeutics and methods of immunizing using the same	The University of Medicine and Dentistry of New Jersey and Albany Medical College
US04,871,488	10/03/1989	10/03/2006	Reconstituting viral glycoproteins into large phospholipid vesicles	Albany Medical College
US04,663,161	05/05/1987	4/22/2005	Liposome methods and	Albany

Medical College compositions (1) We also co-own U.S. Patent 06,340,591 with the University of Maryland and University of Medicine and Dentistry of New Jersey, dealing with gene therapy which has no relation with either drug delivery or vaccines as described in this prospectus. Our interest in the intellectual property is subject to and burdened by various royalty payment obligations and by other material contractual or license obligations. In general, the patent position of biotechnology and pharmaceutical firms is frequently considered to be uncertain and involve complex legal and technical issues. There is considerable uncertainty regarding the breadth of claims allowed in such cases and the degree of protection afforded under such patents. While we believe that our intellectual property position is sound and that we can develop our new drug delivery technology and our HIV therapy, we cannot provide any assurances that our patent applications will be successful or that our current or future intellectual property will afford us the desired protection against competitors. It is possible that our intellectual property will be successfully challenged or that patents issued to others may preclude us from commercializing our drugs. We are aware of two issued United States patents dealing with lipid formulations of Amphotericin B products. The first of these patents, United States Patent No. 04,978,654, claims an Amphotericin B liposome product. We do not believe that our patent or technology are in conflict with this existing patent, although there can be no assurance that a court of law in the United States' patent authorities might determine otherwise. Our belief is based upon the fact that our cochleate product does not contain liposomes, which appears to be the basis for the existing patent. The second of these patents, United States Patent No. 05,616,334, claims a composition of a lipid complex containing Amphotericin B defined during prosecution as a ribbon structure. Our nano-encapsulation technology uses cochleates which are not ribbon structures. Accordingly, we do not believe that we require a license under this patent. If a court were to determine that we infringe either of these patents, we might be required to seek to a license to commercialize Amphotericin B products. There can be no assurance that we would be able to obtain a license from either patent holder. In addition, if we were unable to obtain a license, or if the terms of the license were onerous, there may be a material adverse effect upon our business plan to commercialize these products. Most of the inventions claimed in our patents were made with the United States government support. Therefore, the United States government might have certain rights in the technology, which could be inconsistent with the our plans for commercial development of products and/or processes. We believe to the extent the United States government would have rights in our licensed technology due to their funding, we have to either obtain a waiver from the United States government relating to the United States government's 40 rights in the technology, or have agreements with the United States government which would granting us exclusive rights. We also rely on trade secrets and confidentiality agreements with collaborators, advisors, employees, consultants, vendors and other service providers. We cannot assure you that these agreements will not be breached or that our trade secrets will not otherwise become known or be independently discovered by competitors. Our business would be adversely affected if our competitors were able to learn our secrets or if we were unable to protect our intellectual property. We filed a trademark registration for our proposed brand name, Bioral, which we plan to establish as our brand to use in conjunction with all of our potential oral delivery drugs. There can be no assurance it will be issued. HISTORY OF OUR TECHNOLOGY Below is a table summarizing technology development milestones: April 1995 BioDelivery Sciences, Inc. obtained the worldwide exclusive rights to the Bioral cochleate technology owned by the Universities. September 1995 BioDelivery Sciences, Inc. was awarded a vaccine research grant from Wyeth Lederle Vaccines, an affiliate of American Home Products and American Cyanamid Company. September 1995 BioDelivery Sciences, Inc. established a Research Agreement with the University of Medicine and Dentistry of New Jersey. June 1996 BioDelivery Sciences, Inc. established research and development, and License Agreement for Vaccines with Wyeth Lederle Vaccines which expired in December 1999. August 1996 BioDelivery Sciences, Inc. signed a Material Transfer Agreement ("MTA") and started collaboration with the University of Maryland, Gene Therapy. July 1997 U.S. Patent No. 05,643,574 issued to the Universities. PROTEIN -- OR PEPTIDE-COCHLEATE VACCINES. September 1997 BioDelivery Sciences, Inc. expanded its scientific and administrative staff and moved to new laboratories. November 1997 Initiated on-going collaboration with Public Health Research Institute of New York ("PHRI"). February 1998 Initiated on-going National Institute of Health funded amphotericin cochleate studies with University of Texas. July 1998 AUS Patent No 689505 issued to the Universities. VACCINE & METHODS OF IMMUNIZING. November 1998 U.S. Patent No. 05,834,015, issued to the Universities. AUTOGENOUS VACCINE (HIV). November 1998 U.S. Patent No. 05,840,707 issued to the Universities. STABILIZING AND DELIVERY MEANS OF BIOLOGICAL MOLECULES. March 1999 Moved into current 8,000 square foot facility on the campus of the University of Medicine and Dentistry of New Jersey. July 1999

Awarded Phase I SBIR for Amphotericin Cochleates. September 1999 Awarded Phase I SBIR for Cochleate Gene Therapy. November 1999 U.S. Patent No. 05,994,318 issued to the Universities. COCHLEATE DELIVERY VEHICLES. December 1999 Signed a MTA and started an on-going collaboration in drug delivery with a major pharmaceutical company under a non-disclosure agreement. 41 April 2000 Signed a MTA and started an on-going collaboration in drug delivery with a major pharmaceutical company under a non-disclosure agreement. June 2000 Initiate an on-going collaboration with the National Cancer Institute, Drug Delivery. October 2000 Initiated an on-going collaboration with the Institute for Tuberculosis Research, University of Illinois of Chicago, drug delivery. November 2000 A U.S. Patent No 0722,647 to the Universities. AUTOGENOUS VACCINE (HIV) November 2000 U.S. Patent No. 06,153,217 issued to BioDelivery Sciences, Inc. and the University of Medicine and Dentistry of New Jersey. NANOCOCHLEATE FORMULATIONS. Initiate process for preparation of Investigational New Drug Application for Amphotericin B cochleates. December 2000 U.S. Patent No. 06,165,502, issued to the Universities. AUTOGENOUS VACCINE (cancer etc.). December 2000 U.S. Patent No. 06,340,591, issued to the Universities. January 2001 Signed a MTA and started an on-going collaboration with a major pharmaceutical company under a non-disclosure agreement in drug delivery. April 2001 Establish a MTA and started an on-going collaboration with Utrecht Institute for Pharmaceutical Sciences, and University Medical Center Nijmegen, The Netherlands, to study mechanism of cochleates in drug delivery. May 2001 Signed a MTA with PHRI, NY to develop the cochleates for the treatment of Staphylococcus, drug delivery. June 2001 Signed a MTA with EUR Erasmus University of Rotterdam, The Netherlands, to develop the cochleates for the treatment of Staphylococcus, drug delivery. June 2001 License Agreement with Retina Pharma International, Inc. and Tatton Technology, LLC, affiliates of Dr. O'Donnell a stockholder, director and officer, for such entities to potentially use our technology to encapsulate their proprietary therapies for potential of certain neurodegenerative diseases. July 2001 European Patent No. 722338, issued to the Universities and the University of Maryland. September 2001 Award of $0.9 million, with an additional $1.8 million expected to be awarded NIH(SBIR) Grant for Pre-clinical and Clinical development of Amphotericin B cochleates. COMPETITION The biopharmaceutical industry in general is competitive and subject to rapid and substantial technological change. Developments by others may render our proposed technology and proposed drugs and HIV therapy under development noncompetitive or obsolete, or we may be unable to keep pace with technological developments or other market factors. Technological competition in the industry from pharmaceutical and biotechnology companies, universities, governmental entities and others diversifying into the field is intense and is expected to increase. Below are some examples of companies seeking to develope potentially competitive technologies. Many of these entities have significantly greater research and development capabilities than we do, as well as substantially more marketing, manufacturing, financial and managerial resources. These entities represent significant competition for us. In addition, acquisitions of, or investments in, competing development-stage pharmaceutical or biotechnology companies by large corporations could increase such competitors' research, financial, marketing, manufacturing and other resources. While many development activities are private, and therefore we cannot know what research or progress has actually been made, we are not aware of any other drug delivery technology using a naturally occurring drug delivery vehicle (carrier) that can be used to simultaneously address two important clinical goals; oral delivery of drugs that normally require injection and targeted cell delivery once the drug is in the body. 42 Included amongst companies which we believe are developing potentially competitive technologies are Emisphere (NASDAQ: EMIS), a publicly-traded company and Nobex, a privately-held company. We believe that these potential competitors are seeking to develop and commercialize technologies for the oral delivery of drug which may require customization for various therapeutics or groups of therapeutics. While our information concerning these competitors and their development strategy is limited, we believe our technology can be differentiated because our cochleate technology is seeking to deliver a potential broad base of water soluble and water insoluble (fat of lipid soluble) compounds with limited customization for each specific drug. We believe that our technology may have cell-targeted delivery attributes as well. Additional companies which are developing potentially competitive technologies in this area may include Valentis (NASDAQ: VLTS) and Enzon (NASDAQ: ENZN), both publicly-traded companies, which we believe may be seeking to develop technologies for cell-targeted delivery of drugs. While we have limited information regarding these potential competitors and their development status and strategy, we believe that our technology may be differentiated because unlike these potential competitors, we seek to use our cochleate to encapsulate the therapeutic to achieve drug delivery into the interior of the cells such as inflammatory cells. Although the competitors mentioned above are developing drug delivery techniques conceptually

similar to ours with respect to encapsulation, or more specifically "nano-encapsulation," we believe that our approach is different, proprietary and protected under our patent. One primary way we can be differentiated from our competitors is in our approach of using naturally occurring substances to form a cochleate which encapsulates the drug in a scroll-like multilayered delivery vehicle. We believe that competitors may also be working on patient-specific therapies for cancer. However, we are not aware of any competitors currently attempting to develop patient-specific therapies for HIV. This does not, however, mean to imply that there are not any now or that there will not be in the future. Vaccines can be used for prophylactic (prevention of infection), or therapeutic (treatment following infection) applications. The patient-specific therapeutic, which we are attempting to develop, is intended to boost or alter the immune response in patients already infected with HIV. For the most part, HIV vaccines in development, about which we are aware, are being targeted specifically to prevent infection, however, some of these vaccines may also prove useful for therapeutic applications. As such, these could prove to be competitive with our autologous therapeutic. Our drug delivery technology, specific drugs encapsulated with our drug delivery technology and HIV autologous immunotherapeutics must compete with other existing technologies and/or technologies in development. Such potential competitive technologies may ultimately prove to be safer, more effective or less costly than any drugs which we are currently developing or may be able to develop. Additionally, our competitive position may be materially affected by our ability to develop or successfully commercialize our drugs and technologies before any such competitor. MANUFACTURING During drug development and the regulatory approval process, we plan to rely on third-party manufacturers to produce our compounds for research purposes and for pre-clinical and clinical trials. With regard to our intended Amphotericin B product, we have entered into a manufacturing agreement with Octo Plus, Inc. Under our agreement, Octo Plus, Inc. will manufacture our encochleated Amphotericin B for use in clinical and preclinic trials. Manufacturing by Octo Plus, Inc. is required to comply with Good Manufacturing Practices with demonstrated scale-up capability for submission to the FDA. To date, we have not entered into manufacturing arrangements for any other intended Bioral product. As our intended products near market introduction, we intend to outsource manufacturing to third party manufacturers, which comply with the FDA's applicable Good Manufacturing Practices. While we believe that such commercial manufacturing arrangements may be available, no such relationships have been establish to date. We intend to purchase component raw materials from various suppliers. With regard to our lipids, we have a supply relationship with Avanti Polar Lipids, Inc. which we believe is capable of meeting our anticipated requirements during clinical trials. Avanti Polar Lipids, Inc. is located in Alabaster, Alabama. As 43 our intended products near market introduction, we intend to seek multiple suppliers of all required components although there may not actually be more than one at that time. In the event that Avanti Polar Lipids, Inc. fails to provide us with the necessary supply of required lipids, we would have difficulty replacing such supply in a timely manner which could negatively affect our research and production capabilities. SALES AND MARKETING Our marketing strategy, assuming completion of our drug delivery technology and product development and regulatory approval, is to market each of our approved orally delivered products under the Bioral brand name. Marketing may be conducted through a wide range of potential arrangements such as licensing, direct sales, co-marketing, joint venture and other arrangements. Such arrangements may be with large or small pharmaceutical companies, general or specialty distributors, biotechnology companies, physicians or clinics, or otherwise. We have a non-exclusive distribution arrangement with Biotech Specialty Partners, LLC ("BSP"). BSP is an early-stage alliance of specialty pharmaceutical and biotechnology companies. GOVERNMENT REGULATION The manufacturing and marketing of any drug encapsulated in our drug delivery technology, our autologous HIV therapeutic and our related research and development activities are subject to regulation for safety, efficacy and quality by numerous governmental authorities in the United States and other countries. We anticipate that these regulations will apply separately to each drug to be encapsulated by us in our drug delivery technology. We believe that complying with these regulations will involve a considerable level of time, expense and uncertainty. In the United States, drugs are subject to rigorous federal regulation and, to a lesser extent, state regulation. The Federal Food, Drug and Cosmetic Act, as amended, and the regulations promulgated thereunder, and other federal and state statutes and regulations govern, among other things, the testing, manufacture, safety, efficacy, labeling, storage, record keeping, approval, advertising and promotion of our drugs. Drug development and approval within this regulatory framework is difficult to predict and will take a number of years and involve the expenditure of substantial resources. The steps required before a pharmaceutical agent may be marketed in the United States include: 1. Pre-clinical laboratory tests, in vivo pre-clinical studies and formulation studies; 2. The submission to the FDA of an Investigational New Drug

Application (IND) for human clinical testing which must become effective before human clinical trials can commence; 3. Adequate and well-controlled human clinical trials to establish the safety and efficacy of the product; 4. The submission of a New Drug Application or Biologic License Application to the FDA; and 5. FDA approval of the New Drug Application or Biologic License Application prior to any commercial sale or shipment of the product. In addition to obtaining FDA approval for each product, each domestic product-manufacturing establishment must be registered with, and approved by, the FDA. Domestic manufacturing establishments are subject to biennial inspections by the FDA and must comply with the FDA's Good Manufacturing Practices for products, drugs and devices. Pre-clinical Trials Pre-clinical testing includes laboratory evaluation of chemistry and formulation, as well as tissue culture and animal studies to assess the potential safety and efficacy of the product. Pre-clinical safety tests must be conducted by laboratories that comply with FDA regulations regarding Good Laboratory Practices. No assurance can be given as to the ultimate outcome of such pre-clinical testing. The results of pre-clinical testing are submitted to the FDA as part of an IND and are reviewed by the FDA prior to the commencement 44 of human clinical trials. Unless the FDA objects to an IND, the IND will become effective 30 days following its receipt by the FDA. We intend to largely rely upon contractors to perform pre-clinical trials. With regard to Bioral Clofazimine, our pre-clinical trials are being coordinated by the Institute for Tuberculosis research, University of Illinois at Chicago. To date, we have not established any relationship with regard to pre-clinical testing of our intended Bioral anti-inflammatory products. Clinical Trials Clinical trials involve the administration of the new product to healthy volunteers or to patients under the supervision of a qualified principal investigator. Clinical trials must be conducted in accordance with Good Clinical Practices under protocols that detail the objectives of the study, the parameters to be used to monitor safety and the efficacy criteria to be evaluated. Each protocol must be submitted to the FDA as part of the IND. Further, each clinical study must be conducted under the auspices of an independent institutional review board at the institution where the study will be conducted. The institutional review board will consider, among other things, ethical factors, the safety of human subjects and the possible liability of the institution. Compounds must be formulated according to Good Manufacturing Practices. Clinical trials are typically conducted in three sequential phases, but the phases may overlap. In Phase I, the initial introduction of the product into healthy human subjects, the drug is tested for safety (adverse side effects), absorption, dosage tolerance, metabolism, bio-distribution, excretion and pharmacodynamics (clinical pharmacology). Phase II is the proof of principal stage and involves studies in a limited patient population in order to: - Determine the efficacy of the product for specific, targeted indications; - Determine dosage tolerance and optimal dosage; and - Identify possible adverse side effects and safety risks. When there is evidence that the product may be effective and has an acceptable safety profile in Phase II evaluations, Phase III trials are undertaken to further evaluate clinical efficacy and to test for safety within an expanded patient population at geographically dispersed multi-center clinical study sites. Phase III frequently involves randomized controlled trials and, whenever possible, double blind studies. We, or the FDA, may suspend clinical trials at any time if it is believed that the individuals participating in such trials are being exposed to unacceptable health risks. We intend to rely upon third party contractors to advise and assist us in our clinical trials. We have entered into an agreement with Pharma Research, Inc., Wilmington, Delaware, to assist in the preparation and filing of our IND with regard to Phase I clinical trials and upon acceptance to potentially oversee clinical trials of our "nano-encapsulated" Amphotericin B. Under the agreement, Pharma-Research, Inc. would provide scientific and other professional personnel to assist us in drafting and submitting the IND. We have been given an estimate of the total cost of the project which is subject to variables such as actual time spent on the project. However, at this time, we believe the total project will approximate $100,000. Furthermore, this agreement may be terminated at any time by either party. We have not established similar relationships regarding anticipated clinical trials for any other intended Bioral product. New Drug Application and FDA Approval Process The results of the pharmaceutical development, pre-clinical studies and clinical studies are submitted to the FDA in the form of a New Drug Application for approval of the marketing and commercial shipment of the product. The testing and approval process is likely to require substantial time and effort. In addition to the results of preclinical and clinical testing, the NDA applicant must submit detailed information about chemistry and manufacturing and controls that will determine how the product will be made. The approval process is affected by a number of factors, including the severity of the disease, the availability of alternative treatments and the risks and benefits demonstrated in clinical trials. Consequently, there can be no assurance 45 that any approval will be granted on a timely basis, if at all. The FDA may deny a New Drug Application if applicable regulatory criteria are not satisfied, require additional testing or information or require post-marketing testing (Phase IV) and surveillance to

