IsoRay, Inc.
Form 10KSB/A
May 09, 2006

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

Form 10-KSB/A
Amendment No. 1

(Mark one)

o **Annual Report Under Section 13 or 15(d) of The Securities Exchange Act of 1934**

For the fiscal year ended _________________

x **Transition Report Under Section 13 or 15(d) of The Securities Exchange Act of 1934**

For the transition period from October 1, 2004 to June 30, 2005

Commission File Number: 0-14247

IsoRay, Inc.
(Exact name of small business issuer as specified in its charter)

Minnesota	41-1458152
(State of incorporation)	(IRS Employer ID Number)

350 Hills Street, Suite 106, Richland, WA 99354
(Address of principal executive offices)

(509) 375-1202
(Issuer's telephone number)

Securities registered under Section 12 (b) of the Exchange Act - None

Securities registered under Section 12(g) of the Exchange Act - Common Stock - $0.001 par value

---

Check whether the issuer is not required to file reports pursuant to Section 13 or 15(d) of the Exchange Act. o

Check whether the issuer has (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 12 months (or for such shorter period the Company was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes xNo o

Check if there is no disclosure of delinquent filers in response to Item 405 of Regulation S-B contained in this form, and no disclosure will be contained, to the best of Company's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-KSB or any amendment to this Form 10-KSB. o

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act):

Yes o No x

The issuer's revenues for the nine month transitional period ended June 30, 2005 were $-0-.

The aggregate market value of voting common equity held by non-affiliates as of September 30, 2005 was approximately $34,372,217.

As of September 30, 2005, there were 9,060,221 shares of Common Stock issued and outstanding.

Transitional Small Business Disclosure Format: Yes o No x

IsoRay, Inc.
(formerly Century Park Pictures Corporation)

Transitional Report on Form 10-KSB
for the period from October 1, 2004 through June 30, 2005

Table of Contents

		Page
Part I		
Item 1	Description of Business	1
Item 2	Description of Property	29
Item 3	Legal Proceedings	29
Item 4	Submission of Matters to a Vote of Security Holders	29
Part II		
Item 5	Market for Common Equity, Related Stockholders' Matters, and Small Business Issuer Purchases of Equity Securities	29
Item 6	Management's Discussion and Analysis or Plan of Operation	31
Item 7	Financial Statements	34
Item 8	Changes in and Disagreements with Accountants on Accounting and Financial Disclosures	34
Item 8A	Controls and Procedures	34
Part III		
Item 9	Directors, Executive Officers, Promoters and Control Persons; Compliance with Section 16(a) of the Exchange Act	34
Item 10	Executive Compensation	38
Item 11	Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters	40
Item 12	Certain Relationships and Related Transactions	42
Item 13	Exhibits and Reports on Form 8-K	44
Item 14	Principal Accountant's Fees and Services	48
Signatures		49

Caution Regarding Forward-Looking Information

All statements contained in this Form 10-KSB, other than statements of historical facts, that address future activities, events or developments are forward-looking statements, including, but not limited to, statements containing the words “believe,” “anticipate,” “expect” and words of similar import. These statements are based on certain assumptions and analyses made by us in light of our experience and our assessment of historical trends, current conditions and expected future developments as well as other factors we believe are appropriate under the circumstances. However, whether actual results will conform to the expectations and predictions of management is subject to a number of risks and uncertainties that may cause actual results to differ materially.

Such risks include, among others, the following: international, national and local general economic and market conditions: our ability to sustain, manage or forecast our growth; raw material costs and availability; new product development and introduction; existing government regulations and changes in, or the failure to comply with, government regulations; adverse publicity; competition; the loss of significant customers or suppliers; fluctuations and difficulty in forecasting operating results; changes in business strategy or development plans; business disruptions; the ability to attract and retain qualified personnel; the ability to protect technology; and other factors referenced in this and previous filings.

Consequently, all of the forward-looking statements made in this Form 10-KSB are qualified by these cautionary statements and there can be no assurance that the actual results anticipated by management will be realized or, even if substantially realized, that they will have the expected consequences to or effects on our business operations.

As used in this Form 10-KSB, unless the context requires otherwise, “we” or “us” or the “Company” means IsoRay, Inc. (formerly Century Park Pictures Corporation).

PART I

ITEM 1 - DESCRIPTION OF BUSINESS

General

The Company was organized under Minnesota law in 1983.

The Company had no operations, assets or liabilities since its fiscal year ended September 30, 1999 through June 30, 2005.

On May 27, 2005, the Company, a newly-formed, wholly-owned subsidiary, Century Park Transitory Subsidiary, Inc., a Delaware corporation, Thomas Scallen and Anthony Silverman, shareholders of the Company, and IsoRay Medical, Inc., a Delaware corporation entered into a Merger Agreement (“Merger”). On July 28, 2005, the Merger closed. As a result of the Merger, IsoRay Medical, Inc. became a wholly-owned subsidiary of the Company. The Company concurrently changed its name to IsoRay, Inc. In the Merger, the IsoRay stockholders received approximately 82% of the then outstanding securities of the Company, as described below.

The Company issued shares of its common stock and shares of its preferred stock to holders of common and preferred stock of IsoRay Medical, Inc. at a rate of 0.842362 share of the Company’s common stock for each share of IsoRay Medical, Inc. stock. Options and warrants to purchase common and preferred stock of IsoRay Medical, Inc. were also converted at the same rate into options and warrants to purchase common and preferred stock of the Company. At the

time of the Merger and following its recent 1:30 reverse stock split, the Company had 2,498,319 shares of common stock outstanding. Following the Merger, the Company had 10,237,797 shares of common and preferred stock outstanding. The total amount of shares outstanding, on a fully-diluted basis, post merger was 13,880,822, which included not only shares of common stock, but also shares of preferred stock, warrants, options and convertible debentures that could be exercised or converted into shares of common stock. Following the Merger, on a fully diluted basis, the shareholders of IsoRay Medical, Inc. owned approximately 82% of the Company's outstanding securities.

Description of Former Business Operations

Certain Defined Terms

The technical terms defined below are important to understand as they are used throughout this report and particularly in this discussion of the business of IsoRay Medical. When used in this report, unless the context requires otherwise:

“Brachytherapy” refers to the process of placing therapeutic radiation sources in, or near, diseased tissue. Brachytherapy is derived from a Greek term meaning “short distance” therapy.

“Cesium-131” or “^{131}Cs” is an isotope of the element Cesium that gives off low energy, “soft” x-rays as it decays. Cesium-131 decays to 50% of its original activity every 9.7 days, becoming essentially inert after 100 days.

“EBRT” (external beam radiation therapy) is the external treatment of prostate cancer using an x-ray-like machine that targets a beam of radiation at the cancer site. The treatment damages genetic material within the cancer cells, which prevents the cells from growing and the affected cells eventually die. Treatments are generally performed at an outpatient center five days a week for seven or eight weeks.

“Half-life” means the time required for a radioisotope to decay to one-half of its previous activity. The amount of radiation emitted thus decreases to 25% of original activity in two half-lives, 12.5% in three half-lives, and so on.

“Isotope” refers to atoms of the same element that have different atomic masses. The word “isotope” means “same place,” referring to the fact that isotopes of a given element have the same atomic number and hence occupy the same place in the Periodic Table of the Elements. Thus, they are very similar in their chemical behavior.

“^{131}Cs seed” is the name by which IsoRay Medical’s first product, the Cesium-131-based brachytherapy seed, is currently known.

“Pure-beta particle emitter” is a radioisotope whose only emissions during radioactive decay are beta particles (electrons). Beta particles can travel several millimeters in tissue.

“RP” (radical prostatectomy or prostatectomy) is the complete surgical removal of the prostate, under significant anesthesia. Two main types of surgery have evolved: nerve-sparing and non nerve-sparing. The nerve-sparing surgery is designed to minimize damage to the nerves that control penile erection.

“Radiobiologic” is characteristic of the effects of radiation on organisms or tissues, most commonly the effectiveness of therapeutic radiation in interrupting cell growth and replication.