monitor the safety of a company's products if it does not believe the New Drug Application contains adequate evidence of the safety and efficacy of the drug. Notwithstanding the submission of such data, the FDA may ultimately decide that a New Drug Application does not satisfy its regulatory criteria for approval. Moreover, if regulatory approval of a drug is granted, such approval may entail limitations on the indicated uses for which it may be marketed. Finally, product approvals may be withdrawn if compliance with regulatory standards is not maintained or if problems occur following initial marketing. Post approval studies may be conducted to explore further intervention, new indications or new product uses. Among the conditions for New Drug Application approval is the requirement that any prospective manufacturer's quality control and manufacturing procedures conform to Good Manufacturing Practices and the requirement specifications of the approved NDA. In complying with standards set forth in these regulations, manufacturers must continue to expend time, money and effort in the area of drugion and quality control to ensure full technical compliance. Manufacturing establishments, both foreign and domestic, also are subject to inspections by or under the authority of the FDA and by other federal, state or local agencies. Additionally, in the event of non-compliance, FDA may issue warning letters and seek criminal and civil penalties, enjoin manufacture, seize product or revoke approval. International Approval Whether or not FDA approval has been obtained, approval of a product by regulatory authorities in foreign countries must be obtained prior to the commencement of commercial sales of the drug in such countries. The requirements governing the conduct of clinical trials and drug approvals vary widely from country to country, and the time required for approval may be longer or shorter than that required for FDA approval. Although there are some procedures for unified filings for certain European countries, in general, each country at this time has its own procedures and requirements. Other Regulation In addition to regulations enforced by the FDA, we are also subject to regulation under the Occupational Safety and Health Act, the Environmental Protection Act, the Toxic Substances Control Act, the Resource Conservation and Recovery Act and other present and potential future federal, state or local regulations. Our research and development may involve the controlled use of hazardous materials, chemicals, and various radioactive compounds. Although we believe that our safety procedures for handling and disposing of such materials comply with the standards prescribed by state and federal regulations, the risk of accidental contamination or injury from these materials cannot be completely eliminated. In the event of any accident, we could be held liable for any damages that result and any such liability could exceed our resources. EMPLOYEES As of March 31, 2002, we had nine full-time employees, of which six are scientists and three are administrative. Three of these scientists have Ph.D. degrees. None of our employees are covered by collective bargaining agreements. From time to time, we also employ independent contractors to support our engineering and support and administrative functions. We consider relations with our employees to be good. Each of our current scientific personnel has entered into confidentiality and non-competition agreements with us. FACILITIES We conduct our operations in laboratory and administrative facilities on a single site located on the campus of the University of Medicine and Dentistry of New Jersey. Pursuant to a five year lease agreement with the university ending 2005, we occupy a total of approximately 8,000 square feet. The monthly rent is $3,340 in 2001, $3,840 in 2002, $4,340 in 2003, $4,840 in 2004 and $5,340 in 2005 plus agreed payments for graduate student assistants and supplies used by us. These payments are expected to be approximately 46 $100,000 annually. The terms of the lease allows us flexibility of terminating the lease arrangement and relocating to a new space better suited for our long-term space requirements. Our ability to terminate is without a penalty provided that we give prior written notice. LEGAL PROCEEDINGS We are not subject to any pending legal actions other than described below. However, in May 2001, we settled litigation commenced against BioDelivery Sciences, Inc. by Irving A. Berstein and certain of his family members and affiliates. Mr. Berstein was an officer, director and more than 10% stockholder of Biodelivery Sciences, Inc. A dispute arose between Mr. Berstein and the remaining management team of Biodelivery Sciences, Inc. which was considered to be disruptive to the ongoing operation of Biodelivery Sciences, Inc. The litigation was based upon various legal theories arising out of Mr. Berstein's conduct as an officer and director of Biodelivery Sciences, Inc., the terms and enforceability of certain agreements between Mr. Berstein and Biodelivery Sciences, Inc., the termination of employment of Mr. Berstein as an employee and officer of Biodelivery Sciences, Inc. and the subsequent issuance of stock by Biodelivery Sciences, Inc. to stockholders other than Mr. Berstein. The litigation involved both direct claims by Mr. Berstein against Biodelivery Sciences, Inc. and certain members of management individually and counterclaims by Biodelivery Sciences, Inc. against Mr. Berstein. Claims for compensation for past and future services and under long term contracts were alleged. Further, Mr. Berstein alleged that an issuance of stock to other stockholders of Biodelivery Sciences, Inc. except him around the time of his termination was inappropriate and

dilutive. Mr. Berstein alleged an entitlement to additional shares of stock to prevent dilution to him. In the settlement, all claims of Mr. Berstein and the counterclaims against Mr. Berstein were fully resolved and we purchased Mr. Berstein's entire stock position in Biodelivery Sciences, Inc. The settlement required that we pay $150,000 in cash and $125,000 by promissory note, which is being satisfied in full out of the proceeds of this offering. At the same time, we purchased the shares of BioDelivery Sciences, Inc. held by these plaintiffs for $500,000 which was paid $200,000 in cash and $300,000 by promissory note. As part of the settlement, there is a lien upon all of our assets until all of the outstanding promissory notes have been paid. We will use part of the proceeds to fully satisfy debt owed pursuant to this litigation and remove the lien on our assets. A lawsuit has been filed by Michael Pennessi d/b/a SSP Consultants, who is not affiliated with us, arising out of an introduction to BioDelivery Sciences, Inc. in 2000. Settlement discussions have been conducted. Informal telephonic settlement discussions prior to the filing of the lawsuit, have ranged between an approximately $120,000 cash demand upon us to our counter-offer of approximately $5,000 in cash and 5,000 shares of stock. We do not know if the matter will be settled. If settlement is reached, the damages sought or obtained may be different or greater than that previously discussed in settlement negotiations. We intend to vigorously defend this litigation. It is our belief that the potential claim is neither material nor meritorious. 47 MANAGEMENT Our directors and executive officers and their ages as of June 1, 2002 are as follows: NAME AGE POSITION(S) HELD ---- --- ---------- Francis E. O'Donnell, Jr., 52 M.D. ..... President, Chief Executive Officer, Chairman, and Director Raphael J. Mannino, Ph.D. ..... 55 Executive Vice President, Chief Scientific Officer and Director James A. McNulty..... 51 Secretary, Treasurer, and Chief Financial Officer Donald L. Ferguson..... 53 Senior Executive Vice President Leila Zarif, Ph.D., MBA(1)..... 47 Executive Vice President of Research and Development Christopher Chapman, M.D. ..... 49 Executive Vice President of Medical and Regulatory Affairs and Director of New Business Development Susan Gould-Fogerite, Ph.D. ..... 49 Director of Business Development-Vaccines and Gene Therapy L.M. Stephenson, Ph.D. ..... 59 Director William B. Stone..... 58 Director James R. Butler..... 61 Director John J. Shea..... 75 Director Robert G.L. Shorr..... 48 Director ---------- (1) Dr. Zarif has notified us that she and her family have decided to move back to their native country of France and discontinue working with us. She has indicated to us that her departure is solely for personal reasons and not having any thing to do with this offering or any disagreement with us. We do not believe that Dr. Zarif's termination of employment will have a material adverse effect on our operations. There are no family relationships between any director, executive officer, or person nominated or chosen to become a director or executive officer. Francis E. O'Donnell, Jr., M.D., age 52, has been CEO, President, Chairman and Director on a full time basis since March 29, 2002 when Dr. O'Donnell executed an employment agreement with us to become full-time interim President and CEO. Following the offering, we are intending to identify a replacement CEO and President for Dr. O'Donnell, who will assume full day-to-day responsibilities of our operations. For more than the last five years, Dr. O'Donnell has served as managing director of The Hopkins Capital Group, an affiliation of limited liability companies which engage in business development and venture activities. He has been Chairman of Laser Sight Inc. (LASE), a publicly traded manufacturer of advanced refractive laser systems since 1993. He is also the founder and a director of BioKeys Pharmaceuticals, Inc., a publicly traded biopharmaceutical company. He is a founder and chairman of PhotoVision Pharmaceuticals, Inc. and since early 2001, the chairman of RetinaPharma, Inc. He is a non-managing partner of Tatton Technologies, LLC, a biotechnology company and a managing partner of Biotech Specialty Partners, LLC, an alliance of specialty pharmacy and biotechnology companies. Dr. O'Donnell is a graduate of The Johns Hopkins School of Medicine and received his residency training at the Wilmer Ophthalmological Institute. Dr. O'Donnell is a former professor and Chairman of the Department of Ophthalmology, St. Louis University School of Medicine. Dr. O'Donnell holds 25 U.S. Patents. Dr. O'Donnell is the 2000 Recipient of the Jules Stein Vision Award sponsored by Retinitis Pigmentosa International. James McNulty, age 51, has been Secretary, Treasurer, and Chief Financial Officer on a part time basis (estimated to constitute approximately 80% of his time) since October 2000. Mr. McNulty has, since May 2000, also served as Chief Financial Officer of Hopkins Capital Group, an affiliation of limited liability companies which engage in venture activities. Hopkins Capital Group is owned and controlled by Dr. Francis E. O'Donnell. Mr. McNulty has performed accounting and consulting services as a certified public accountant 48 for approximately 27 years. He co-founded, Pender McNulty Newkirk, which became one of Florida's largest regional CPA firms, and was a founder/principal in two other CPA firms, McNulty & Company, and McNulty Garcia & Ortiz. He served as CFO of Star Scientific, Inc. (STSI) from October 1998 to May 2000. Since June 2000 he has served as CFO/COO of American Prescription Providers, Inc. He is a principal in

Pinnacle Group Holdings, a real estate development company developing a major downtown Tampa destination entertainment complex. He is a published co-author (with Pat Summerall) of Business Golf, The Art of Building Relationships Through Golf, and is chairman of Business Links International, Inc., a business development training company, which uses golf as its focus. Mr. McNulty is a graduate of University South Florida, a licensed Certified Public Accountant, and is a member of the American and Florida Institutes of CPA's. Donald L. Ferguson, age 53, has been Senior Executive Vice President on a part time basis since October 2000. Mr. Ferguson has been Chief Executive Officer and principal owner of Land Dynamics, Inc., a developer of real estate projects since its founding in 1979 and currently owns in excess of 20 real estate properties. Mr. Ferguson is an investor in early stage technology and biotechnology companies including Nanovision Technologies, Inc., Star Scientific, Inc., BioKeys Pharmaceuticals, Inc. and PhotoVision Pharmaceuticals, Inc. Mr. Ferguson holds an M.B.A. Degree from the University of Kansas and a B.S. Degree in industrial engineering from Oklahoma State University. Raphael J. Mannino, Ph.D., age 55, has been Executive Vice President and Chief Scientific Officer since October 2000, and a Director since October 2001. Dr. Mannino has served as President, CEO, Chief Scientific Officer, and a member of the Board of Directors of BioDelivery Science, Inc. since its incorporation in 1995. Dr. Mannino's previous experience includes positions as Associate Professor, at the University of Medicine and Dentistry of New Jersey (1990 to present), Assistant, then Associate Professor, Albany Medical College (1980 to 1990), and Instructor then Assistant Professor, Rutgers Medical School (1977 to 1980). His postdoctoral training was from 1973 to 1977 at the Biocenter in Basel, Switzerland. Dr. Mannino received his Ph.D. in Biological Chemistry in 1973 from the Johns Hopkins University, School of Medicine. Leila Zarif, Ph.D., MBA., age 47, has been Executive Vice President of Research and Development since October 2000. Dr. Zarif joined BioDelivery Sciences, Inc. in 1997 as Director of European Operations, and then moved to the United States headquarters as Vice President from October 1997 until October 2000. Dr. Zarif served as a Director and Treasurer from March 1998 until March 2000. Dr. Zarif's prior experience includes eleven (11) years with ATTA, SA. (Application and Transfer of Advanced Technology, French subsidiary of Alliance Pharmaceutical Corp., San Diego) beginning as Head of New Technology Assessment and promoted to President in 1993. Previously, Dr. Zarif worked as a postdoctoral fellow with the French CNRS (National Center of Scientific Research). Dr. Zarif received her Ph.D. in Chemistry in 1988, her MBA in 1992, and her Habilitation to Direct Research in 1995 from the University of Nice, France. Dr. Zarif has notified us that she and her family have decided to move back to their native country of France and discontinue working with us. She has indicated to us that her departure is solely for personal reasons and not having any thing to do with this offering or any disagreement with us. Christopher Chapman, M.D., age 49, has been the Executive Vice President of Medical and Regulatory Affairs and Director of New Business Development (pharmaceuticals) on a part time basis since October 2000. Dr. Chapman received his M.D. degree from Georgetown University in Washington, D.C. in 1987 where he completed his internship in Internal Medicine. He completed a residency in Anesthesiology and a fellowship in Cardiovascular and Obstetric Anesthesiology at Georgetown University. Since 1995, Dr. Chapman has been a critical care physician on the staff at Doctor's Community Hospital, Lanham, Maryland. He was most recently President of Chapman Pharmaceutical Consulting. From 1995 to April 2000, Dr. Chapman was Executive Director, Medical Affairs, Quintiles Consulting and a founding Co-Director of Quintiles BRI (QBRI) Medical Affairs, Drug Safety and Medical Writing Departments. Susan Gould-Fogerite, Ph.D., age 49, has been Director of Business Development -- Vaccines and Gene Therapy since October 2000. Dr. Gould-Fogerite served as Vice President and Secretary, and has been a member of the Board of Directors of BioDelivery Sciences, Inc. since its incorporation in 1995. Dr. Gould-Fogerite's previous experience includes her positions as Associate Professor (2001 to present), 49 Assistant Professor (1991-2001), at University Of Medicine And Dentistry Of New Jersey, New Jersey Medical School, and Research Instructor (1985 to 1988), then Research Assistant Professor (1988-1990), at Albany Medical College. Dr. Gould-Fogerite received her Ph.D. in Microbiology and Immunology from the Albany Medical College in 1985. L.M. Stephenson, Ph.D., age 59, is a member of the Board of Directors of the Company. Dr. Stephenson has been associated with the University of Medicine and Dentistry of New Jersey since 1995 where he is currently the Vice President for Research with responsibility over developing the research capability, research funding and intellectual property of New Jersey's medical science campuses, including three medical schools, dental, nursing and public health schools and a graduate school of biomedical sciences. He also serves as the Acting Associate Dean for Research of the New Jersey Medical School where he is temporarily responsible for managing and reorganizing the Sponsored Projects Office. Dr. Stephenson also currently serves as the Director of Patents and Licensing of the University of

Medicine and Dentistry of New Jersey where he is responsible for management of the Intellectual Property Assets, including marketing of patents and establishment of new ventures. Dr. Stephenson is a graduate of the University of North Carolina where he earned a BS in chemistry and was awarded the Venable Medal for outstanding senior in chemistry. Dr. Stephenson earned his Ph.D. in chemistry from the California Institute of Technology where he earned the Kodak Prize for outstanding chemistry graduate student and was an NSF Predoctoral Fellow. Additionally, Dr. Stephenson was a Research Fellow at Harvard University. Dr. Stephenson also serves on the board of directors of the following institutions: Kessler Medical Rehabilitation & Research Corporation (Non-Profit), University Heights Sciences Park (Non-Profit), New Jersey Entrepreneurs Network, Rutgers Help Desk & Business Incubator, Crescent Genomics and the New Jersey Research and Development Council. William B. Stone, age 58, is a member of our Board of Directors. For the past 20 years, Mr. Stone has been continuously employed with Mallinckrodt Inc. in various capacities such as Vice-President Corporate Controller and CIO. Mr. Stone retired in October 2000. Mr. Stone is a graduate of the University of Missouri-Columbia where he earned a BS and MA degree in accounting. Mr. Stone is also a Certified Public Accountant. James R. Butler, age 61, is currently a director of Durect Corporation and has served in this capacity since July 1999. Mr. Butler is retired from ALZA Corporation where the last position he held was President of Alza International and from which he retired in June 2001. Mr. Butler was employed at Alza from August 1993 to June 2001. Prior to that, Mr. Butler worked at Glaxo Inc. for 23 years where the last position he held was Vice President -- General Manager of Corporate Division. He is currently on the Board of Directors of Hematrope Pharmaceuticals and is the Chairman of the Board of Directors of Respirics, Inc. In addition, he is also a Senior Advisor/Principal to Apothogen, Inc., which is a start up company funded by J.P. Morgan Partners, as well as Pharmaceutical Products Development, Inc. Mr. Butler is on the Pharmacy School Board at the University of Florida and is on the Board of Advisors at Campbell University, North Carolina. Mr. Butler is also a principal in a start up pharmaceutical company called Apothogen Pharmaceuticals. Mr. Butler earned a B.S. in marketing at the University of Florida. John J. Shea, age 75, is currently the head of his own firm of John J. Shea & Associates and a Quality Systems Adviser with Quintiles, a private consulting firm. Mr. Shea has been employed at John J. Shea Associates since 1989. Mr. Shea has also served in the capacity of Director of Quality Assurance which is responsible for the implementation of quality assurance procedures in a number of public and private companies. From 1987-1989, he served as Director of Quality Assurance at NeoRx Corporation. Mr. Shea was also the Director of Corporate Quality Assurance at Hexcel Corporation from 1980-1987. Mr. Shea has also served as the quality assurance person for other companies including, Teledyne Relays, Ortho Diagnostics, Inc. and Bio Reagents & Diagnostics, Inc. Mr. Shea earned a B.S. in Chemistry at Bethany College. Robert G.L. Shorr, Ph.D., age 48, is currently President and CEO of Cornerstone Pharmaceuticals, a company focussed on novel tumor targeting drug delivery and novel anticancer agent technologies. He is also on the faculty of State University of New York (SUNY) Stony Brook Department of Biomedical Engineering where he serves as the Director of Business Development for the Center for Advanced Technology State University of New York at Stony Brook. He has served in that position since October 1998. As Director of 50 Business Development for the State University of New York at Stony Brook Center for Biotechnology, Dr. Shorr has been responsible for working with faculty and the university technology transfer office to establish grant funded entrepreneurial programs for promising commercializable technology. From 1991 to 1998, Dr. Shorr served as Vice President Science and Technology and as Vice President for Research and Development at Enzon Inc., a public company. Among his many accomplishments, Dr. Shorr was responsible for management of the co-development with Schering Plough of the product PEG INTRON A, which is now approved in the US and Europe. Dr. Shorr also served as chief scientist for another public company, United Therapeutics, Inc. since 1998 and continues to be a consultant. Dr. Shorr was also Associate Director for Molecular Pharmacology at SmithKline and >French Upper Marion, PA; working under the direction of Stanley T. Crooke, M.D., Ph.D. and President of World Wide Research and Development. Dr. Shorr received his B.S. in Biology from the State University of New York (Buffalo) in 1975, his D.I.C. from Imperial College of Science & Technology in London, England in 1982, and his Ph.D., in Biochemistry from the University of London in 1981. BOARD COMPOSITION Directors are elected annually at our annual meeting of stockholders, and serve for the term for which they are elected and until their successors are duly elected and qualified. There is only one class of directors. BOARD COMPENSATION The Company's policy is to pay $1,000 per diem compensation to members of the Board for attendance at formal Board meetings or committee meetings and no compensation for informal meetings such as telephonic meetings and written consent actions. All directors are reimbursed for travel and other related expenses incurred in attending meetings of the Board. Directors