“Radioisotope” is a natural or man-made isotope of an element that spontaneously decays while emitting ionizing radiation.

“Seed” is a common term for small radiation sources consisting of a radioisotope sealed within a biocompatible capsule such as gold or titanium, suitable for temporary or permanent brachytherapy implantation.

“Therapeutic radiation” refers to ionizing radiation with sufficient energy to disrupt basic biological processes of cells.

“Yttrium-90” or “^{90}Y” is a radioisotope that emits high energy beta particles with a half-life of 2.67 days.

“Zirconium-90” is a stable (non-radioactive) decay product of Yttrium-90.

2

Overview

IsoRay Medical, Inc. was formed on June 15, 2004 as a corporation in the State of Delaware, and in October 2004 it merged with two predecessor companies to combine all of the IsoRay operations into one company.

IsoRay Medical intends to utilize its patented radioisotope technology, experienced chemists and engineers, and management team to create a major therapeutic medical isotope and medical device company with a goal of providing improved patient outcomes in the treatment of prostate cancer and other solid cancer tumors. IsoRay Medical began production and sales of its initial Food and Drug Administration (“FDA”) approved product, the IsoRay ^{131}Cs brachytherapy seed, in October 2004 for the treatment of prostate cancer. Management believes its technology will allow it to capture a leadership position in an expanded brachytherapy market. The more clinically beneficial characteristics of the Cesium-131 (Cs-131 or ^{131}Cs) isotope are expected to decrease radiation exposure to the patient and reduce the severity and duration of side effects, while treating cancer cells as effectively, if not more so than other isotopes used in seed brachytherapy. Cesium-131 could also enable meaningful penetration in other solid tumor applications such as breast, lung, liver, brain and pancreatic cancer, expanding the total available market opportunity. The second radioisotope, Yttrium-90 (Y-90 or ^{90}Y), is currently being used in the treatment of non-Hodgkin’s lymphoma and is in clinical trials for other applications. Other manufacturers have received FDA approval for ^{90}Y and IsoRay Medical believes production will not require clinical trials or an extensive FDA application process. Production is expected to begin in 2006.

Brachytherapy seeds are small devices used in an internal radiation therapy procedure. In recent years the procedure has become one of the primary treatments for prostate cancer and is now used more often than surgical removal of the prostate. The brachytherapy procedure places radioactive seeds as close as possible to (in or near) the cancer tumor (the word “brachytherapy” means close therapy). The seeds deliver therapeutic radiation by killing the tumor cells and cells located in the immediate vicinity of the tumor while minimizing exposure to adjacent healthy tissue. This allows doctors to administer a higher dose of radiation at one time than is possible with external beam radiation. Each seed contains a radioisotope sealed within a welded titanium capsule. Approximately 85 to 135 seeds are permanently implanted in the prostate in a 45-minute outpatient procedure. The isotope decays over time and the seeds become inert. The seeds may be used as a primary treatment or, in conjunction with other treatment modalities such as external beam radiation therapy, chemotherapy, or as treatment for residual disease after excision of primary tumors.

Management believes that the IsoRay ^{131}Cs seed represents the first major advancement in brachytherapy technology in over 18 years with attributes that could make it the long term “seed of choice” for internal radiation procedures. The ^{131}Cs seed has FDA approval for treatment of malignant disease (e.g. cancers of the head and neck, brain, liver, lung, breast, prostate, etc.) and may be used in surface, interstitial, and intracavity applications for tumors with known radiosensitivity.

The ^{131}Cs isotope appears to have specific clinical advantages for treating cancer over Iodine-125 (I-125 or ^{125}I) and Palladium-103 (Pd-103 or ^{103}Pd), the other isotopes commonly used in brachytherapy procedures. IsoRay Medical believes that the short half-life and higher dose rate characteristics of ^{131}Cs will expand industry applications and facilitate meaningful penetration into the treatment of other forms of cancer tumors such as breast cancer. The shorter half-life of 9.7 days for ^{131}Cs (versus 17.5 days for ^{103}Pd and 60 days for ^{125}I) mitigates negative effects of long radiation periods on healthy tissue and is believed to reduce the duration of certain side effects. The higher initial dose rate is believed to be more effective on fast growing cancers by aggressively attacking cancer cells and disrupting cancer cell re-population cycles. The characteristics of ^{131}Cs may result in the use of 10-30% fewer seeds per procedure thereby reducing the total physical radiation dose to the patient and reducing the costs of the procedure for both third party payers and the patient.