are eligible to participate in our 2001 stock option plan. We grant each director upon agreeing to serve an option to purchase 20,000 shares of common stock. We award an additional 10,000 for each committee chairmanship and 5,000 shares for each committee membership. We grant subsequent grants of options to purchase 20,000 shares upon each anniversary of such director's appointment. Such options are granted at an exercise price equal to the fair market value of the common stock on the grant date and are exercisable 13 months following the completion of this offering or 24 months from the date of grant. We have indemnified each member of the board of directors and our executive officers to the fullest extent authorized, permitted or allowed by law. BOARD COMMITTEES The board of directors has a compensation committee that reviews and recommends the compensation arrangements for our management. The members of the compensation committee are Dr. O'Donnell, L.M. Stephenson, and William Stone. The board of directors designated an audit committee on March 6, 2002 that reviews our annual audit and meets with our independent auditors to review our internal controls and financial management practices. The board's audit committee currently consists of James R. Butler, John J. Shea, Robert G.L. Shorr, and William Stone. We believe that these individuals qualify as independent directors in accordance with the rules of the Nasdaq Stock Market. The functions of the audit committee are to make recommendations to the board of directors regarding the selection of independent auditors, review the results and scope of the audit and other services provided by our independent auditors and review and evaluate our audit and control functions. The audit committee is also charged with reviewing all related party transactions. One of the first acts of the audit committee was to review all related-party agreements and transactions which we had executed. The audit committee reviewed our related party transactions including agreements with RetinaPharma International, Inc., Tatton Technologies, LLC, and BioKeys Pharmaceuticals, Inc and subsequently ratified them on March 13, 2002. 51 SCIENTIFIC ADVISORY BOARD We have established our Scientific Advisory Board as an additional scientific and technical resource for our management team. Members of our advisory board have entered into consulting agreements which provide for expense reimbursements, 10,000 non-qualified stock options and cash compensation of $1,500 for attendance at each formal board meeting. The following is a short discussion of our advisory board members' background: Ralph Arlinghaus, Ph.D. is Professor and Chairman of the Department of Molecular Pathology at M. D. Anderson Cancer Center since 1986. Dr. Arlinghaus has an extensive research background and experience in several fields, including small RNA viruses (picornaviruses), retroviruses, including HIV, molecular mechanisms involved in signal transduction, and molecular aspects of leukemia research both at the level of diagnostics and developing novel strategies to treat leukemia. From 1983-1986 Dr. Arlinghaus was Director of Vaccine Development at the Johnson & Johnson Biotechnology Center in La Jolla, CA. Floyd H. Chilton, Ph.D., is Founder, Director, President, Chief Executive Officer and Chief Scientific Officer of Pilot Therapeutics. Prior to joining Pilot Therapeutics as CEO and CSO in December 2000, Dr. Chilton was Director of Molecular Medicine, Professor of Physiology and Pharmacology, Professor of Internal Medicine (Section on Pulmonary and Critical Care Medicine) and Professor of Biochemistry at the Wake Forest University School of Medicine. Dr. Chilton is widely recognized in academia and industry for his leading work on the role of arachidonic acid metabolism in human diseases. Gerald Lee Mandell, M.D., MACP is the Owen R. Cheatham Professor of the Sciences and Professor of Medicine at the University of Virginia. He is the founding editor of the world's leading reference source, Principles and Practices of Infectious Diseases and the journal Current Infectious Diseases. He is a past-President of the Infectious Diseases Society of America and was holder of an NIH MERIT Award for his research focused on neutrophils and infection and neutrophil interactions with antibiotics. He is a member of the Institute of Medicine. James M. Oleske, M.D., MPH is Francois-Xavier Bagnoud Professor of Pediatrics and Director, Division of Pulmonary, Allergy, Immunology and Infectious Diseases Department of Pediatrics UMD-New Jersey Medical School. Dr. Oleske is an internationally recognized expert in the management of children with HIV/AIDS. His earlier interest in immune based therapy for infants and children with primary immunodeficiency has been extended to children with HIV infection His multiple medical Board certifications (Allergy/Immunology, Infectious Disease, Laboratory Immunology and Palliative/Hospice Care and Pain) reflect his lifelong commitment of advocacy for children. David S. Perlin, Ph.D., is the Scientific Director of The Public Health Research Institute, an internationally recognized 60 year-old biomedical research institute in New York City that emphasizes molecular approaches to infectious diseases research. Dr. Perlin is widely published, and his research activities focus on investigating the molecular properties of fungal membrane proteins, novel approaches to fungal diagnostics, and the molecular basis for clinical resistance to antifungal agents. Leo A. Whiteside, M.D., is founder and President of Missouri Bone and Joint Center, Missouri Bone and Joint Research Laboratory, and Whiteside Biomechanics Inc. Dr. Whiteside is an

internationally recognized arthritis surgeon and innovator, specializing in total replacement of the hip and knee. He has been the surgeon-inventor for three major hip replacement and two major knee replacement systems, and his company is involved with developing and marketing orthopaedic surgical instruments and implantable devices. He is past president of the Hip Society, recipient of the Charnley award for excellence for research involving hip replacement surgery, and is currently on the editorial board of The Journal of Arthroplasty and Clinical Orthopaedics and Related Research. LIMITATION ON LIABILITY AND INDEMNIFICATION MATTERS Our certificate of incorporation and bylaws limit or eliminate the personal liability of our directors for monetary damages for breach of the directors' fiduciary duty of care. The duty of care generally requires that, when acting on behalf of the corporation, directors exercise an informed business judgment based on all 52 material information reasonably available to them. Consequently, our directors or officers will not be personally liable to us or our stockholders for monetary damages for breach of their fiduciary duty as a director, except for: - any breach of the director's duty of loyalty to us or our stockholders; - acts or omissions not in good faith or that involve intentional misconduct or a knowing violation of law; - unlawful payments of dividends or unlawful stock repurchases, redemptions or other distributions; and - any transaction from which the director derived an improper personal benefit. Our certificate of incorporation also provides that we will indemnify, to the fullest extent permitted by law, any person made or threatened to be made a party to any action or proceeding by reason of the fact that he or she is or was one of our directors or officers or serves or served at any other enterprise as a director, officer or employee at our request. Our bylaws provide that we will, to the maximum extent and in the manner permitted by Delaware law, indemnify each of the following persons against expenses, including attorneys' fees, judgments, fines, settlements, and other amounts incurred in connection with any proceeding arising by reason of the fact that he or she is or was our agent: - one of our current or past directors or officers; - a current or past director or officer of another enterprise who served at our request; or - a current or past director or officer of a corporation that was our predecessor corporation or of another enterprise at the request of a predecessor corporation. In addition, we will acquire directors' and officers' insurance providing indemnification for our directors, officers and certain employees for certain liabilities. We believe that these indemnification provisions and agreements are necessary to attract and retain qualified directors and officers. The limited liability and indemnification provisions in our certificate of incorporation and bylaws may discourage stockholders from bringing a lawsuit against directors for breach of their fiduciary duty and may reduce the likelihood of derivative litigation against directors and officers, even though a derivative action, if successful, might otherwise benefit us and our stockholders. Furthermore, a stockholder's investment in us may be adversely affected to the extent we pay the costs of settlement and damage awards against our directors and officers under these indemnification provisions. EXECUTIVE COMPENSATION The following table provides certain summary information concerning the compensation earned for services rendered to us during the fiscal year ended December 31, 2001 by our Chief Executive Officer and our four other most highly compensated executive officers who earned more than $100,000 in fiscal 2001 and were serving as executive officers at the end of fiscal 2001, whom we refer to collectively as the named executive officers. 53 The annual and long-term remuneration to or accrued for the executive officers, for services rendered during the years ended December 31, 1999, 2000 and 2001 was as follows: SUMMARY COMPENSATION TABLE* LONG TERM COMPENSATION ---------- ANNUAL COMPENSATION(1) AWARDS PAYOUTS ---------- ---------- ---------- (a) (b) (c) (d) (f) (g) (e) RESTRICTED SECURITIES (h) (i) OTHER ANNUAL STOCK UNDERLYING LTIP ALL OTHER NAME AND PRINCIPAL POSITION YEAR SALARY BONUS COMPENSATION AWARD(S) OPTIONS/SARS PAYOUTS COMPENSATION(2) ---------- ---- -------- ----- ---------- ---------- ---------- ------- ---------- ($) ($) ($) ($) (#) ($) ($) Francis E. O'Donnell, Jr., 2001 -- -- -- -- 8,009 -- -- M.D.,..... CEO, President and Chairman 2000 -- -- -- -- -- -- -- 709 The Hampton Lane 1999 -- -- -- -- -- -- -- Chesterfield, MO 63017 James McNulty, CFO,..... 2001 $ 40,000 -- -- -- -- -- -- Secretary and Treasurer 2000 -- -- -- -- -- -- -- 4419 W. Sevilla Street 1999 -- -- -- -- -- -- -- Tampa, Florida 33629 Donald L. Ferguson,..... 2001 -- -- -- -- 274,600 -- -- Senior Executive Vice 2000 -- -- -- -- -- -- -- President Land Dynamics, Inc. 1999 -- -- -- -- -- -- -- 11719 Old Ballas Road, Suite 110 St. Louis, MO 63141 Raphael J. Mannino, Ph.D., ... 2001 $ 83,650 -- -- -- 96,110 -- $726,957 Executive Vice President, 2000 $ 64,800 -- -- -- -- -- -- Chief Scientific Officer 1999 $ 64,800 -- -- -- -- -- -- UMDNJ New Jersey Medical School 185 South Orange Avenue Building 4 Newark, NJ 07103 Christopher Chapman, ... 2001 $ 80,000 -- -- -- 91,533 -- -- Director of Medical and 2000 -- -- -- -- -- -- -- Regulatory Affairs and 1999 -- -- -- -- -- -- -- Director of New Business Management 800 Falls Lake Drive Mitchelsville, MD 20720

Leila Zarif, Ph.D.,(3) ..... 2001 $139,514 -- -- -- 91,533 -- $726,957 Executive Vice President 2000 $114,716 -- -- -- -- -- -- of Research and Development 1999 $109,622 -- -- -- -- -- -- UMDNJ New Jersey Medical School 185 South Orange Avenue Building 4 Newark, NJ 07103 54 LONG TERM COMPENSATION ---------- ANNUAL COMPENSATION(1) AWARDS PAYOUTS ---------- ---------- ---------- (a) (b) (c) (d) (f) (g) (e) RESTRICTED SECURITIES (h) (i) OTHER ANNUAL STOCK UNDERLYING LTIP ALL OTHER NAME AND PRINCIPAL POSITION YEAR SALARY BONUS COMPENSATION AWARD(S) OPTIONS/SARS PAYOUTS COMPENSATION(2) ---------- ---- -------- ----- ---------- ---------- ---------- ------- ---------- ($) ($) ($) ($) (#) ($) ($) Susan Gould-Fogerite, 2001 $ 40,800 -- -- -- 34,324 -- $581,564 Ph.D., ... Director of Business 2000 $ 40,800 -- -- -- -- -- -- Development -- Vaccines and 1999 $ 40,800 -- -- -- -- -- -- Gene Therapy UMDNJ New Jersey Medical School 185 South Orange Avenue Building 4 Newark, NJ 07103 ---------- * Salary reflects total compensation paid to these executives (pre-merger and post-merger with BioDelivery Sciences, Inc. during these periods). (1) The annual amount of perquisites and other personal benefits, if any, did not exceed the lesser of $50,000 or 10% of the total annual salary reported for each named executive officer and has therefore been omitted. (2) Reflects the increase in value of the permanent discount stock (a variable award) and the compensation expense recorded by us as a result of the agreement to remove the permanent discount and put rights. (3) Dr. Zarif has notified us that she and her family have decided to move back to their native country of France and discontinue working with us. She has indicated to us that her departure is solely for personal reasons and not having any thing to do with this offering or any disagreement with us. OPTION GRANTS DURING YEAR ENDED DECEMBER 31, 2001 POTENTIAL REALIZABLE VALUE AT ASSUMED ANNUAL RATES INDIVIDUAL GRANTS OF STOCK PRICE APPRECIATION FOR OPTION TERM ---------- ---------- (a) (c) (d) (e) (f) (g) (b) PERCENT OF NUMBER OF TOTAL SECURITIES OPTIONS/SARS EXERCISE UNDERLYING GRANTED TO OR BASE OPTIONS/SARS EMPLOYEES IN PRICE NAME GRANTED (#) FISCAL YEAR ($/SH) EXPIRATION DATE 5% ($) 10% ($) ---- ---------- ---------- -------- ---------- --------- --------- Francis E. O'Donnell, Jr. M.D. ..... 8,009 0.96% $ 3.06 September 30, 2006 $ 6,808 $ 14,977 Donald L. Ferguson..... 137,300 16.48% $ 3.06 September 30, 2006 $ 116,705 $ 256,751 68,650 8.24% $11.80 September 30, 2006 $ -- $ -- 68,650 8.24% $17.48 September 30, 2006 $ -- $ -- Raphael J. Mannino, Ph.D. ..... 45,767 5.49% $ 3.06 September 30, 2006 $ 38,902 $ 85,584 22,883 2.75% $11.80 September 30, 2006 $ -- $ -- 22,883 2.75% $17.48 September 30, 2006 $ -- $ -- Christopher Chapman, M.D. ..... 45,767 5.49% $ 3.06 September 30, 2006 $ 38,902 $ 85,584 22,883 2.75% $11.80 September 30, 2006 $ -- $ -- 22,883 2.75% $17.48 September 30, 2006 $ -- $ -- Leila Zarif, Ph.D. ..... 45,767 5.49% $ 3.06 September 30, 2006 $ 38,902 $ 85,584 22,883 2.75% $11.80 September 30, 2006 $ -- $ -- 22,883 2.75% $17.48 September 30, 2006 $ -- $ -- Susan Gould-Fogerite, Ph.D. ..... 17,162 2.06% $ 3.06 September 30, 2006 $ 14,588 $ 32,093 8,581 1.03% $11.80 September 30, 2006 $ -- $ -- 8,581 1.03% $17.48 September 30, 2006 $ -- $ -- 55 AGGREGATED OPTION EXERCISES IN LAST FISCAL YEAR AND FISCAL YEAR-END OPTION VALUES No options were exercised during the fiscal year-end December 31, 2001. AGGREGATED OPTIONS/SAR EXERCISES IN LAST FISCAL YEAR AND FY-END OPTION/SAR VALUES NUMBER OF VALUE OF SECURITIES UNEXERCISED UNDERLYING UNEXERCISABLE UNEXERCISED IN-THE-MONEY OPTIONS/SARS AT OPTIONS/SARS AT SHARES FISCAL YEAR-END(#) FISCAL YEAR-END($) ACQUIRED ON VALUE EXERCISABLE/ EXERCISABLE/ NAME AND PRINCIPAL POSITION EXERCISE(#) REALIZED($) UNEXERCISABLE UNEXERCISABLE ---------- ---------- ---------- ---------- ---------- (a) (b) (c) (d) (e) Francis E. O'Donnell, Jr., M.D. ..... -- -- -- -- CEO, President and Chairman 709 The Hampton Lane Chesterfield, MO 63017 James McNulty, CFO..... -- -- -- -- Secretary and Treasurer 4419 W. Sevilla Street Tampa, Florida 33629 Donald L. Ferguson..... -- -- -- -- Senior Executive Vice President Land Dynamics, Inc. 11719 Old Ballas Road, Suite 110 St. Louis, MO 63141 Raphael J. Mannino, Ph.D. ..... -- -- -- -- Executive Vice President, Chief Scientific Officer UMDNJ New Jersey Medical School 185 South Orange Avenue Building 4 Newark, NJ 07103 Christopher Chapman..... -- -- -- -- Director of Medical and Regulatory Affairs and Director of New Business Management 800 Falls Lake Drive Mitchelsville, MD 20720 Leila Zarif, Ph.D. ..... -- -- -- -- Executive Vice President of Research and Development UMDNJ New Jersey Medical School 185 South Orange Avenue Building 4 Newark, NJ 07103 56 NUMBER OF VALUE OF SECURITIES UNEXERCISED UNDERLYING UNEXERCISABLE UNEXERCISED IN-THE-MONEY OPTIONS/SARS AT OPTIONS/SARS AT SHARES FISCAL YEAR-END(#) FISCAL YEAR-END($) ACQUIRED

ON VALUE EXERCISABLE/ EXERCISABLE/ NAME AND PRINCIPAL POSITION EXERCISE(#) REALIZED($) UNEXERCISABLE UNEXERCISABLE ---------- ---------- ---------- ---------- ---------- (a) (b) (c) (d) (e) Susan Gould-Fogerite, Ph.D. ..... -- -- -- -- Director of Business Development -- Vaccines and Gene Therapy UMDNJ New Jersey Medical School 185 South Orange Avenue Building 4 Newark, NJ 07103 EMPLOYMENT AGREEMENTS Except for Dr. Frank O'Donnell, Mr. James McNulty and Dr. Christopher Chapman, we currently have no written employment agreements or confidentiality and non-compete agreements with any of our officers, directors, or key employees. We may elect to pursue obtaining employment agreements with certain of these individuals at some point in the future. Under our employment at will arrangement, our officers received the following annualized salaries and other benefits in 2001: (i) Dr. O'Donnell, President, CEO and Chairman - On March 29, 2002, Dr. O'Donnell executed an employment agreement to be our full-time President and CEO at an annual salary of $150,000. Dr. O'Donnell's term of employment shall be no longer than three years or until another CEO candidate is appointed. (ii) James McNulty, CFO, Secretary and Treasurer - Although he is a part-time CFO, he has an employment agreement with us for a base salary of $48,000, which terminates on March 1, 2004. Under the terms of this agreement, he is also entitled to the following benefits: medical and dental. Notwithstanding his part-time status, he has been paid $67,461 in 2002 through June 7 because we have been using his services on a more regular basis. (iii) Donald Ferguson, Senior Executive Vice President - Receives no salary and no benefits. (iv) Dr. Raphael Mannino, Ph.D., Executive Vice President, and Chief Scientific Officer-Receives a salary of $90,000 and receives no benefits. (v) Dr. Leila Zarif, Executive Vice President of Research and Development - Receives a salary of $170,000. Under the terms of this agreement, she is also entitled to the following benefits: medical and dental. Dr. Zarif has notified us that she and her family have decided to move back to their native country of France and discontinue working with us. She has indicated to us that her departure is solely for personal reasons and not having any thing to do with this offering or any disagreement with us. (vi) Dr. Susan Gould-Fogerite, Director of Business Development - Receives a salary of $40,800 and is entitled to the following benefits: a 401k Plan. (vii) Chistopher Chapman, MD, Director of Medical and Regulatory Affairs and Director of New Business Management -- Receives $6,667 per month pursuant to a consulting contract and receives no other benefits from us. This consulting contract was entered into prior to Dr. Chapman becoming an officer, however, he continues to receive remuneration under the consulting agreement. Prior to the effective date, such consulting agreement will be reconstituted into an employment agreement on similar terms and conditions. 57 Drs. Raphael Maninno, Leila Zarif, and Susan Gould-Fogerite have outstanding debt payable to us which was incurred with their purchase of stock of BioDelivery Sciences, Inc. in 1999. Simultaneously with the closing of this offering, we are forgiving those notes and providing these same individuals with a total of approximately $200,000 as compensation for their tax liability. 2001 STOCK OPTION PLAN The purpose of the 2001 stock option plan is (i) to align our interests and recipients of options under the 2001 stock option plan by increasing the proprietary interest of such recipients in our growth and success, and (ii) to advance our interests by providing additional incentives to officers, key employees and well-qualified non-employee directors and consultants who provide services to us, who are responsible for our management and growth, or otherwise contribute to the conduct and direction of its business, operations and affairs. Our board of directors will administer the 2001 stock option plan, select the persons to whom options are granted and fix the terms of such options. Under our 2001 stock option plan, we reserved 572,082 shares. The plan was approved by our stockholders at our October 2001 annual meeting. Our board of directors subsequently voted to increase the plan to 1,100,000 shares which will be submitted to our stockholders for approval at the next annual meeting. Options to purchase 978,355 shares of common stock have been granted under the 2001 stock option plan a portion of which is subject to shareholder approval. Options may be awarded during the ten-year term of the 2001 stock option plan to our employees (including employees who are directors), consultants who are not employees and our other affiliates. Our 2001 stock option plan provides for the grant of options intended to have been approved by our Board and qualify as incentive stock options under Section 422A of the Internal Revenue Code of 1986, as amended, ("Incentive Stock Options"), and options which are not Incentive Stock Options ("Non-Statutory Stock Options"). Only our employees or employees of our subsidiaries may be granted Incentive Stock Options. Our affiliates or consultants or others as may be permitted by our board of directors, may be granted Non-Statutory Stock Options. Directors are eligible to participate in the 2001 stock option plan. The 2001 stock option plan provides for an initial grant of an option to purchase up to 20,000 shares of common stock to each director upon first joining our board of directors and subsequent grants of options to purchase 20,000 shares upon each anniversary of such director's appointment. Additionally, directors will be granted

10,000 options for each committee chairmanship and 5,000 options for each committee membership. Such options are granted at an exercise price equal to the fair market value of the common stock on the grant date and fully vest following one year of service after the date of grant. Options and warrants to purchase 978,355 shares of our common stock at prices ranging from $2.87 to $17.48 have been granted as of April 23, 2002. None of our options have been granted at less than 85% of the fair market value at the time of grant. Certain options granted under the 2001 options plan do not vest or are not exercisable until the earlier of: (i) 13 months following the completion this offering registered with the SEC; or (ii) 24 months from the date of grant. None of our outstanding options have terms in excess of five (5) years from the date of grant. CERTAIN TRANSACTIONS During 2001, we entered into agreements with RetinaPharma, Inc. and Tatton Technology LLC. Both are biotechnology companies which are developing neutraceutical neuroprotective therapies for treating neurodegenerative disease such as macular degeneration and Parkinson's disease. To the extent that such drugs utilize Bioral cochleate technology, we will support drug development and will share in ten percent (10%) of all net revenue from such sales of Bioral encapsulated drugs. The Hopkins Capital Group II, LLC, one of our significant stockholders and Dr. Francis E. O'Donnell, Jr., our CEO, President and a director are affiliated as stockholders and a director of RetinaPharma, Inc. Additionally, Hopkins Capital Capital, LLC, 58 which is affiliated with Hopkins Capital Group II, LLC and Dr. O'Donnell, is a significant stockholder of Tatton Technologies, LLC. Dr. O'Donnell is the managing director of Hopkins Capital Group, LLC and Hopkins Capital Group II, LLC. Dr. Francis O'Donnell and Donald Ferguson have personally guaranteed a line of credit up to $1,050,000 with a bank and other liabilities for our benefit at a rate of prime plus 2% of which $850,000 matured in May 2002 but is being deferred pending the completion of this offering and $200,000 will mature in June 2002. As of March 31, 2002, we used $598,000 for expenses related to this offering. We have also entered into an agreement with Biotech Specialty Partners, LLC, an emerging alliance of early stage biotechnology and specialty pharmaceutical companies. Biotech Specialty Partners, LLC is in its formative stage and to date has not distributed any pharmaceutical products. Under this agreement, Biotech Specialty Partners, LLC will serve as a nonexclusive distributor of our Bioral drugs in consideration of a ten (10%) discount to the wholesale price, which our board of directors have determined to be commercially reasonable. The Hopkins Capital Group II, LLC, which is affiliated with Dr. Francis E. O'Donnell, Jr., our CEO and director, are affiliated as stockholders, and a member of the management, of Biotech Specialty Partners, LLC. We have also entered into a letter agreement with BioKeys Pharmaceutical, Inc, a biotechnology company, which is developing several potential products which are vaccine based. To the extent that BioKeys Pharmaceutical, Inc. utilizes our Bioral drug delivery technology, we will earn a flat royalty which we will negotiate and be approved by our independent audit committee. Regent Court Technologies LLC, which is affiliated with one of our stockholders, and Dr. Francis E. O'Donnell, our CEO and director, and Donald L. Ferguson, our senior executive vice-president, are affiliated as stockholders and Dr. O'Donnell is a member of the board of directors of BioKeys Pharmaceutical, Inc. We have also received a $35,000 loan from BioKeys Pharmaceutical, Inc. to begin research on their products using our technology. The loan is in the form of a demand note with an interest rate of 1% plus prime. Mr. James McNulty, our current Secretary, Treasurer and part-time Chief Financial Officer, is also the Chief Financial Officer of The Hopkins Capital Group II, LLC, which is affiliated with Dr. Francis E. O'Donnell, our president and CEO. Samuel S. Duffey, Esq., through Friday Harbour, LLC, a Florida limited liability company owned with his spouse, owns 74,371 shares of our common stock. An aggregate of 51,487 additional shares are owned by trusts for the benefit of Mr. Duffey's adult children. Mr. Duffey is a partner in Duffey & Dolan, P.A. which provides legal services to us and Friday Harbour, LLC, which provides consulting services to us and Hopkins Capital Group, LLC. In 2001, we settled litigation commenced against BioDelivery Sciences, Inc. by Irving A. Berstein and certain of his family members and affiliates. Mr. Berstein was a stockholders, and former officer and director of BioDelivery Sciences, Inc. The settlement required that we pay $150,000 in cash and $125,000 by promissory note, which is being satisfied in full out of the proceeds of this offering. At the same time, we purchased the shares of BioDelivery Sciences, Inc. owned by these stockholders for $500,000 which was paid $200,000 in cash and $300,000 by promissory note which is being satisfied in full out of the proceeds of this offering. In December 2001, we exchanged 447,391 shares of our stock for 1,470,000 shares of BioDelivery Sciences, Inc. redeemable common stock. Drs. Raphael J. Mannino, Leila Zarif and Susan Gould-Fogerite, officers of the company, principally owned those BioDelivery Sciences Inc. shares. In connection with this exchange, we removed certain restrictions, put rights with respect to those shares and expect to forgive loans of approximately $320,000 that are secured by the BioDelivery Sciences Inc. shares upon the successful completion of the offering. In

connection with forgiveness of the notes, we will provide them with approximately $200,000 for compensation for their tax liability. Due to the variable nature of the underlying stock award, we recognized compensation expense totaling $2,140,000 in 2001. This compensation expense does not include any amount with respect to the expected forgiveness of loans. We also issued an additional 137,300 shares during 2001 to the University of Medicine and Dentistry of New Jersey to settle outstanding payments owed to them under our research agreement. 59 As a matter of corporate governance policy, we have not and will not make loans to officers or loan guarantees available to "promoters" as that term is commonly understood by the SEC and state securities authorities. We believe that the terms of the above transactions with affiliates were as favorable to us or our affiliates as those generally available from unaffiliated third parities. At the time of the above referenced transactions, we did not have sufficient disinterested directors to ratify or approve the transactions; however, the present board of directors includes four independent directors. These independent directors are William Stone, James Butler, John Shea, and Robert Shorr. All future transactions between us and our officers, directors or five percent stockholders, and respective affiliates will be on terms no less favorable than could be obtained from unaffiliated third parties and will be approved by a majority of our independent directors who do not have an interest in the transactions and who had access, at our expense, to our legal counsel or independent legal counsel. We intend to maintain at least two independent members on our Board of Directors. PPDI has expressed its intent in purchasing up to 690,000 Units in this offering, constituting approximately 34.5% of this offering (assuming an offering of 2,000,000 Units), at a price equal to the initial public offering price. The shares of common stock will be issued to PPDI with the voting and disposition rights vesting in its board of directors. The board may elect to delegate the voting and disposition rights to a member or members of PPDI's management. The current board of directors of PPDI consists of the following eight members: Stuart Bondurant, M.D., Fredric N. Eshelman, Frederick Frank, Catherine M. Klema, Terry Magnuson, Ernest Mario, John A. McNeill, Jr. and Paul J. Rizzo. There is one vacancy on PPDI's board resulting from a former director's decision not to stand for re-election. The vacancy will be filled as soon as practicable. We are also in the process of beginning stages of negotiation with PPDI as to the terms of one or more license agreements, pursuant to which we would be exploring the possibility of granting PPDI a non- exclusive license to our drug delivery technology. Although each side has expressed an interest in further negotiations to formalize the proposed licensing relationship, there is not currently a license agreement or any other document which reflects any definitive or binding arrangements. If PPDI purchases all of the Units for which it has expressed an interest, any negotiations with PPDI after the offering will be with a party that owns more than a 5% beneficial interest in our securities. 60 PRINCIPAL STOCKHOLDERS The following table presents information concerning the beneficial ownership of the shares of our common stock. - each person who is known by us to beneficially own more than 5% of our common stock; - each of our directors; - each of the named executive officers; and - all of our directors and executive officers of as a group. The number and percentage of shares beneficially owned are based on 5,000,863 shares of common stock outstanding. In computing the outstanding shares of common stock, we have excluded all shares of common stock subject to options or warrants since they are not currently exercisable or exercisable within 60 days of the effective date and are therefore not deemed to be outstanding and beneficially owned by the person holding the options or warrants for the purpose of computing the number of shares beneficially owned and the percentage ownership of that person. Except as indicated in the footnotes to this table, and subject to applicable community property laws, these persons have sole voting and investment power with respect to all shares of our common stock shown as beneficially owned by them. Percentage ownership figures after the offering do not include shares that may be purchased by each person in this offering. PERCENTAGE PERCENTAGE NO. OF SHARES OF CLASS OF CLASS OF COMMON PRIOR TO THIS AFTER THIS NAME OF BENEFICIAL OWNER POSITION STOCK OFFERING OFFERING ---------- -------- ---------- ---------- ---------- Hopkins Capital Group II, LLC(1) 4419 W. Sevilla Street Tampa, FL 33629 Stockholder 3,111,579 62.22% 44.45% Francis E. O'Donnell, Jr., M.D.(2) CEO, President and Chairman 709 The Hampton Lane Chesterfield, MO 63017 Chief Executive Officer, Chairman and Director 3,161,922 63.23% 45.16% University of Medicine and Dentistry of New Jersey(3) 65 Bergen Street MB 1414 University Heights Newark, NJ 07103 Stockholder 139,522 2.79% 1.99% Albany Medical College(3) Director of Research Admin 47 New Scotland Avenue Albany, NY 12202 Stockholder 2,222 0.04% 0.03% John R. Williams, Sr.(4) 1 Starwood Lane Manakin-Sabot, VA 23103 Stockholder 3,203,112 64.05% 45.75% Dennis Ryll, M.D.(5) 1029 Speckledwood Manor Court Chesterfield, MO 63017 Stockholder 3,157,346 63.14% 45.10% James A. McNulty 4419 W. Sevilla Street Tampa, FL 33629 Chief Financial Officer Treasurer and Secretary 76,659 1.53% 1.09% 61 PERCENTAGE PERCENTAGE NO. OF

SHARES OF CLASS OF CLASS OF COMMON PRIOR TO THIS AFTER THIS NAME OF BENEFICIAL OWNER POSITION STOCK OFFERING OFFERING ---------- -------- ---------- ---------- ---------- Donald L. Ferguson(6) 11719 Old Ballas Road, Suite 110 St. Louis, MO 63141 Sr. Executive Vice President 91,533 1.83% 1.31% Raphael J. Mannino, Ph.D.(7) 185 South Orange Avenue Building 4 Newark, NJ 07103 Executive Vice President, Chief Scientific Officer and Director 182,609 3.65% 2.61% Susan Gould-Fogerite, Ph.D.(8) 185 South Orange Avenue Building 4 Newark, NJ 07103 Director of Business Development -- Vaccines and Gene Therapy 152,174 3.04% 2.17% Leila Zarif, Ph.D.(9) 185 South Orange Avenue Building 4 Newark, NJ 07103 Executive Vice President of Research and Development 152,174 3.04% 2.17% Pharmaceutical Product Development, Inc.(10) 3151 South Seventeenth Street Wilmington, NC 28412 Stockholder 690,000 -- 9.86% L.M. Stephenson, Ph.D.(11) University of Medicine and Dentistry of New Jersey 65 Bergen Street MB 1414 University Heights Newark, NJ 07103 Director -- -- -- William Stone(12) 11120 Geyers Down Lane Frontenac, MO 63131 Director -- -- -- James R. Butler(13) 109 Cutler Court Ponte Bedra Beach, FL 32082 Director -- -- -- John J. Shea(13) 90 Poteskeet Trail Kitty Hawk, NC 27949 Director -- -- -- Robert G. L. Shorr(13) 28 Brookfall Road Edison, NJ 08817 Director -- -- -- All directors and officers as a group (2)(6)(7)(8)(9)(11)(12)(13) 3,817,071 76.33% 54.52% ---------- (1) Hopkins Capital Group II, LLC is owned one third by each of: (i) various trusts of the Francis E. O'Donnell family; (ii) John R. Williams, Sr. and his family trusts; and (iii) MOAB LLC, which is beneficially owned by Dennis Ryll and members of his family. 62 (2) Includes the shares owned by Hopkins Capital Group II, LLC (see Note 1) and 45,767 shares of common stock, owned by his wife, as to which he disclaims beneficial interest of. Does not include options to purchase 8,009 shares of common stock at an exercise price of $3.06 per share and 26,991 shares of common stock at an exercise price of $5.50 per share exercisable 13 months from the date of this prospectus. The remaining 4,576 shares of common stock are personally owned by Dr. O'Donnell. (3) Excludes warrants owned by both of the universities with each owning warrants to purchase 9,951 additional shares of common stock at an exercise price of $3.05 per share vesting 13 months from the date of this prospectus. These warrants were granted in October 2001. (4) Includes the shares owned by Hopkins Capital Group II, LLC (see Note 1) and 45,767 shares of common stock, converted from preferred stock prior to this offering, owned by his wife, as to which he disclaims beneficial interest of. The remaining 45,766 shares of common stock are personally owned by Mr. Williams. (5) Includes the shares owned by Hopkins Capital Group II, LLC. The remaining 45,767 shares of common stock are personally owned by Mr. Ryll. (6) Does not include options to purchase 137,300 shares of common stock at an exercise price of $3.06 per share vesting the earlier of 13 months from the date of this prospectus or October 2003; options to purchase 68,650 shares of common stock at an exercise price of $11.80 per share vesting the earlier of 13 months from the date of this prospectus or October 2003; and options to purchase 68,650 shares of common stock at an exercise price of $17.48 per share vesting the earlier of 13 months from the date of this prospectus or October 2003. (7) Does not include options to purchase 45,767 shares of common stock at an exercise price of $3.06 per share vesting the earlier of 13 months from the date of this prospectus or October 2003; options to purchase 22,883 shares of common stock at an exercise price of $11.80 per share vesting the earlier of 13 months from the date of this prospectus or October 2003; and options to purchase 22,883 shares of common stock at an exercise price of $17.48 per share vesting the earlier of 13 months from the date of this prospectus or October 2003. (8) Does not include options to purchase 17,162 shares of common stock at an exercise price of $3.06 per share vesting the earlier of 13 months from the date of this prospectus or October 2003; options to purchase 8,581 shares of common stock at an exercise price of $11.80 per share vesting the earlier of 13 months from the date of this prospectus or October 2003; and options to purchase 8,581 shares of common stock at an exercise price of $17.48 per share vesting the earlier of 13 months from the date of this prospectus or October 2003. (9) Does not include options to purchase 45,767 shares of common stock at an exercise price of $3.06 per share vesting the earlier of 13 months from the date of this prospectus or October 2003; options to purchase 22,883 shares of common stock at an exercise price of $11.80 per share vesting the earlier of 13 months from the date of this prospectus or October 2003; and options to purchase 22,883 shares of common stock at an exercise price of $17.48 per share vesting the earlier of 13 months from the date of this prospectus or October 2003. Dr. Zarif has notified us that she and her family have decided to move back to their native country of France and discontinue working with us. She has indicated to us that her departure is solely for personal reasons and not having any thing to do with this offering or any disagreement with us. (10) Includes PPDI's intended purchase of up to 690,000 Units as part of this offering. (11) Does not include options to purchase 6,865 shares of common stock at an exercise price of $3.06 per share and 23,135 shares of common stock at an exercise price of $5.50 per share exercisable 13 months

from the date of this prospectus. (12) Does not includes options to purchase 8,009 shares of common stock at an exercise price of $3.06 per share and 26,991 shares of common stock at an exercise price of $5.50 per share exercisable 13 months from the date of this prospectus. (13) Does not include options to purchase 25,000 shares of common stock at an exercise price of $5.50 per share exercisable 13 months from the date of this prospectus. 63 DESCRIPTION OF CAPITAL STOCK Our authorized capital stock consists of 45,000,000 shares of common stock and 5,000,000 shares of preferred stock. Upon the completion of this offering, our outstanding capital stock will consist of 7,000,863 shares of common stock, $.001 par value, and no shares of preferred stock, $.001 par value. There will also be 2,000,000 outstanding Class A warrants to purchase 2,000,000 shares of common stock in the aggregate. These figures do not include securities to be issued as part of the exercise of the overallotment option, the Representative's unit purchase option or the 2001 Incentive Stock Option Plan. UNITS Each Unit consists of: (i) one share of our common stock, par value $.001 per share; and (ii) one redeemable Class A common stock purchase warrant. The common stock and warrants will not trade as separate securities until 30 days after this offering unless the Representative of the underwriters determines that separate trading should occur earlier. After the 30 day period, the securities contained in the Units will automatically begin to trade separately and the Units will no longer trade as a security. COMMON STOCK There are 5,000,863 shares of common stock outstanding, held of record by approximately 227 stockholders. The holders of common stock are entitled to one vote for each share held of record on all matters submitted to a vote of the stockholders. Subject to preferential rights with respect to any outstanding preferred stock, holders of common stock are entitled to receive ratably such dividends as may be declared by the board of directors out of funds legally available therefor. See "Dividend Policy." In the event of our liquidation, dissolution or winding up, the holders of common stock are entitled to share ratably in all assets remaining after payment of liabilities and satisfaction of preferential rights of any outstanding preferred stock. Our common stock has no preemptive or conversion rights or other subscription rights. There are no sinking fund provisions applicable to the common stock. The outstanding shares of common stock are, and the shares of common stock to be issued upon completion of this offering will be, fully paid and non-assessable. CLASS A WARRANTS Each Class A warrant entitles the holder to purchase one share of our common stock at a price of $6.30 (120% of the initial offering price of the Units). The exercise price of the Class A warrants is subject to adjustment, including anti-dilution provisions for corporate events, such as stock splits and for issuance of securities at less than the current exercise price. You may exercise your warrants at any time during the four years commencing one year after the date of this prospectus unless we have redeemed them. The Class A warrants are exercisable from June 24 2003 until June 24 2007. We may redeem the outstanding Class A warrants for $.10 per warrant upon no less than 30 days written notice to the warrant holder; provided: (i) that there is then an effective registration statement under the Securities Act allowing the issuance of the shares issuable upon exercise of the Class A warrants; (ii) the average closing sale price of the common stock equals or exceeds 150% of the offering price of the Units for the 10 trading days prior to the date of the notice of redemption; and (iii) that 12 months has elapsed since the date of this prospectus. The Class A warrants will be issued pursuant to a warrant agreement among us, Kashner Davidson Securities Corporation and American Stock Transfer and Trust Company, as warrant agent. The shares of common stock underlying the Class A warrants, when issued upon exercise of the Class A warrants, will be fully paid and non-assessable. PREFERRED STOCK We have authorized 5,000,000 shares of preferred stock, none of which have been designated or are outstanding. Prior to this offering, all outstanding shares of preferred stock were rescinded and shares of common stock issued in replacement thereof. The issuance of preferred stock with voting and conversion rights may adversely affect the voting power of the holders of common stock, including voting rights, of the 64 holders of common stock. In certain circumstances, such issuance could have the effect of decreasing the market price of the common stock. Notwithstanding the broad discretion granted to the Board of Directors with respect to designating the terms and conditions of any series of preferred stock, our Board of Directors has agreed to refrain from issuing shares of preferred stock, unless such designation and issuance are approved by a majority of our independent directors who do not have an interest in the transactions and who have access to and consulted with (at our expense) our counsel or counsel of their choosing. OPTIONS We have outstanding options and warrants to purchase 978,355 shares of our common stock at exercise prices ranging from $2.87 to $17.48. Up to 121,645 additional shares of common stock may be subject to options granted in the future under the 2001 stock option plan. See "2001 incentive stock option plan." In order for the holders of the rights to resell the common stock issuable upon exercise of the rights, there must be a current prospectus available under the Securities Act of 1933 and applicable state securities laws. REGISTRATION RIGHTS Except for the registration