IsoRay Medical's second product, Yttrium-90, is also a short-lived (half-life of 64 hrs) radioisotope that is already used in the treatment of non-Hodgkin's lymphoma, leukemia, ovarian cancer, prostate cancer, osteosarcomas, and tumors of the breast, lung, kidney, colon and brain. These applications apply primarily to metastasized, or spread through the body, cancers. Currently more than 20 clinical trials using ^{90}Y are underway in the U.S. Yttrium-90 is also used at multiple treatment centers in Europe. Several members of the current IsoRay Medical team developed a process to produce high-purity ^{90}Y for medical applications during the mid-1990s. Currently over 90 percent of the ^{90}Y used in the U.S. is imported. IsoRay Medical's management believes there is an immediate market opportunity for a highly purified ^{90}Y.

3

IsoRay Medical and its predecessor companies have accomplished the following key milestones:

- Opened a new manufacturing and production facility (October 2005);
- Deployed a direct sales force to the market (July 2004 - July 2005);
- Developed a treatment protocol for prostate cancer with a leading oncologist (January 2005);
- Treated the first patient (October 2004);
- Commenced production of the ^{131}Cs seed (August 2004);
- Filed five additional patent applications for ^{131}Cs and ^{90}Y processes (November 2003 - August 2004);
- Obtained a Nuclear Regulatory Commission Sealed Source and Device Registration required by the Washington State Department of Health and the FDA (September 2004);
- Received a Radioactive Materials License from the Washington State Department of Health (July 2004);
- Implemented an ISO-9000 Quality Management System and production operating procedures (under continuing development);
- Signed a Commercial Work for Others Agreement between Battelle (manager of the Pacific Northwest National Laboratory or PNNL) and IsoRay Medical, allowing initial production of seeds through 2006 at PNNL (April 2004);
- Raised over $10.3 M in debt and equity funding (September 2003 - July 2005)
- Obtained favorable Medicare reimbursement codes for the Cs-131 brachytherapy seed (November 2003);
- Obtained FDA 510(k) approval to market the first product: the ^{131}Cs brachytherapy seed (March 2003);
- Completed initial radioactive seed production, design verification, computer modeling of the radiation profile, and actual dosimetric data compiled by the National Institute of Standards and Technology and PNNL (October 2002); and
- Obtained initial patent for ^{131}Cs isotope separation and purification (May 2000).

Industry Information

Incidence of Prostate Cancer

Excluding skin cancer, prostate cancer is the most common form of cancer, and the second leading cause of cancer deaths in men. The American Cancer Society estimated there will be about 232,090 new cases of prostate cancer diagnosed and an estimated 30,350 deaths associated with the disease in the United States during 2005. Because of early detection techniques (e.g., screening for prostate specific antigen, or PSA) approximately 70% (162,400) of these cases are potentially treatable with seed brachytherapy, when the cancers are still locally confined within the prostate.

The prostate is a walnut-sized gland surrounding the male urethra, located below the bladder and adjacent to the rectum. The two most prevalent prostate diseases are benign prostatic hyperplasia (BPH) and prostate cancer. BPH is

a non-cancerous enlargement of the innermost part of the prostate. Prostate cancer is a malignant tumor that begins most often in the periphery of the gland and, like other forms of cancer, may spread beyond the prostate to other parts of the body.

Prostate cancer incidence and mortality increase with age. Prostate cancer is found most often in men who are over the age of 50. More than seven out of ten men diagnosed with prostate cancer are over the age of 65. According to the American Cancer Society, approximately one man in six will be diagnosed with prostate cancer during his lifetime, although only one man in thirty-three will die of this disease.