rights granted to the underwriters pursuant to the underwriting agreement, there are no registration rights granted to investors. See "Underwriting." ANTI-TAKEOVER LAW We are subject to Section 203 of the Delaware General Corporation Law, which restricts certain transactions and business combinations between a corporation and an "interested stockholder" (as defined in Section 203) owning 15% or more of the corporation's outstanding voting stock, for a period of three years from the date the stockholder becomes an interested stockholder. Subject to certain exceptions, unless the transaction is approved by the board of directors and the holders of at least two-thirds of our outstanding voting stock (excluding shares held by the interested stockholder), Section 203 prohibits significant business transactions such as a merger with, disposition of assets to, or receipt of disproportionate financial benefits by the interested stockholder, or any other transaction that would increase the interest stockholder's proportionate ownership of any class or series of the corporation's stock. The statutory ban does not apply if, upon consummation of the transaction in which any person becomes an interested stockholder, the interested stockholder owns at least 85% of the outstanding voting stock of the corporation (excluding shares held by persons who are both directors and officers or by certain employee stock plans). TRANSFER AGENT AND REGISTRAR American Stock Transfer & Trust Company will be our transfer agent and registrar for our common stock and warrant agent for the Class A warrants. LISTING The Nasdaq SmallCap Market has accepted for quotation the Units, Class A warrants and common stock under the symbols "BDSIU", "BDSI", and "BDSIW", respectively. Also, the Boston Stock Exchange has accepted for quotation the Units, common stock and Class A warrants under the same symbols. 65 SHARES ELIGIBLE FOR FUTURE SALE Prior to this offering, there has been no public market for our common stock. Future sales of substantial amounts of common stock in the public market, or the perception that such sales may occur, could adversely affect prevailing market prices. Upon consummation of the offering, we will have an aggregate of 7,000,863 shares of common stock outstanding, assuming that the underwriters do not exercise their over-allotment option and none of the outstanding options and warrants are exercised. Of the 7,000,863 shares outstanding after the offering, only the 2,000,000 shares sold in this offering (excluding an additional 300,000 shares included in the underwriter's overallotment option and shares underlying the Class A warrants) will be freely tradable without restriction under the Securities Act, except for any shares that may be sold or purchased by our "affiliates." Shares purchased by our affiliates will be subject to the volume and other limitations of Rule 144 of the Securities Act, or "Rule 144" described below. As defined in Rule 144, an "affiliate" of an issuer is a person who, directly or indirectly, through one or more intermediaries, controls, is controlled by or is under common control with the issuer. Of the outstanding shares, 3,934,237 shares are subject to the volume and other limitations of Rule 144 and 319,765 shares are subject to only the limitations of Rule 144(k). The remaining 746,861 shares will become eligible for sale at various times. The Representative required as a condition to closing of the offering that all officers, directors, and certain stockholders agree to contractual restrictions for a period of twelve months (three years in the case of Dr. Francis O'Donnell and The Hopkins Group II, LLC.) from the effective date of this prospectus, as follows: - such parties may not offer, pledge, sell, contract to sell, sell any option or contract to purchase, purchase any option or contract to sell, grant any option, right or warrant to purchase, lend, or otherwise transfer or dispose of, directly or indirectly, any shares of common stock or any securities convertible into or exercisable or exchangeable for common stock; or - such parties may not enter into any swap or other arrangement that transfers to another, in whole or in part, any of the economic consequences of ownership of the common stock, whether any such transaction described above is to be settled by delivery of common stock or other securities, in cash or otherwise. These persons and entities own an aggregate of 4,955,442 shares of common stock, and 778,525 warrants and/or options. Upon the expiration of the applicable "lock-up" period, all these shares will be available for sale subject to Rule 144. Kashner Davidson Securities Corporation may choose to release some or all of these shares from such restrictions prior to the expiration of the applicable "lock-up" period, although it has no current intention of doing so. RULE 144 Under Rule 144 as currently in effect, a person who has beneficially owned restricted shares of common stock for at least one year, including the holding period of any prior owner who is not an affiliate, would be entitled to sell a number of the shares within any three-month period equal to the greater of 1% of the then outstanding shares of the common stock or the average weekly reported volume of trading of the common stock on the Nasdaq Small Cap Market during the four calendar weeks preceding such sale. Immediately after the offering, 1% of our outstanding shares of common stock would equal approximately 70,001 shares. Under Rule 144, restricted shares are subject to manner of sale and notice requirements and requirements as to the availability of current public information concerning us. Under Rule 144(k), a person who is not deemed to have been an affiliate at any time during the 90 days preceding a sale, and who has

beneficially owned the shares proposed to be sold for at least two years, including the holding period of any prior owner who is not an affiliate, is entitled to sell such shares without regard to the volume or other limitations of Rule 144 just described. 66 RULE 701 Immediately after this offering, excluding the underwriter's over-allotment, there will be options outstanding to purchase approximately 978,335 shares of common stock. Subject to the provisions of the lock-up agreements described above, holders of these options may rely on the resale provisions of Rule 701 under the Securities Act. Rule 701 permits non-affiliates to sell their shares without having to comply with the volume, holding period or other limitations of Rule 144 and permits affiliates to sell their shares without having to comply with the holding period limitation of Rule 144, in each case beginning 90 days after the consummation of this offering. 67 UNDERWRITING Under the terms and subject to the conditions contained in an underwriting agreement dated the date hereof, the underwriters named below through their representative Kashner Davidson Securities Corporation have severally agreed to purchase, and we have agreed to sell to them, severally and not jointly, the respective number of Units set forth opposite their names at the public offering price less the underwriting discounts and commission set forth on the cover page of this prospectus below: NUMBER OF UNDERWRITERS UNITS ---------- ------ Kashner Davidson Securities Corporation..... 700,000 Roan/Meyers Associates, L.P. ..... 475,000 Investors Capital Corp. ..... 370,000 Sterling Financial Investment Group, Inc. ..... 370,000 Schneider Securities, Inc..... 85,000 --------- Total..... 2,000,000 The underwriters are collectively referred to as the "underwriters." The underwriting agreement provides that the obligations of the several underwriters to pay for and accept delivery of the Units offered hereby are subject to the approval of certain legal matters by their counsel and to certain other conditions. The underwriters are obligated to take and pay for all of the Units offered by this prospectus if any Units are taken except for those covered by the overallotment option. These conditions include requirements that no stop order be in effect and that no proceedings for such purpose be instituted or threatened by the Securities and Exchange Commission. The Representative has informed us that the underwriters propose to offer the Units directly to the public at the public offering price set forth on the cover page hereof and part to certain dealers at a price that represents a concession not in excess of $.225 a Unit under the public offering price. After the initial offering of the Units, the offering price and other selling terms may from time to time be changed by the representative. We have granted to the Representative an option, exercisable for 45 days from the date of this prospectus, to purchase up to an aggregate of 300,000 additional Units at the public offering price set forth on the cover page hereof, less underwriting discounts and commissions. The underwriters may exercise such option solely for the purpose of covering over-allotments, if any, made in connection with the offering of the Units offered hereby. To the extent such option is exercised, each underwriter will become obligated, subject to certain conditions, to purchase approximately the same percentage of such additional Units as the number set forth next to such underwriter's name in the preceding table bears to the total number of Units set forth next to the names of all underwriters in the preceding table. We have also agreed to issue to the Representative a Unit Option Agreement granting the Representative the right to purchase up to 200,000 Units at an exercise price equal to 165% of the initial offering price of the Units. The exercise price and the number of underlying securities in the warrants contained in the Representative's Units are subject to adjustment upon the same terms as contained the Class A warrants being sold in the Units. The securities to be delivered upon exercise of the Representative's Unit Option are the same as the Units being sold to the public in this offering, and include the same provisions for redemption of the Class A warrants as being sold to the public. These Unit warrants are exercisable during the four year period beginning one year from the date of effectiveness of the registration statement of which this prospectus forms a part. The Representative's Unit Purchase Option will be restricted from sale, transfer, assignment or hypothecation for a period of one year from the effective date of the offering except to officers or partners (not directors) of the underwriter and members of the selling group and/or their officers or partners in compliance with NASD Rule 2710(c)(7)(A). The representative's unit purchase option is not redeemable by us. In addition, we have agreed to certain "demand and piggyback" registration rights for the securities underlying the representative's unit purchase option. The holder of the representative's unit purchase option can demand, on one occasion, at anytime until 68 five years from the effective date of the registration statement, that we register the shares and warrants for resale under the Securities Act of 1933. The "piggyback" registration provision provides that we will include the underlying shares and Class A warrants in any registration statement filed by us during the five-year period commencing after the effective date. The holders of the representative's unit purchase option will have, in that capacity, no voting, dividend or other stockholder rights. Any profit realized by the representative on the sale of the securities issuable upon exercise of the representative's unit

purchase option may be deemed to be additional underwriting compensation. The securities underlying the representative's unit purchase option are being registered in the registration statement. During the term of the representative's unit purchase option, the holders thereof are given the opportunity to profit from a rise in the market price of our common stock. We may find it more difficult to raise additional equity capital while the representative's unit purchase option are outstanding. At any time at which the representative's unit purchase option are likely to be exercised, we may be able to obtain additional equity capital on more favorable terms. We have also paid to an underwriter $90,000 on account of the underwriters' expenses in connection with this offering to be applied to the non-accountable expense allowance equal to 3% of the gross proceeds of the offering (including proceeds from the sale, if any, of the over allotment option securities). In addition, an associated person of the Underwriters has received compensation of $26,076 which will be included, pursuant to applicable NASD rules, as underwriter compensation. This compensation was paid in connection with a consulting agreement between us and the affiliated person. The agreement has been terminated in full. The representative has informed us that sales to discretionary accounts by the underwriters will not exceed 5% of the securities offered in the offering. We have agreed, in connection with the exercise of the Class A warrants, to pay to the representative a fee of 5% of the exercise price for each Class A warrants exercised; provided, however, that the representative will not be entitled to receive such compensation in warrant exercise transactions in which (i) the market price of common stock at the time of exercise is lower than the exercise price of the warrants; (ii) the warrants are held in any discretionary account; (iii) disclosure of compensation arrangements is not made, in addition to the disclosure provided in this Prospectus, in documents provided to holders of warrants at the time of exercise; (iv) the holder of the warrants has not confirmed in writing that the representative solicited such exercise; or (v) the solicitation of exercise of the warrants was in violation of Regulation M promulgated under the Securities Act. The Representative will not solicit the exercise of warrants prior to 12 months from the date of this prospectus and NASD members will not be compensated for solicitations sooner than such date. In addition, unless granted an exemption by the Commission from Regulation M under the Exchange Act, the representative will be prohibited from engaging in any market making activities or solicited brokerage activities until the later of the termination of such solicitations activity or the termination by waiver or otherwise of any right the representative may have to receive a fee for the exercise of the warrants following such solicitation. Such a prohibition, while in effect, could impair the liquidity and market price of the securities offered pursuant to the offering. The Representative required as a condition to closing of the offering that all officers, directors, and certain significant stockholders agree to contractual restrictions for a period of twelve months (three years in the case of Dr. Francis O'Donnell and The Hopkins Group II, LLC) from the effective date of this prospectus, as follows: - such parties may not offer, pledge, sell, contract to sell, sell any option or contract to purchase, purchase any option or contract to sell, grant any option, right or warrant to purchase, lend or otherwise transfer or dispose of, directly or indirectly, any Unit or any securities convertible into or exercisable or exchangeable for common stock, or - such parties may not enter into any swap or other arrangement that transfers to another, in whole or in part, any of the economic consequences of ownership of the common stock, whether any such transaction described above is to be settled by delivery of common stock or such other securities, in cash or otherwise. 69 The restrictions described above do not apply to: - the sale of Units to the underwriters; - the issuance by us of shares of common stock upon the exercise of an option or a warrant or the conversion of a security outstanding on the date of this prospectus of which the underwriters have been advised in writing, provided that purchasers enter into similar "lock-up" agreements; or - transactions by any person other than us relating to the Units or other securities acquired in open market transactions after the completion of the offering of the shares. PPDI, has expressed its interest in purchasing up to 690,000 Units as part of this offering. In the event that PPDI fails to consummate the purchase of 690,000 Units, then the Representative has the right to terminate the offering. The underwriters will receive the stated commission and expense allowance on the sale of these Units. Following this offering, and assuming PPDI purchases these Units, PPDI will beneficially own up to a 9.9% of our outstanding common stock (9.5% if the Underwriter's Over Allotment Option is exercised). PPDI will agree not to sell any Units, common stock or Class A warrants for a period of at least 180 days, following the date of the final Prospectus without the Representative's approval. REGULATION M In order to facilitate the offering of the Units, the underwriters may engage in transactions that stabilize, maintain or otherwise affect the price of the Units. Specifically, the underwriters may sell more shares than they are obligated to purchase under the underwriting agreement, creating a short position. A short sale is covered if the short position is no greater than the number of Units available for purchase by the underwriters under the over-allotment option. The underwriters

can close out a covered short sale by exercising the over-allotment option or purchasing Units in the open market. In determining the source of shares to close out a covered short sale, the underwriters will consider, among other things, the open market price of the Units compared to the price available under the over-allotment option. The underwriters may also sell the Units in excess of the over-allotment option, creating a naked short position. The underwriters must close out any naked short position by purchasing shares in the open market. A naked short position is more likely to be created if the underwriters are concerned that there may be downward pressure on the price of the Unit in the open market after pricing that could adversely affect investors who purchase in the offering. As an additional means of facilitating the offering, the underwriters may bid for, and purchase, the Units in the open market to stabilize the price of the Unit. The underwriting syndicate may also reclaim selling concessions allowed to an underwriter or a dealer for distributing the Units in the offering, if the syndicate repurchases previously distributed Units to cover syndicate short positions or to stabilize the price of the Unit. These activities may raise or maintain the market price of the common stock above independent market levels or prevent or retard a decline in the market price of the common stock. The underwriters are not required to engage in these activities, and may end any of these activities at any time. We and the underwriters have agreed to indemnify each other against certain liabilities, including liabilities under the Securities Act. DETERMINATION OF OFFERING PRICE Before this offering, there has been no public market for the units and the common stock and Class A warrants contained in the units. Accordingly, the initial public offering price of the units offered by this prospectus and the exercise price of the Class A warrants were determined by negotiation between us and the representative. Among the factors considered in determining the initial public offering price of the units and the exercise price of the warrants were: - our history and our prospects; - the industry in which we operate; - the status and development prospects for our proposed products and services; - our past and present operating results; - the previous experience of our executive officers; and 70 - the general condition of the securities markets at the time of this offering. The offering price stated on the cover page of this prospectus should not be considered an indication of the actual value of the units. That price is subject to change as a result of market conditions and other factors, and we cannot assure you that the units, or the common stock and warrants contained in the units, can be resold at or above the initial public offering price. LEGAL MATTERS The validity of the common stock offered hereby will be passed upon for us by Ellenoff Grossman Schole & Cyruli, LLP, New York, New York. Goldstein & DiGioia LLP is acting as counsel for Kashner Davidson Securities Corporation as Representative, and the underwriters. EXPERTS The financial statements for our company as of December 31, 2000 and 2001 and for the years ended December 31, 2000 and 2001 and the financial statements of BioDelivery Sciences, Inc. for the nine months ended September 30, 2000, included in this Prospectus and in the registration statement, have been audited by Grant Thornton LLP, independent certified public accountants, as stated in their reports included herein and in the registration statement, and are included herein in reliance upon the reports given upon the authority of that firm as experts in auditing and accounting. WHERE YOU CAN FIND MORE INFORMATION We have filed with the Securities and Exchange Commission a registration statement on Form SB-2 under the Securities Act, and the rules and regulations promulgated thereunder, with respect to the common stock offered hereby. This prospectus, which constitutes a part of the registration statement, does not contain all of the information set forth in the registration statement and the exhibits thereto. Statements contained in this prospectus as to the contents of any contract or other document that is filed as an exhibit to the registration statement are not necessarily complete and each such statement is qualified in all respects by reference to the full text of such contract or document. For further information with respect to us and the common stock, reference is hereby made to the registration statement and the exhibits thereto, which may be inspected and copied at the principal office of the Commission, 450 Fifth Street, N.W., Washington, D.C. 20549, and at the regional offices of the Commission located at Seven World Trade Center, Suite 1300, New York, New York 10048 and Citicorp Center, 500 West Madison Street, Suite 1400, Chicago, Illinois 60661, and copies of all or any part thereof may be obtained at prescribed rates from the Commission's Public Reference Section at such addresses. Also, the Commission maintains a World Wide Web site on the Internet at http://www.sec.gov that contains reports, proxy and information statements and other information regarding registrants that file electronically with the Commission. Prior to filing this registration statement on Form SB-2, we have voluntarily complied with the information and periodic reporting requirements of the Exchange Act and, in accordance therewith, will file periodic reports, proxy and information statements and other information with the Commission. Such periodic reports, proxy and information statements and other information will be available for inspection and copying at the regional offices, public reference facilities and Web site of the Commission referred to above. 71 INDEX TO FINANCIAL STATEMENTS PAGE ----