In addition to age, other risk factors are linked to prostate cancer, such as genetics. Men who have relatives that have been affected, especially if the relatives were young at the time of diagnosis, have an even higher risk of contracting the disease. Researchers have discovered that changes in certain genes, influenced by DNA mutations inherited from a parent, may cause some men to be more inclined to develop prostate cancer. It has also been suggested that environmental factors such as exposure to cancer-causing chemicals or radiation may cause DNA mutations in many organs, but this theory has not been confirmed. Another factor that may contribute to prostate cancer is diet, with diets high in fat and high in calcium possibly increasing the risk of prostate cancer.

The American Cancer Society recommends that men without symptoms, risk factors and who have a life expectancy of at least ten years, should begin regular annual medical exams at the age of 50, and believes that health care providers should offer as part of the exam the prostate-specific antigen (PSA) blood test and a digital rectal examination. The PSA blood test determines the amount of prostate specific antigen present in the blood. PSA is found in a protein secreted by the prostate, and elevated levels of PSA can be associated with either prostatitis (a noncancerous inflammatory condition) or a proliferation of cancer cells in the prostate. Transrectal ultrasound tests and biopsies are typically performed on patients with elevated PSA readings to confirm the existence of cancer.

A tumor found by a prostate biopsy is usually assigned a grade by a pathologist. The most common prostate cancer grading system is called the Gleason grading system. A Gleason score, which ranges from 2 to 10, usually is used to estimate the tumor’s growth rate. Typically, the lower the score, the slower the cancer grows. Most localized cancers of the prostate gland are associated with an intermediate score ranging from Gleason scores 4 through 6.

Staging is the process of determining how far the cancer has spread. The treatment and recovery outlook depend on the stage of the cancer. The TNM system is the staging process used most often. The TNM system describes the extent of the primary tumor (T stage), whether the cancer has spread to nearby lymph nodes (N stage), and the absence or presence of distant metastasis (M stage). The TNM descriptions can be grouped together with stages labeled 0 through IV (0-4). The higher the number, the further the cancer has spread. The following table summarizes the various stages of prostate cancer.

Stages	Characteristics of prostate cancer
T1 or T2	Localized in the prostate
T3 or T4	Locally advanced
N+ or M+	Spread to pelvic lymph nodes (N+)or distant organs (M+)

Treatment Options and Protocol

In addition to brachytherapy, localized prostate cancer is commonly treated with radical prostatectomy (RP) and external beam radiation therapy (EBRT). Recently, intensity modulated radiation therapy (IMRT) has seen increased application, particularly in combination with brachytherapy for cancers that have begun to spread beyond the prostate. Other treatments include cryosurgery, hormone therapy, watchful waiting, and finasteride, a drug commonly prescribed to treat benign enlargement of the prostate and male baldness. Some of these therapies may be combined in special cases to address a specific cancer stage or patient need. When the cancerous tissue is not completely eliminated, the cancer typically returns to the primary site, often with metastases to other areas.

Radical Prostatectomy. Historically the most common treatment option for prostate cancer, radical prostatectomy is an invasive surgical procedure in which the entire prostate gland is removed. RP is performed under general anesthesia and typically involves a hospital stay of several days for patient observation and recovery. This procedure is often associated with relatively high rates of impotence and incontinence. For instance, a study published in the *Journal of the American Medical Association* in January 2000 reported that approximately 60% of men who had received RP reported erectile dysfunction as a result of surgery. The same report found that approximately 40% of the patients studied reported at least occasional incontinence. New bilateral nerve-sparing techniques are currently being used more frequently in order to address these side effects, but these techniques require a high degree of surgical skill. RP is typically more expensive than other common treatment modalities.