 F-1 REPORT OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS Board of Directors BioDelivery Sciences International, Inc. We have audited the accompanying consolidated balance sheets of BioDelivery Sciences International, Inc. (a development stage company) and subsidiary as of December 31, 2001 and 2000, and the related consolidated statements of operations, stockholders' equity, and cash flows for each of 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 BioDelivery Sciences International, Inc. and subsidiary as of December 31, 2001 and 2000, and the consolidated results of their operations and cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America. We also audited the combination of the accompanying consolidated statements of operations and cash flows for the period January 6, 1997 (date of incorporation) to December 31, 2001, which includes the statements of operations and cash flows for the period January 6, 1997 (date of incorporation) to December 31, 1999 that were audited and reported on separately by another auditor; in our opinion, such consolidated statements have been properly combined. /s/ GRANT THORNTON LLP Tampa, Florida March 1, 2002 F-2 BIODELIVERY SCIENCES INTERNATIONAL, INC. (A DEVELOPMENT STAGE COMPANY) CONSOLIDATED BALANCE SHEETS DECEMBER 31, MARCH 31, ---------- ---------- 2000 2001 2002 ---------- ---------- ---------- (UNAUDITED) ASSETS CURRENT ASSETS: Cash and cash equivalents..... $ 950,939 $ 75,513 $ -- Prepaid expenses and other assets..... 54,481 111,684 247,553 ---------- ---------- ---------- Total current assets..... 1,005,420 187,197 247,553 EQUIPMENT, net..... 253,390 233,562 193,905 OTHER ASSETS, net..... 30,124 912,810 1,144,791 ---------- ---------- ---------- TOTAL ASSETS..... $1,288,934 $ 1,333,569 $ 1,586,249 ========== ========== ========== LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIT) CURRENT LIABILITIES: Accounts payable and accrued liabilities..... $ 394,020 $ 814,279 $ 1,085,738 Due to related parties..... 515,584 74,331 106,608 Line of credit..... -- 282,527 618,732 Deferred revenue..... -- 37,000 -- Current portion of capital lease payable..... 11,307 14,804 14,804 Current portion of notes payable..... -- 149,524 119,141 ---------- ---------- ---------- Total current liabilities..... 920,911 1,372,465 1,945,023 CAPITAL LEASE PAYABLE, LESS CURRENT PORTION..... 28,372 18,369 18,369 NOTES PAYABLE, less current portion..... -- 151,733 127,069 COMMITMENTS AND CONTINGENCIES..... -- -- -- REDEEMABLE COMMON STOCK, net of notes receivable of approximately $321,000..... 2,346 -- -- STOCKHOLDERS' EQUITY (DEFICIT): Preferred stock, $.001 par value, 20,000,000 shares authorized, 462,243 and 0 shares issued and outstanding in 2000 and 2001, respectively..... 462 -- -- Common stock, $.001 par value, 80,000,000 shares authorized, 3,512,586 and 5,000,863 shares issued and outstanding including issuable shares in

2000 and 2001, respectively..... 3,513 5,001 5,001 Additional paid-in capital..... 1,006,136 4,903,368 4,903,368 Deficit accumulated during development stage..... (672,806) (5,117,367) (5,412,581) ---------- ---------- ---------- Total stockholders' equity (deficit)..... 337,305 (208,998) (504,212) ---------- ---------- ---------- TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIT)..... $1,288,934 $ 1,333,569 $ 1,586,249 ========== ========== ========== The accompanying notes are an integral part of these financial statements. F-3 BIODELIVERY SCIENCES INTERNATIONAL, INC. (A DEVELOPMENT STAGE COMPANY) CONSOLIDATED STATEMENTS OF OPERATIONS PERIOD FROM JANUARY 6, 1997 (DATE OF THREE MONTHS ENDED MARCH YEAR ENDED YEAR ENDED INCORPORATION) 31, DECEMBER 31, DECEMBER 31, TO DECEMBER 31, ---------- 2000 2001 2001 2001 2002 ---------- ---------- ---------- ---------- ---------- (UNAUDITED) (UNAUDITED) Sponsored research revenues..... $ 56,000 $ 478,385 $ 534,385 $ -- $ 275,000 Expenses: Research and development... 312,736 1,663,932 1,976,668 331,483 450,475 General and administrative: General and administrative..... 265,239 679,883 945,197 74,394 205,768 Stock compensation..... -- 2,192,084 2,192,084 -- -- Legal settlement..... 275,000 383,625 658,625 -- -- ---------- ---------- ---------- ---------- ---------- Total expenses..... 852,975 4,919,524 5,772,574 405,877 656,243 Interest income (expense), net..... 21,772 (21,957) (185) 13,406 (9,814) ---------- ---------- ---------- ---------- ---------- Loss before income taxes and minority interest..... (775,203) (4,463,096) (5,238,374) (392,471) (391,057) Income tax benefit..... -- 18,535 18,535 -- 95,843 ---------- ---------- ---------- ---------- ---------- Loss before minority interest..... (775,203) (4,444,561) (5,219,839) (392,471) (295,214) Minority interest in net loss of subsidiary..... 102,472 -- 102,472 -- -- ---------- ---------- ---------- ---------- ---------- Net loss..... $ (672,731) $(4,444,561) $(5,117,367) $ (392,471) $ (295,214) ========== ========== ========== ========== ========== ========== Net loss per common share: Basic and diluted..... $ (0.19) $ (1.15) $ (.11) $ (.06) ========== ========== ========== ========== Weighted average common stock shares outstanding (including issuable shares) -- basic and diluted..... 3,512,586 3,851,587 3,518,179 5,000,863 ========== ========== ========== ========== The accompanying notes are an integral part of these financial statements. F-4 BIODELIVERY SCIENCES INTERNATIONAL, INC. (A DEVELOPMENT STAGE COMPANY) CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY (DEFICIT) DEFICIT ACCUMULATED TOTAL PREFERRED STOCK COMMON STOCK ADDITIONAL DURING STOCKHOLDERS' ---------- ---------- ---------- PAID-IN DEVELOPMENT EQUITY SHARES AMOUNT SHARES AMOUNT CAPITAL STAGE (DEFICIT) -------- ------ --------- ------ ---------- ---------- ---------- BALANCE, JANUARY 6, 1997 (date of incorporation) Shares issued to founders..... -- $ -- 80,091 $ 80 $ 31 $ -- $ 111 Shares issued for services..... -- -- 1 -- -- -- -- Net loss..... -- -- -- -- -- (75) (75) -------- ----- --------- ------ ---------- ---------- ---------- BALANCE, DECEMBER 31, 1999..... -- -- 80,092 80 31 (75) 36 Shares issued to founders..... -- -- 3,432,494 3,433 (3,433) -- -- Preferred stock issued for cash..... 462,243 462 -- -- 1,009,538 -- 1,010,000 Net loss..... -- -- -- -- -- (672,731) (672,731) -------- ----- --------- ------ ---------- ---------- ---------- BALANCE, DECEMBER 31, 2000..... 462,243 462 3,512,586 3,513 1,006,136 (672,806) 337,305 Shares issued for cash..... -- -- 368,421 369 804,631 -- 805,000 Shares issued for satisfaction of debt..... -- -- 137,300 137 499,447 -- 499,584 Shares issued in replacement of preferred stock..... (462,243) (462) 462,243 462 -- -- -- Shares issuable in merger with subsidiary..... -- -- 520,313 520 2,540,148 -- 2,540,668 Issuance of stock options..... -- -- -- -- 53,006 -- 53,006 Net loss..... -- -- -- -- -- (4,444,561) (4,444,561) -------- ----- --------- ------ ---------- ---------- ---------- BALANCE, DECEMBER 31, 2001..... -- -- 5,000,863 $5,001 $4,903,368 $(5,117,367) (208,998) Net loss (unaudited)..... BALANCE, MARCH 31, 2002 (unaudited)..... -- -- -- -- -- (295,214) (295,214) -------- ----- --------- ------ ---------- ---------- ---------- $ -- 5,000,863 $5,001 $4,903,368 $(5,412,581) $ (504,212) ======== ===== ========= ====== ========== ========== ========== The accompanying notes are an integral part of this financial statements. F-5 BIODELIVERY SCIENCES INTERNATIONAL, INC. (A DEVELOPMENT STAGE COMPANY) CONSOLIDATED STATEMENTS OF CASH FLOWS PERIOD FROM JANUARY 6, 1997 (DATE OF YEAR ENDED YEAR ENDED INCORPORATION) THREE MONTHS ENDED MARCH 31, DECEMBER 31, DECEMBER 31, TO DECEMBER 31, ---------- 2000 2001 2001 2001 2002 ---------- ---------- ---------- ---------- ---------- (UNAUDITED) (UNAUDITED) OPERATING ACTIVITIES: Net loss..... $ (672,731) $(4,444,561) $(5,117,367) $(392,471) $(295,214) Adjustments to reconcile net loss to net cash used in operating activities: Depreciation and amortization..... 23,455

104,789 128,298 23,665 40,358 Loss applicable to minority interest..... (102,472) -- (102,472) -- -- Deferred revenue..... (56,000) 37,000 (19,000) -- (37,000) Litigation settlement..... -- 425,000 425,000 -- -- Compensation expense..... -- 2,190,395 2,190,395 -- -- Changes in assets and liabilities: Prepaid expenses and other assets..... 33,077 (417,103) (384,005) (3,923) (368,551) Accounts payable and accrued liabilities..... 307,064 420,259 727,323 (66,846) 271,459 Due to/from related parties..... 178,081 52,754 230,835 (16,000) 32,277 ---------- ---------- ---------- --------- --------- Net cash used by operating activities..... (289,526) (1,631,467) (1,920,993) (455,575) (356,671) ---------- ---------- ---------- --------- --------- INVESTING ACTIVITIES: Net cash received with business combination..... 380,465 -- 380,465 -- -- Purchase of equipment..... -- (84,862) (84,862) -- -- Purchase of minority interest..... -- (116,375) (116,375) -- -- ---------- ---------- ---------- --------- --------- Net cash provided (used) by investing activities..... 380,465 (201,237) 179,228 -- -- ---------- ---------- ---------- --------- --------- FINANCING ACTIVITIES: Issuance of Preferred Stock..... 1,010,000 -- 1,010,000 -- -- Issuance of Common Stock..... -- 805,000 805,000 100,000 -- Net change in line of credit..... -- 282,527 282,527 -- 336,205 Payment on capital lease payable..... -- (6,506) (6,506) (4,249) -- Payment on notes payable..... (150,000) (123,743) (273,743) -- (55,047) ---------- ---------- ---------- --------- --------- Net cash provided by financing activities..... 860,000 957,278 1,817,278 95,751 281,158 ---------- ---------- ---------- --------- --------- NET CHANGE IN CASH..... 950,939 (875,426) 75,513 (359,824) (75,513) CASH AT BEGINNING OF PERIOD..... -- 950,939 -- 950,939 75,513 ---------- ---------- ---------- --------- --------- CASH AT END OF PERIOD..... $ 950,939 $ 75,513 $ 75,513 $ 591,115 $ -- ========== ========== ========== ========= =========

The Company paid interest of $0, and $28,178 during 2000 and 2001, respectively. In 2001, in addition to paying cash of $350,000, the Company issued notes payable totaling $425,000 in connection with a litigation settlement and re-acquisition of the BioDelivery Sciences, Inc. common shares previously held by certain minority stockholders. This transaction resulted in the recognition of goodwill of $116,375. In 2001, the Company issued 137,300 shares of its common stock in full payment of a related-party payable of approximately $500,000. In 2001, the Company agreed to exchange 72,922 shares of its common stock for common shares of BioDelivery Sciences, Inc. previously held by minority stockholders, This agreement resulted in the recognition of goodwill of $401,070. In addition, the Company agrees to exchange 447,391 shares of its common stock for outstanding redeemable permanent discount common shares of BioDelivery Sciences, Inc. The variable nature of this underlying stock award, as modified by the removal of discount and redemption provisions resulted in the recognition of compensation expense of approximately $2,140,000. During 2001, the Company granted stock options to non-employees resulting in the recognition of compensation expense of approximately $53,000. The accompanying notes are an integral part of these financial statements. F-6 BIODELIVERY SCIENCES INTERNATIONAL, INC. (A DEVELOPMENT STAGE COMPANY) NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (INCLUDING NOTES APPLICABLE TO UNAUDITED PERIODS) NOTE 1 -- ORGANIZATION BioDelivery Sciences International, Inc. ("BDSI" or "Company") (formerly known as MAS Acquisition XXIII Corp.) was incorporated in the State of Indiana on January 6, 1997. BDSI and its subsidiary, BioDelivery Sciences, Inc. ("BDS"), are collectively referred to as the Company. In October 2000, BDSI acquired 84.8% of the voting rights of BioDelivery Sciences Inc. through the purchase of BioDelivery Sciences Inc. Series A Preferred Stock. As of December 2001, BDSI and BDS had entered into a merger agreement. The merger was then subsequently consummated on January 7, 2002 (the "Merger"). The Company considers December 31, 2001 to be the acquisition date for accounting purposes as the rights of ownership of BDS had been essentially transferred to BSDI, without restrictions, by that date. The agreement required an exchange of 1.33 shares of identical BDSI common stock for each share of BDS common stock outstanding, including redeemable common stock. The Company would also exchange 72,922 shares of common stock for 239,600 shares of BDS common stock and 447,391 shares of common stock for 1,470,000 shares of BDS redeemable common stock. The acquisition of the 239,600 shares of common stock represents the acquisition of minority interest which resulted in recorded goodwill of approximately $401,000. Prior to the acquisition of the 1,470,000 shares of redeemable common stock the Company agreed to remove the permanent discount and redemption provisions and agreed to the forgiveness of the stockholder debt associated with these shares upon, or soon after, the proposed IPO (see Note 16). The redeemable stock was originally characterized as a variable stock award for accounting purposes and therefore, the acquisition of the redeemable stock and the removal of the restrictions in December 2001 involved the recognition of compensation costs totaling approximately $2,137,000. As of December 2001, the permanent discount and redemption provisions with respect to

such shares have been terminated. The Company is a development stage company that has devoted substantially all of its efforts to research and product development involving drug delivery technology (e.g., cochleate technology) and has not yet generated any revenues from the sale of products or licensing of technology. The Company intends to obtain additional funds for research and development through collaborative arrangements with corporate partners, additional financings, and from other sources. The Company operates in one segment focused on the development of its drug delivery platform technology. The accompanying consolidated statements of operations and cash flows for the period January 6, 1997 (date of incorporation) to December 31, 2001 include the statements of operations and cash flows for the period January 6, 1997 (date of incorporation) to December 31, 1999 that were audited and reported on separately by an auditor previously engaged by the Company. In March 2002, the Company approved a one for 4.37 reverse stock split. The financial statements have been retroactively restated to reflect this reverse stock split. NOTE 2 -- SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES PRINCIPLES OF CONSOLIDATION The financial statements include the accounts of BDSI and its subsidiary (until the Merger), BioDelivery Sciences Inc. All significant inter-company balances have been eliminated. Minority interest in net loss of subsidiary reflects the losses attributable to the common stockholders of BioDelivery Sciences Inc. to the extent that net assets were attributed to those stockholders on the business combination date. At December 31, 2000 those stockholders owned 100% of the common stock of BioDelivery Sciences Inc. while BDSI owns preferred stock with voting rights, representing 84.8% of the total voting rights. At December 31, 2000, the equity attributable to the minority interest holders was at a deficit balance and accordingly was reduced to F-7 BIODELIVERY SCIENCES INTERNATIONAL, INC. (A DEVELOPMENT STAGE COMPANY) NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED) (INCLUDING NOTES APPLICABLE TO UNAUDITED PERIODS) NOTE 2 -- SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES -- (CONTINUED) zero. In connection with a litigation settlement (see Note 7) and in connection with the Merger of BDSI and BDS (see Note 1) the remaining minority interest was acquired by the Company. REVENUE RECOGNITION Sponsored research amounts are recognized as revenue, when the research underlying such payments has been performed or when the funds have otherwise been utilized, such as for the purchase of operating assets. Revenue is recognized to the extent provided for under the related grant or collaborative research agreement. Research and development expenses are charged to operations as incurred. Research and development expenses principally include, among other things, consulting fees and cost reimbursements to the University of Medicine and Dentistry of New Jersey ("UMDNJ"), testing of compounds under investigation, and salaries and benefits of employees engaged in research and development activities. Patent costs are expensed as incurred as research and development expenses. CASH AND CASH EQUIVALENTS The Company considers all highly liquid debt instruments with an original maturity of three months or less to be cash equivalents. EQUIPMENT Office and laboratory equipment are carried at cost less accumulated depreciation, which is computed on a straight-line basis over their estimated useful lives, generally 5 years. Accelerated depreciation methods are utilized for income tax purposes. GOODWILL Goodwill represents amounts paid for the Company's acquisitions of the BDS minority interest common shares in excess of fair market value. Those amounts paid prior to July 1, 2001 are amortized over 10 years. INCOME TAXES Deferred income tax assets and liabilities are determined based on differences between the financial statement and tax bases of assets and liabilities as measured by the enacted tax laws and rates applicable to the periods in which the differences are expected to affect taxable income. Income tax expense is the tax payable or refundable for the period plus or minus the change during the period in deferred tax assets and liabilities. USE OF ESTIMATES IN FINANCIAL STATEMENTS The preparation of the accompanying financial statements conforms with accounting principles generally accepted in the United States of America and requires management to make certain estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures 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 and assumptions. IMPAIRMENT OF ASSETS The Company periodically reviews long-lived assets for impairment, whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. The Company uses an F-8 BIODELIVERY SCIENCES INTERNATIONAL, INC. (A DEVELOPMENT STAGE COMPANY) NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED) (INCLUDING NOTES APPLICABLE TO UNAUDITED PERIODS) NOTE 2 -- SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES -- (CONTINUED) estimate of the undiscounted cash flows over the remaining life of its long-lived assets in measuring whether the assets to be held and used will be realizable. In the event of an impairment, the Company would discount

the future cash flows using its then estimated incremental borrowing rate to estimate the amount of the impairment. CONCENTRATION OF CREDIT RISK The Company derived substantially all of its working capital from the sale of its Common and Preferred Stock. BioDelivery Sciences Inc. historically derived its working capital from research and development arrangements. STOCK BASED COMPENSATION The Company follows Statement of Financial Accounting Standards (SFAS) No. 123, Accounting for Stock-Based Compensation (SFAS 123), which establishes a fair value based method of accounting for stock-based employee compensation plans; however, the Company has elected to continue to account for its employee stock compensation plans under Accounting Principles Board Opinion No. 25 with pro forma disclosures of net earnings and earnings per share, as if the fair value based method of accounting defined in SFAS 123 had been applied. REDEEMABLE COMMON STOCK Redeemable Common Stock represents the Company's obligation to re-purchase the 1,470,000 shares of BioDelivery Sciences Inc. redeemable permanent discount common stock at the option of the holder. The Company accounted for its ten-year re-purchase obligation (through 2009) using variable plan accounting; however, through the date of the modification of the terms of this stock (see Note 1) the value of the stock (less the permanent discount) was lower than the initial redemption value. Accordingly, no compensation expense has been recognized related to the redeemable permanent discount common stock. Under the terms of the redemption agreement, holders required the Company to repurchase, at the then fair value (less the permanent discount), the permanent discount common stock beginning in 2004 or upon an employee's termination, whichever was earlier. In December 2001, the Company agreed to remove the permanent discount and redemption rights, resulting in the recognition of approximately $2,140,000 of compensation expenses. FAIR VALUE OF FINANCIAL INSTRUMENTS At December 31, 2001, the carrying amount of cash, accounts payable, accrued expenses, capital lease obligations and notes payable approximate fair value based either on the short term nature of the instruments or on the related interest rate approximating the current market rate. NEW ACCOUNTING PRONOUNCEMENTS In July, 2001, the Financial Accounting Standards Board (FASB) issued SFAS 141, Business Combinations, and SFAS 142, Goodwill and Intangible Assets. SFAS 141 is effective for all business combinations completed after June 30, 2001. SFAS 142 is effective for the year beginning January 1, 2002; however certain provisions of this Statement apply to goodwill and other intangible assets acquired between July 1, 2001, and the effective date of SFAS 142. The Company is evaluating the effect, if any, of adopting F-9 BIODELIVERY SCIENCES INTERNATIONAL, INC. (A DEVELOPMENT STAGE COMPANY) NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED) (INCLUDING NOTES APPLICABLE TO UNAUDITED PERIODS) NOTE 2 -- SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES -- (CONTINUED) SFAS 142, but does not believe the adoption of these standards will have a material impact on the Company's financial statements. In July 2001, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 143, Accounting for Asset Retirement Obligations. This statement addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. This Statement applies to all entities. It applies to legal obligations associated with the retirement of long-lived assets that result from the acquisition, construction, development and (or) the normal operation of a long-lived asset, except for certain obligations of lessees. This Statement is effective for financial statements issued for fiscal years beginning after June 15, 2002. The Company is evaluating the impact of the adoption of this standard and has not yet determined the effect of adoption on its financial position and results of operations. In August 2001, the FASB issued SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. This statement addresses financial accounting and reporting for the impairment or disposal of long-lived assets and supersedes FASB Statement No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of. The provisions of this statement are effective for financial statements issued for fiscal years beginning after December 15, 2001. The Company adopted this standard effective January 1, 2002, which did not have a material impact on the Company's financial statements. UNAUDITED FINANCIAL STATEMENTS The unaudited financial statements and the related notes thereto for March 31, 2002 and 2001 include all normal and recurring adjustments which, in the opinion of management, are necessary for a fair presentation and are prepared on the same basis as audited annual statements. The interim results are not necessarily indicative of the results that may be expected for the full year. NOTE 3 -- BUSINESS COMBINATION On October 10, 2000, BDSI acquired 210,006 shares of newly issued BioDelivery Sciences Inc. Series A Convertible Preferred Stock representing 84.8% of the voting rights of BioDelivery Sciences Inc. in exchange for cash and notes payable to BioDelivery Sciences Inc. of $1,000,000 and $14,000,000, respectively. Since its inception in 1995, BioDelivery Sciences Inc. has