External Beam Radiation Therapy. EBRT allows patients to receive treatment on an outpatient basis and at a lower cost than RP. EBRT involves directing a beam of radiation from outside the body at the prostate gland in order to destroy cancerous tissue. The course of treatment usually takes seven to eight weeks to deliver the total dose of radiation prescribed to kill the tumor. Studies have shown, however, that the ten-year disease free survival rates with treatment through EBRT are less than the disease free survival rates after RP or brachytherapy treatment. In addition, because the radiation beam travels through the body to reach the prostate, normal tissue lying in the path of the radiation beam is also damaged. Other side effects are associated with EBRT. For instance, rectal wall damage caused by the radiation beam is a noted negative side effect. Data suggests that between 30% and 40% of the patients who undergo EBRT suffer problems with erectile dysfunction after treatment.

Intensity Modulated Radiation Therapy. IMRT is a newer, more advanced form of EBRT in which sophisticated computer control is used to aim the beam at the target volume from multiple different angles and to vary the intensity of the beam. Thus, damage to normal tissue and critical structures is minimized by distributing the unwanted radiation over a larger geometric area. The course of treatment is similar to EBRT and requires daily doses over a period of seven to eight weeks to deliver the total dose of radiation prescribed to kill the tumor. IMRT is relatively new and thus not widely available for use as a treatment modality. As a result fewer clinical data regarding treatment effectiveness and the incidence of side effects are available. One advantage of IMRT, and to some extent EBRT, is the ability to treat cancers that have begun to spread from the tumor site. An increasingly popular therapy for patients with more advanced prostate cancer is a combination of IMRT with seed implant brachytherapy (which until protocols are developed, does not include the Cesium-131 seed).

Cryosurgery. Cryosurgery, a procedure in which tissue is frozen to destroy tumors, is another treatment option for prostate cancer. Currently, this procedure is less widely used, although promising treatment outcomes have been reported. Cryosurgery typically requires a one to two day hospital stay and is associated with higher rates of impotence and other side effects than brachytherapy.

Other Treatments. Other treatments include hormone therapy and chemotherapy, which may be used to reduce the size of cancerous tumors. However, these treatments are not intended to ultimately cure a patient of prostate cancer. Instead, such treatment choices are made by physicians in an attempt to extend patients' lives if the cancer has reached an advanced stage or as ancillary treatment methods used in conjunction with other treatment modalities. Common side effects of hormone therapy are impotence, decreased libido and development of breasts, and common side effects of chemotherapy are nausea, hair loss and fatigue.

"Watchful waiting," while not a treatment, is recommended by some physicians in extreme circumstances based on the severity and growth rate of the disease, as well as the age and life expectancy of the patient. Physicians and patients who choose watchful waiting are frequently seeking to avoid the negative side effects associated with RP or other treatment modalities. Through careful monitoring of PSA levels and close examination for advancing symptoms of prostate cancer, physicians may choose more active treatments at a later date.

Treatment Protocol. Prostate cancer patients electing seed therapy first undergo an ultrasound test or CT scan, which generates a two-dimensional image of the prostate. With the assistance of a computer program, a three-dimensional treatment plan is created that calculates the number and placement of the seeds required for the best possible distribution of radiation to the prostate. Once the implant model has been constructed, the procedure is scheduled and the seeds are ordered. The number of seeds implanted normally ranges from 85 to 135, with the number of seeds varying with the size of the prostate. The procedure is usually performed under local anesthesia in an outpatient setting. The seeds are implanted using needles inserted into the prostate. When all seeds have been inserted, seed placement is verified through an ultrasound image, CT scan, fluoroscope or MRI. An experienced practitioner typically performs the procedure in approximately 45 minutes, with the patient normally returning home the same day. Most patients are able to return to their normal activities within one or two days following the procedure.

Origin of Brachytherapy seeds

One of the first reports in the medical literature regarding brachytherapy seeds that deliver "soft x-ray" radiation directly to tumors by permanent implantation appeared in 1965, authored by Donald C. Lawrence and Dr. Ulrich K. Henschke. Don Lawrence later developed and patented the titanium-encapsulated ^{125}I brachytherapy seed. His company, Lawrence Soft Ray Inc., provided the world's supply of seeds from 1967 to 1978 until the 3M Corporation purchased the technology. Eventually 3M sold the business to Amersham PLC, which spun off this business to its division ONCURA, today the market leader in Iodine-125 seeds. All commercially available seeds trace their origin to Mr. Lawrence's invention. Don Lawrence was a founder of IsoRay, LLC, the first predecessor company to IsoRay Medical.