been principally engaged in developing a cochleate based drug delivery platform and had no pre-existing relationship with BDSI prior to the acquisition. The business combination was accounted for as a purchase and the operations of BioDelivery Sciences Inc. are included in the consolidated financial statements since September 30, 2000 as the operations during the period October 1, 2000 through October 10, 2000 were not significant. The shares of Series A Preferred were convertible into BioDelivery Sciences Inc. Common Stock on a 50-for-1 basis, subject to customary anti-dilution adjustments. Dividends accrued on the Series A Preferred at the rate of 8% per annum. In the event of liquidation, dissolution, or winding up of BioDelivery Sciences Inc., the Series A Preferred Stockholders would have been entitled to receive, in preference to Common Stockholders of BioDelivery Sciences Inc., an amount per share equal to the original purchase price plus any accrued dividends per share. The Series A Preferred Stock was convertible at the option of the preferred stockholders, but would automatically convert at the earlier of the initial public offering of BDS's common stock, or September 2005. The BioDelivery Sciences Inc. Series A Preferred Stock and note are eliminated in consolidation. BDSI and BioDelivery Sciences Inc. had amended the payment terms of the $14.0 million notes to defer the commencement of payments to August 1, 2001. The first scheduled payment under the notes was otherwise required on January 1, 2001. F-10 BIODELIVERY SCIENCES INTERNATIONAL, INC. (A DEVELOPMENT STAGE COMPANY) NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED) (INCLUDING NOTES APPLICABLE TO UNAUDITED PERIODS) NOTE 3 -- BUSINESS COMBINATION -- (CONTINUED) In conjunction with the business combination, the following was acquired: Cash acquired..... $ 380,465 Fair value of non-cash assets acquired..... 394,491 --------- Liabilities assumed, including minority interests of $102,472..... $(774,956) ========= The following unaudited pro forma summary combines the historical results of operations of BDSI with the historical operations of BioDelivery Sciences Inc. (exclusive of the impact of minority interest) as if the acquisition had occurred at January 1, 2000. This pro forma summary does not necessarily reflect the results of operations as they would have been if BDSI and BioDelivery Sciences Inc. operated as a single entity during such period. YEAR ENDED DECEMBER 31, 2000 ---------- --------- Sponsored research revenues..... $ 670,001 Net income (loss)..... $(981,207) Net income (loss) per share -- basic..... $ (0.28) Net income (loss) per share -- diluted..... $ (0.28) All the BioDelivery Sciences Inc. common stock was subsequently acquired with the settlement of certain litigation (see Note 7) and the merger of BioDelivery Sciences Inc. with BDSI (see Note 1). The Series A Convertible Preferred Stock of BioDelivery Sciences Inc. was retired as part of the merger. NOTE 4 -- RESEARCH AND DEVELOPMENT ARRANGEMENTS Upon its formation, BioDelivery Sciences Inc. originally secured license rights from two universities that have exclusive rights to certain technology. In exchange for these rights, BioDelivery Sciences Inc. issued shares of common stock with anti-dilution provisions and agreed to make future royalty payments to the universities upon a) the licensing of rights to sub-licensees (up to 25% of fees); b) sales by sub-licensees (25% of BioDelivery Sciences Inc. proceeds); or c) BioDelivery Sciences Inc. sales (3% of revenue). BioDelivery Sciences Inc. has also entered into various collaborative research arrangements with third parties, whereby the third parties ultimately obtain licensing rights for new inventions/patents arising from the associated research. These agreements generally provide for joint ownership of the patent rights developed from collaborative efforts. The parties also agree to later negotiate a reasonable royalty arrangement upon commercialization of any such product developed under the collaborative efforts. BioDelivery Sciences Inc. has entered into a research agreement with UMDNJ. For the period from the acquisition of voting rights of BioDelivery Sciences Inc. by BDSI through December 31, 2000 and for the year ended December 31, 2001, BioDelivery Sciences Inc. incurred costs of $78,081 and $159,025, respectively, to UMDNJ under the terms of the research agreement. For the three months ended March 31, 2000 and 2001, respectively, BDSI incurred costs of approximately $260,000 and $0 under the terms of the research agreement. At December 31, 2000, BioDelivery Sciences Inc. owed UMDNJ $415,584 under this agreement, which is included in due to related parties. The research agreement provides for the procurement of supplies, rent (until April 2001 -- See Note 7), certain payroll costs, and other expenses associated with research performed under the research agreement. On April 1, 2001, the Company agreed to issue approximately 137,300 shares of common stock in consideration for payment in full of its approximate $500,000 payable at March 31, 2001, to UMDNJ. At December 31, 2001, the Company owes an additional $74,331 under this agreement. At March 31, 2002, the Company owes $106,608 under this agreement. F-11 BIODELIVERY SCIENCES INTERNATIONAL, INC. (A DEVELOPMENT STAGE COMPANY) NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED) (INCLUDING NOTES APPLICABLE TO UNAUDITED

PERIODS) NOTE 4 -- RESEARCH AND DEVELOPMENT ARRANGEMENTS -- (CONTINUED) On July 1, 1996, BioDelivery Sciences Inc. entered into a license agreement with a commercial pharmaceutical company ("Funding Company"). This agreement allowed for the Funding Company to obtain an exclusive license in and to all inventions, developments, improvements, or know-how relating to cochleates, liposomes and proteoliposomes, owned, controlled or licensed to BioDelivery Sciences Inc. The Funding Company would also have the rights to all BioDelivery Sciences Inc. developed vaccines designed to induce an antigen specific immune response in humans; including vaccines to prevent or treat allergies. In exchange for the exclusive license, the Funding Company agreed to pay research and royalty payments which ultimately totaled $6.7 million. The agreement commenced upon execution and was to expire five years following the first commercial sale of a licensed product or the date of expiration of the last licensed patent having a valid claim covering any licensed product, whichever is later. However, the Funding Company chose to terminate the agreement effective in 2000. The Company incurred $56,000 of costs under this arrangement in 2000. During 2001, the Company entered into agreements with RetinaPharma, Inc. and Tatton Technology LLC. Both are biotechnology companies which are developing neutraceutical neuroprotective therapies for treating neurodegenerative disease such as macular degeneration and Parkinson's disease. To the extent that such drugs utilize Bioral cochleate technology, the Company will support drug development and will pay a royalty of ten percent (10%) on net revenues from such sales of Bioral encapsulated drugs. The CEO/director is affiliated with these companies. The Company incurred a deminimus amount of costs relating to these agreements in 2001. The Company has also entered into an agreement with Biotech Specialty Partners, LLC, an emerging alliance of early stage biotechnology and specialty pharmaceutical companies. Biotech Specialty Partners, LLC is in its formative stage and to date has not distributed any pharmaceutical products. Under this agreement, Biotech Specialty Partners, LLC will serve as a nonexclusive distributor of the Company's Bioral drugs in consideration of a ten percent (10%) discount to the wholesale price, which the board of directors has determined commercially reasonable. The CEO/director is affiliated with this company. The Company incurred a deminimus amount of costs relating to this agreement in 2001. The Company has also entered into an agreement with BioKeys Pharmaceutical, Inc., a biotechnology company, which is developing several potential products which are vaccine based. To the extent that BioKeys Pharmaceutical, Inc. utilizes the Company's Bioral drug delivery technology, the Company will earn a royalty ranging between 15% to 30% of product sales incorporating its technology and between 10% and 20% of any royalty income earned by BioKeys Pharmaceutical, Inc. with regard to licenses involving its technology. BioKeys has provided a $35,000 advance to the Company under their agreement, which is included with accounts payable and accrued expenses. The CEO/director and the senior executive vice president are affiliated with this company. The Company incurred a deminimus amount of costs relating to this agreement in 2001. F-12 BIODELIVERY SCIENCES INTERNATIONAL, INC. (A DEVELOPMENT STAGE COMPANY) NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED) (INCLUDING NOTES APPLICABLE TO UNAUDITED PERIODS) NOTE 5 -- OTHER ASSETS Other assets consist of the following. YEAR ENDED DECEMBER 31, MARCH 31, ---------- ---------- 2000 2001 2002 -------- -------- ---------- (UNAUDITED) Goodwill..... $ -- $517,445 $ 517,445 Deferred offering costs..... -- 365,340 598,022 Other..... 42,520 43,821 43,821 -------- -------- ---------- 42,520 926,606 1,159,288 Less: Accumulated amortization..... (12,396) (13,796) (14,497) -------- -------- ---------- Total other assets, net..... $ 30,124 $912,810 $1,144,791 ======== ======== ========== The Company has incurred and capitalized offering costs of approximately $366,000 and $598,000 at December 31, 2001 and March 31, 2002, respectively, related to the anticipated proposed public offering (see Note 16). NOTE 6 -- EQUIPMENT Equipment consists of the following: DECEMBER 31, ---------- MARCH 31, 2000 2001 2002 -------- --------- ---------- (UNAUDITED) Office and laboratory equipment..... $236,466 $ 321,338 $ 321,338 Leased equipment..... 39,679 39,679 39,679 -------- --------- --------- 276,145 361,017 361,017 Less accumulated depreciation and amortization... (22,755) (127,455) (167,112) -------- --------- --------- Net equipment..... $253,390 $ 233,562 $ 193,905 ======== ========= ========= Depreciation and amortization expense related to equipment for the years ended December 31, 2000 and 2001 and the three month periods ended March 31, 2002 and 2001 was approximately $23,000, $104,000, $23,000 and $40,000, respectively. NOTE 7 -- COMMITMENTS AND CONTINGENCIES LITIGATION During May 2001, the Company entered into a settlement agreement with a former consultant and certain stockholders related to the consultant (together, the Plaintiffs). Under the terms of the settlement agreement, the Company agreed to pay $150,000 in cash and $125,000

in a note payable to the Plaintiffs. The $125,000 note is payable in monthly installments through June 2002 and bears interest at 9%. The Company also agreed to re-purchase all of the BioDelivery Sciences Inc. common stock owned by the Plaintiffs valued at $116,375 for cash of $200,000 and a note payable of $300,000. The $300,000 note is payable monthly through June 2004 and bears interest at 9%. The notes are secured by all of BDS's tangible and intangible assets, including license agreements. Relating to this litigation, the Company accrued approximately $300,000 at F-13 BIODELIVERY SCIENCES INTERNATIONAL, INC. (A DEVELOPMENT STAGE COMPANY) NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED) (INCLUDING NOTES APPLICABLE TO UNAUDITED PERIODS) NOTE 7 -- COMMITMENTS AND CONTINGENCIES -- (CONTINUED) December 31, 2000 and recorded an additional $380,000 of legal expense for the year ended December 31, 2001. At December 31, 2001 maturities of these notes payable are as follows: YEAR ENDING DECEMBER 31, ---------- 2002..... $149,524 2003..... 105,089 2004..... 46,644 -------- $301,257 ======== The Company has received notification of a potential claim for a finder's fee, and a lawsuit has been filed by Michael J. Pennesi and SSP Consultants, who are not affiliated with the Company, arising out of an introduction to BioDelivery Sciences, Inc. in 2000. Settlement discussions have been conducted. Informal telephonic settlement discussions prior to the filing of the lawsuit, have ranged between an approximately $120,000 cash demand upon the Company to the Company's counter-offer of approximately $5,000 in cash and 5,000 shares of stock. The Company intends to vigorously defend this litigation. It is the Company's belief that the potential claim is neither material nor meritorious. OPERATING LEASE Beginning in April 2001, the Company leases a facility from UMDNJ under an operating lease that runs through December 31, 2005. Lease expense for the year ended December 31, 2001 was approximately $30,000. The future minimum commitments on this operating lease at December 31, 2001 are as follows: 2002..... $44,580 2003..... 50,580 2004..... 56,580 2005..... 62,580 CAPITAL LEASE The Company leases certain equipment under a capital lease. Future minimum lease payments at December 31, 2001 remaining on this capital lease are as follows. 2002..... $22,070 2003..... 14,713 2004..... 4,905 Less amount representing interest..... (8,515) ------- $33,173 ======= NOTE 8 -- PREFERRED STOCK During 2000, the Company issued 462,243 shares of Preferred Stock for $1,010,000. The Preferred Stock was convertible to Common Stock on a one-for-one basis, is non-redeemable, and does not pay dividends. In F-14 BIODELIVERY SCIENCES INTERNATIONAL, INC. (A DEVELOPMENT STAGE COMPANY) NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED) (INCLUDING NOTES APPLICABLE TO UNAUDITED PERIODS) NOTE 8 -- PREFERRED STOCK -- (CONTINUED) December 2001, the Company rescinded the 462,243 shares of preferred stock as replacement for issuance of 462,243 shares of common stock. NOTE 9 -- LINE OF CREDIT In September 2001, the Company entered into a line of credit facility with a bank. Originally the available line of credit was $250,000 and was increased to $350,000 at December 31, 2001 and has been subsequently increased to $950,000. Interest on the line of credit accrues at a rate of prime plus 2.0% (6.75% at December 31, 2001) and principally matures in May 2002. Borrowings under the line of credit are collateralized by all business assets of the Company and personal guarantees by certain stockholders. There are no restrictive covenants associated with the line of credit. NOTE 10 -- STOCK OPTIONS In October 2001, the Company approved a stock option plan, which covers a total of 572,082 shares of common stock. The Board has approved, subject to stock holder approval at the next meeting, to increase the shares available under the 2001 stock option plan to 1,100,000. Options may be awarded during the ten-year term of the 2001 stock option plan to Company employees, directors, consultants and other affiliates. The Company has adopted only the disclosure provisions of Financial Accounting Standard No. 123, "Accounting for Stock-Based Compensation," as it relates to employment awards. It applies APB Opinion 25, "Accounting for Stock Issued to Employees," and related interpretations in accounting for its plans and does not recognize compensation expense based upon the fair value at the grant date for awards under these plans consistent with the methodology prescribed by SFAS 123, the Company's net loss and loss per share would be reduced to the proforma amounts indicated below: 2000 2001 --------- ---------- Net Loss..... As Reported $(672,731) $(4,444,561) ProForma $(672,731) $(4,588,120) Net Loss Per Common Stock..... Basic As Reported $ (0.19) $ (1.15) Basic ProForma $ (0.19) $ (1.19) Net Loss Per Common Share..... Diluted As Reported $ (0.19) $ (1.15) Diluted ProForma $ (0.19) $ (1.19) The fair value of each option grant is estimated on the date of grant using the Black Scholes options-pricing

model with the following weighted-average assumptions used for grants in 2001: No dividend yield, expected volatility of 73%; risk-free interest rates of 5.5%, and expected lives of 3 years. F-15 BIODELIVERY SCIENCES INTERNATIONAL, INC. (A DEVELOPMENT STAGE COMPANY) NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED) (INCLUDING NOTES APPLICABLE TO UNAUDITED PERIODS) NOTE 10 -- STOCK OPTIONS -- (CONTINUED) Activity related to options is as follows: WEIGHTED AVERAGE EXERCISE NUMBER OF SHARES PRICE PER SHARE ---------- ---------- Outstanding at inception (January 6, 1997) through December 31, 2000..... -- $ -- Granted in 2001: Officers and Directors..... 610,983 $8.59 Others..... 222,112 $5.01 Options Expired..... -- $ -- ------- ----- Outstanding at December 31, 2001..... 833,095 $7.64 ======= ===== OUTSTANDING SHARES WEIGHTED AVERAGE REMAINING RANGE OF NUMBER CONTRACTUAL LIFE WEIGHTED AVERAGE EXERCISE PRICES OUTSTANDING (YEARS) EXERCISE PRICE ---------- ---------- ---------- ---------- $2.87 -- $3.06 481,587 4.8 $ 3.03 $6.60 30,000 4.8 $ 6.60 $11.80 160,754 4.8 $11.80 $17.48 160,754 4.8 $17.48 EXERCISABLE SHARES RANGE OF NUMBER WEIGHTED AVERAGE EXERCISE PRICES OUTSTANDING EXERCISE PRICE ---------- ---------- ---------- $2.87 -- $3.06 36,443 3.01 The options outstanding at December 31, 2001 expire on various dates throughout 2006. The weighted average grant date fair value of options granted during 2001 whose exercise price is equal to the market price of the stock at the grant date was $1.58. The weighted average grant date fair value of options granted whose exercise price is less than the estimated market price of the stock at the grant date is $1.63. The weighted average grant date fair value of options granted whose exercise price is greater than the estimated market price of the stock at the grant date is $1.37. Compensation expense in connection with the issuance of stock options totaled approximately $53,000 for the year ended December 31, 2001. NOTE 11 -- INCOME TAXES Other than a $18,000 income tax benefit recognized in 2001 due to the prior year understatement of income taxes receivables, the Company has no income tax expense or benefit for 2001 and 2000 as the Company has incurred net operating losses since inception and has recognized valuation allowances for all deferred tax assets. F-16 BIODELIVERY SCIENCES INTERNATIONAL, INC. (A DEVELOPMENT STAGE COMPANY) NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED) (INCLUDING NOTES APPLICABLE TO UNAUDITED PERIODS) NOTE 11 -- INCOME TAXES -- (CONTINUED) Reconciliation of the Federal statutory income tax rate of 34% to the effective rate is as follows: YEAR ENDED THREE MONTHS ENDED DECEMBER 31, MARCH 31, ---------- ---------- 2000 2001 2001 2002 ------ ------ ---------- ---------- (UNAUDITED) (UNAUDITED) Federal statutory income tax rate..... 34.00% 34.00% 34.00% 34.00% State taxes, net of federal benefit..... 4.95 4.95 4.95 4.95 Permanent differences -- compensation expense..... -- (21.23) -- -- Valuation allowance..... (38.95) (17.30) (38.95) (14.44) ------ ------ ------ ------ --% 0.42% --% 24.51% ====== ====== ====== ====== In March 2002, a new tax law changed the carryback period from two to five years. This allowed the Company to carryback its net operating losses to 1996 and 1997, which resulted in an additional benefit of $95,843. The tax effects of temporary differences and net operating losses that give rise to significant portions of deferred tax assets and liabilities consisted of the following: DECEMBER 31, ---------- 2000 2001 --------- --------- Deferred tax assets (liabilities) Depreciation..... $ (37,000) $ (21,000) Accrued liabilities and other..... 128,000 21,000 Net operating loss carryforward..... 214,000 1,077,000 --------- --------- 305,000 1,077,000 Less valuation allowance..... (305,000) (1,077,000) --------- --------- Net deferred tax..... $ -- $ -- ========= ========== At December 31, 2001, the Company has a federal and state net operating loss carryforward of approximately $2.7 million, which expires beginning in 2007. NOTE 12 -- NET LOSS PER COMMON SHARE The following table reconciles the numerators and denominators of the basic and diluted income per share computations. The 3,512,586 shares of common stock outstanding in 2000 reflects the recapitalization of the Company in 2000. The recapitalization included the cancellation of all but 80,092 shares and the issuance of 3,432,494 shares for nominal consideration to founding members of management during 2000. The weighted average shares outstanding at December 31, 2001 includes the 520,313 shares of common stock exchanged in the Merger (see Note 1) which was consummated on January 7, 2002. The Company considers F-17 BIODELIVERY SCIENCES INTERNATIONAL, INC. (A DEVELOPMENT STAGE COMPANY) NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED) (INCLUDING NOTES APPLICABLE TO UNAUDITED PERIODS) NOTE 12 -- NET LOSS PER COMMON SHARE -- (CONTINUED) December 31, 2001 to be the acquisition date as the rights of ownership of BDS had been essentially

transferred to BDSI, without restrictions, by that date. THREE MONTHS ENDED MARCH YEAR ENDED DECEMBER 31, 31, ---------- ---------- 2000 2001 2001 2002 ---------- ---------- ---------- ---------- (UNAUDITED) (UNAUDITED) ---------- ---------- Net loss -- (numerator)..... $ (672,731) $(4,444,561) $ (392,471) $ (295,214) ========== ========== ========== ========== Basic: Weighted average Shares outstanding (denominator)..... 3,512,586 3,851,587 3,518,179 5,000,863 ========== ========== ========== ========== ========== Net loss per common share -- basic..... $ (0.19) $ (1.15) (.11) (.06) ========== ========== ========== ========== Diluted: Weighted average shares outstanding..... 3,512,586 3,851,587 3,518,179 5,000,863 Effect of dilutive options..... -- -- -- -- ---------- ---------- ---------- ---------- Adjusted weighted average shares (denominator)..... 3,512,586 3,851,587 3,518,179 5,000,863 ========== ========== ========== ========== Net loss per common share -- diluted..... $ (0.19) $ (1.15) $ (.11) $ (.06) ========== ========== ========== ========== The effects of all Preferred Stock and stock options have been excluded from Common Stock equivalents because their effect would be anti-dilutive. NOTE 13 -- RELATED PARTY TRANSACTIONS During the year ended December 31, 2000, the Company sold 45,767 shares of Preferred Stock to a relative of a principal stockholder for $100,000. The terms of the Preferred Stock sold to this related party were identical to those for Preferred Stock sold to unrelated parties. NOTE 14 -- NATIONAL INSTITUTES OF HEALTH GRANT In 2001, the National Institutes of Health (NIH) awarded the Company a Small Business Innovation Research Grant (SBIR), which will be utilized in research and development efforts. NIH has formally awarded the Company a 2001 grant of $883,972. Additionally, this award refers to funding levels of $814,398 and $989,352 that the Company expects to be awarded in 2002 and 2003, respectively, subject to availability and satisfactory progress of the project. Therefore, the Company expects to receive a total of approximately $2.7 million related to its initial application for the grant through June 2004. The initial application was for approximately $3.0 million. However, due to the expected purchase of certain materials from sources outside the United States, the expected funding was accordingly reduced. The grant is subject to provisions for monitoring set forth in NIH Guide for Grants and Contracts dated February 24, 2000, specifically, the NIAID Policy on Monitoring Grants Supporting Clinical Trials and Studies. If NIH believes that satisfactory progress is not achieved, the 2002 and 2003 amounts noted above may be reduced or eliminated. The company incurred approximately $477,000 and $260,000 of costs related to this agreement in 2001 and the three month period ended March 31, 2002, respectively. During the year ended December 31, 2001, the Company received $479,000 (inclusive of $37,000 of deferred revenue) and recognized revenue of $442,000 from this grant. During the three month period ended F-18 BIODELIVERY SCIENCES INTERNATIONAL, INC. (A DEVELOPMENT STAGE COMPANY) NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED) (INCLUDING NOTES APPLICABLE TO UNAUDITED PERIODS) NOTE 14 -- NATIONAL INSTITUTES OF HEALTH GRANT -- (CONTINUED) March 31, 2002, the Company received $148,000 and recognized revenue of $259,000 from this grant. As awarded on September 19, 2001, the grant provided for reimbursement of, or advances for, future research and development efforts. During October 2001, the Company negotiated a lump sum payment of $220,000. The terms that were negotiated in October 2001 allowed the Company to recover $220,000 of costs principally incurred in the third quarter of 2001, which were recognized as revenue upon agreement of those negotiated terms in October 2001. Upon receiving funding under the grant and utilizing the funds as specified, no amounts are refundable. NOTE 15 -- PLAN OF OPERATIONS Since inception, the Company has financed its operations principally from the sale of equity securities. Historically, the Company's subsidiary financed its operations principally from funded research arrangements. The Company has not generated revenue from the sale of any product or from any licensing arrangement since inception. The Company intends on financing its research and development efforts and its working capital needs from existing and new sources of financing. For instance, the Company was granted up to approximately $2.7 million from the National Institutes of Health to fund specific research efforts conducted by the Company (see Note 14). The Company has also recently filed Form SB-2 and expects to offer for sale up to 2,000,000 units, each consisting of one share of common stock and one warrant to purchase an additional share of common stock (see Note 16). The expected offering price for each unit is between $5.00 and $6.00 per unit. There can be no assurance that the offering will result in the sale of any such securities. Should the offering not occur nor additional funding be obtained, the principal shareholder has committed to fund the operations of the Company through 2002. The Company expects to raise additional funding from traditional financing sources, including term notes from unrelated parties or advances from related parties. While there can be no assurance that such sources will provide adequate funding for the

Company's operations, management believes such sources will be available to the Company. NOTE 16 -- SUBSEQUENT EVENTS In April 2002, the Company filed Form SB-2 with the Securities and Exchange Commission. The proposed public offering consists of up to 2,000,000 Units, each comprised of one share of common stock and one redeemable Class A common stock purchase warrant. F-19 REPORT OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS To the Board of Directors and Stockholders of BioDelivery Sciences, Inc. We have audited the accompanying statement of operations of BioDelivery Sciences, Inc. (a development stage company) and the related statement of cash flows for the nine months ended September 30, 2000. 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 audit. We conducted our audit in accordance with auditing standards generally accepted in the United Stated 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 audit provides a reasonable basis for our opinion. In our opinion, the financial statements referred to above present fairly, in all material respects, the results of operations of BioDelivery Sciences, Inc. and cash flows for the nine months ended September 30, 2000, in conformity with accounting principles generally accepted in the United States of America. /s/ GRANT THORNTON LLP Tampa, Florida December 15, 2000 F-20 BIODELIVERY SCIENCES, INC. (A DEVELOPMENT STAGE COMPANY) STATEMENTS OF OPERATIONS PERIOD FROM MARCH 28, 1995 NINE MONTHS (DATE OF ENDED INCORPORATION) SEPTEMBER 30, TO SEPTEMBER 30, 2000 2000 ---------- ---------- (UNAUDITED) Sponsored research revenues..... $ 614,001 $7,338,501 EXPENSES: Research and development..... 820,551 6,816,444 General and administrative..... 62,480 423,233 --------- ---------- Total expenses..... 883,031 7,239,677 OTHER INCOME (EXPENSE) Interest income..... 21,570 169,318 Other income..... 3,720 17,856 --------- ---------- Net income (loss) before income tax benefit (expense)..... (243,740) 285,998 Income tax benefit (expense)..... 37,736 (183,925) --------- ---------- Net income (loss)..... $(206,004) $ 102,073 ========= ========== The accompanying notes are an integral part of these financial statements. F-21 BIODELIVERY SCIENCES, INC. (A DEVELOPMENT STAGE COMPANY) STATEMENTS OF CASH FLOWS PERIOD FROM MARCH 28, 1995 NINE MONTHS (DATE OF ENDED INCORPORATION) SEPTEMBER 30, TO SEPTEMBER 30, 2000 2000 ---------- ---------- (UNAUDITED) Net income (loss)..... $(206,004) $ 102,073 Adjustments to reconcile net income (loss) to net cash provided by operating activities: Depreciation and amortization..... 70,422 243,688 Changes in assets and liabilities: Prepaid expenses and other assets..... (31,124) (87,558) Accounts payable and accrued liabilities..... 14,734 86,955 Deferred revenue..... (46,000) 56,000 Due to related party..... 234,471 337,503 --------- --------- Net cash provided by operating activities..... 36,499 738,661 INVESTING ACTIVITIES: Purchases of equipment..... (18,391) (468,458) Purchase of other assets..... -- (42,484) --------- --------- Net cash used in investing activities..... (18,391) (510,942) FINANCING ACTIVITIES: Issuance of common stock..... -- 2,746 Proceeds from notes payable..... 350,000 350,000 --------- --------- Net cash provided by financing activities..... 350,000 352,746 NET CHANGE IN CASH..... 368,108 580,465 CASH AT BEGINNING OF PERIOD..... 212,357 -- --------- --------- CASH AT END OF PERIOD..... $ 580,465 $ 580,465 ========= ========= SUPPLEMENTAL INFORMATION Cash paid for taxes..... $ -- $ 221,661 ========= ========= The accompanying notes are an integral part of these financial statements. F-22 BIODELIVERY SCIENCES, INC. (A DEVELOPMENT STAGE COMPANY) NOTES TO FINANCIAL STATEMENTS NOTE 1 -- ORGANIZATION BioDelivery Sciences, Inc. ("BDS" or the "Company") was incorporated in the State of Delaware on March 28, 1995. The Company was formed to develop and commercialize the delivery of certain pharmaceutical drugs and vaccines orally. The Company is a development stage company, which has devoted substantially all of its efforts to research and product development and has not yet generated any revenues from the sale of products. At this time, there can be no assurance of future revenues. In addition, the Company expects to continue to incur losses for the foreseeable future, and there can be no assurance that the Company will successfully complete the transition from a development stage company to successful

operations. In order to continue its research and product development activities as planned, the Company has raised capital through sponsored research agreements with commercial entities and other third parties. The Company has also raised capital from investors subsequent to September 30, 2000, as more fully discussed in Note 7, which management believes will provide adequate funding through September 30, 2001. The Company intends to obtain additional funds for research and development through collaborative arrangements with corporate partners, additional financings, and from other sources; however, there can be no assurance that the Company will be able to obtain necessary financing when required or what the terms of any such financing, if obtained, might be. Accordingly, there can be no assurance of the Company's future success. NOTE 2 -- SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES REVENUE RECOGNITION Sponsored research amounts are recognized as revenue when the research underlying such payments has been performed or when the funds have otherwise been utilized, such as for the purchase of operating assets. Research and development expenses are charged to operations as incurred. Research and development expenses principally include, among other things, consulting fees and cost reimbursements to the University of Medicine and Dentistry of New Jersey ("UMDNJ"), testing of compounds under investigation, and salaries and benefits of employees engaged in research and development activities. Patent costs are expensed as incurred as research and development expenses. CASH AND CASH EQUIVALENTS The Company considers all highly liquid debt instruments with an original maturity of three months or less to be cash equivalents. EQUIPMENT Office and laboratory equipment are carried at cost less accumulated depreciation, which is computed on a straight-line basis over their estimated useful lives, generally 5 years. Accelerated depreciation methods are utilized for income tax purposes. Depreciation and amortization expense related to equipment for the nine months ended September 30, 2000 was $68,265. INCOME TAXES Deferred income tax assets and liabilities are computed annually for differences between the financial statement and tax bases of assets and liabilities that will result in taxable or deductible amounts in the future based on enacted tax laws and rates applicable to the periods in which the differences are expected to affect taxable income. Income tax expense is the tax payable or refundable for the period plus or minus the change during the period in deferred tax assets and liabilities. F-23 BIODELIVERY SCIENCES, INC. (A DEVELOPMENT STAGE COMPANY) NOTES TO FINANCIAL STATEMENTS -- (CONTINUED) NOTE 2 -- SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES -- (CONTINUED) USE OF ESTIMATES IN FINANCIAL STATEMENTS The preparation of the accompanying financial statements conforms with accounting principles generally accepted in the United States of America and requires management to make certain estimates and assumptions that affect the reported amounts of 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 and assumptions. ACCOUNTING FOR THE IMPAIRMENT OF LONG-LIVED ASSETS The Company reviews long-lived assets to be held and used or disposed of, for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. The Company uses an estimate of the undiscounted cash flows over the remaining life of its long-lived assets in measuring whether the assets to be held and used will be realizable. CONCENTRATION OF CREDIT RISK As described in Note 3, the Company derived substantially all of its working capital from a research and development arrangement that was terminated during 1999. STOCK OPTIONS, WARRANTS, AND SARS The Company follows SFAS No. 123, "Accounting for Stock-Based Compensation" (SFAS 123), which establishes a fair value based method of accounting for stock-based employee compensation plans; however, the Company has elected to continue to account for its employee stock compensation plans under Accounting Principles Board Opinion No. 25 with pro forma disclosures of net earnings and earnings per share, as if the fair value based method of accounting defined in SFAS 123 has been applied. Through September 30, 2000 no options or warrants have been granted by the Company. NOTE 3 -- RESEARCH AND DEVELOPMENT ARRANGEMENTS As part of the Company's grant of an exclusive technology license to a third party, the Company agreed to conduct research in certain areas in exchange for funding. Research funding received under this agreement was $325,000 in 2000, respectively. This agreement was terminated by the third party during 1999 and the Company was relieved of its obligations to provide exclusive technology licensing. Additionally, the Company has entered into various other collaborative research arrangements with third parties, whereby the third parties ultimately obtain licensing rights for new inventions/patents arising from the associated research. In 1996, the Company issued 7,300 shares of common stock each to UMDNJ and Albany Medical College ("AMC") for exclusive, worldwide license agreement rights. Under the terms of the license agreement, the Company is obligated to pay royalties of 3% for sales of product and 25% of its income arising from sales of product sold by sub-licensees that the Company may contract

with in the future. The Company has also entered into a research agreement with UMDNJ. For the nine month period ended September 30, 2000, the Company incurred costs of $243,805, to UMDNJ under the terms of the research agreement. At September 30, 2000, the Company owed UMDNJ $337,503, under this agreement. The research agreement provides for the procurement of supplies, rent, certain payroll costs, and other expenses associated with research performed under the research agreement. F-24 BIODELIVERY SCIENCES, INC. (A DEVELOPMENT STAGE COMPANY) NOTES TO FINANCIAL STATEMENTS -- (CONTINUED) NOTE 4 -- COMMITMENTS AND CONTINGENCIES LITIGATION During 1996, the Company entered into an agreement with a consultant/stockholder under which the Company is obligated to pay a monthly consulting fee of $15,000 for services through January 2001. The agreement also provides for additional costs payable to the consultant beginning in 2000 through 2004, upon the Company obtaining certain levels of financing. In August 1999, the Company unilaterally terminated the contract with this consultant and ceased making further payments. The consultant subsequently filed suit against the Company alleging that, among other things, the Company is required to pay the monthly consulting fees. The Company has filed a counter suit against the consultant and management believes that the Company is not liable for any alleged damages and that the Company is entitled to a refund of a portion of previously paid consulting fees. Accordingly, no reserve has been recognized associated with this dispute. The Company is subject to claims arising in the ordinary course of business, but does not believe that any such claims presently identified will have a material adverse effect on its financial condition or results of operations. OPERATING LEASES The Company leases a facility from UMDNJ under an operating lease. Lease expense for the nine months ended September 30, 2000 was approximately $30,000. While the Company intends to continue leasing this facility, there are no future minimum commitments on operating leases at September 30, 2000. CAPITAL LEASES The Company leases certain equipment under a capital lease. Future minimum lease payments remaining on this capital lease are as follows. 2000 (3 months)..... $ 3,678 2001..... 14,713 2002..... 14,713 2003..... 14,713 2004..... 4,904 Less amount representing interest..... (13,042) -------- $ 39,679 ======== NOTE 5 -- STOCK OPTIONS, WARRANTS, AND OTHER INCENTIVE COMPENSATION In 1999, the board of directors of the Company approved the 1999 Stock Option Plan (1999 Plan) and reserved 500,000 shares of common stock for issuance of stock options to employees and consultants. No options were granted under this plan. During 1999, certain employees of the Company purchased 1,470,000 shares of redeemable common stock for $0.22 per share (the fair value of the stock less a permanent discount) in exchange for cash and notes payable. The Company is obligated to re-purchase the stock at fair value less the original discount at the option of the holder beginning in 2004, or earlier upon termination of the respective employee. The notes amount to approximately $321,000, bear interest of 6% annually, and mature in 2009. Upon the fair value of the common stock exceeding $2.22 per share, the Company will recognize compensation expense for the F-25 BIODELIVERY SCIENCES, INC. (A DEVELOPMENT STAGE COMPANY) NOTES TO FINANCIAL STATEMENTS -- (CONTINUED) NOTE 5 -- STOCK OPTIONS, WARRANTS, AND OTHER INCENTIVE COMPENSATION -- (CONTINUED) amount in excess of $2.22 per share and adjust compensation in future periods based on variable accounting requirements. Through September 30, 2000, no compensation expense has been recognized. NOTE 6 -- INCOME TAXES The Company's provision (benefit) for income taxes for the nine months ended September 30, 2000 is as follows: Current Tax: Federal..... $(37,736) State..... -- Deferred Tax: Federal..... -- State..... -- -------- $(37,736) ======== The Company's Federal net operating loss carryforward of $93,312 expires in 2020. The Company's State net operating loss of $289,836 expires in 2007. The Company's effective tax rate of approximately 15% in 2000 varies from the statutory rate primarily due to the valuation allowance associated with net operating loss carryforwards and the effect of graduated tax rates. NOTE 7 -- SUBSEQUENT EVENT On October 10, 2000, the Company sold 210,006 shares of Series A Convertible Preferred Stock representing 84.8% of the voting rights of the Company to BioDelivery Sciences International, Inc. in exchange for cash and notes receivable of $1.0 million and $14.0 million, respectively. The shares of Series A Preferred are convertible to Common Stock on a 50-for-1 basis, subject to customary anti-dilution adjustments. Dividends shall accrue on the Series A Preferred at the rate of 8% per annum. In the event of liquidation, dissolution, or winding up of the Company, the Series A Preferred Stockholders will be entitled to receive, in preference to the Company's Common Stockholders, an amount per share equal to the original purchase price plus any accrued dividends per share. The Series A Preferred Stock is convertible at the earlier of voluntary

conversion by the preferred stockholders, initial public offering of the Company's common stock, or 2005. F-26
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