Brachytherapy has been used as a treatment for prostate cancer for more than 30 years. Formerly, seeds containing the radioactive isotope Iodine-125 were implanted in prostate tumors through open surgery. However, this technique fell into disfavor because the seeds were often haphazardly arranged resulting in radiation not reaching all of the targeted cancerous tissue. Compounding this was the fact that often an unintended radiation dose was delivered to healthy surrounding tissues, particularly the urethra and rectum. Originally, brachytherapy earned an unfavorable reputation because the early adopters did not have the imaging technologies needed for accurate placement of the seeds. This resulted in poor tumor control and greater damage to surrounding healthy tissue. Since the introduction of the ultrasound-guided, transperineal implantation technique in the late 1980's, brachytherapy has become a treatment that not only provides excellent therapeutic value but is very convenient and economical for the patient. The benefits of the advancements in imaging, computer dose planning, and the actual implant procedure are borne by the improved clinical results achieved using modern brachytherapy techniques.

The introduction of Palladium-103 in the mid-1980s represented a major technology advancement in brachytherapy and played a significant role in the dramatic increase in the number of brachytherapy procedures performed. Within a relatively short period of time, ^{103}Pd captured 40% of the growing brachytherapy market.

Cesium-131 represents the first major advancement in brachytherapy technology in over 18 years with attributes that management believes could make it the long term "seed of choice" for internal radiation procedures. Management believes that the ^{131}Cs seed has specific clinical advantages for treating cancer over ^{125}I and ^{103}Pd.

There is a large and growing potential market for the Company's products. Several significant clinical and market factors are contributing to the increasing popularity of the brachytherapy procedure. In Europe brachytherapy is growing in excess of 20% per year and it is expected that market growth in the U.S. will also increase dramatically. In 1996 only 4% of prostate cancer cases were treated with brachytherapy, or about 8,000 procedures. In 2005, it is estimated that over 60,000 brachytherapy procedures will be performed for prostate cancer. Brachytherapy as a treatment is now more common than radical prostatectomy and has become the treatment of choice for early-stage prostate cancer. Considerable attention is now being given to high risk and faster growing prostrate cancers as well. Brachytherapy has significant advantages over competing treatments including lower cost, better survival data, fewer side effects, a faster recovery time and the convenience of a single outpatient procedure that generally lasts 45 minutes (Merrick, et al., *Techniques in Urology*, Vol. 7, 2001; Potters, et al., *Journal of Urology*, May 2005; Sharkey, et al., *Current Urology Reports*, 2002).

Clinical Results

Long term survival data are now available for brachytherapy with ^{103}Pd and ^{125}I, which support the efficacy of brachytherapy. Clinical data indicate that brachytherapy offers success rates for early-stage prostate cancer treatment that are equal to or better than those of RP or EBRT. While clinical studies of brachytherapy to date have focused on results from brachytherapy with Pd-103 and I-125, management believes that this data will be relevant for brachytherapy with Cs-131, and Cs-131 may offer improved clinical outcomes over Pd-103 and I-125, given its shorter half-life and higher energy.

Improved patient outcomes. A number of published studies on the use of ^{103}Pd and ^{125}I brachytherapy in the treatment of early-stage prostate cancer have been very positive. We have not obtained consent to cite the studies listed below.

· A twelve-year clinical study published in the 2004 Supplement of the *International Journal of Radiation Oncology, Biology and Physics*, reported that the relative survival rate is 84% for low risk cancer patients, 78% for intermediate risk cancer patients and 68% for high risk cancer patients. The study was conducted by Dr. Lou Potters, et al. of the New York Prostate Institute and included 1,504 patients treated with brachytherapy between 1992 and 2000.

· A study published in the January 2004 issue of the *International Journal of Radiation Oncology, Biology and Physics*, reported that brachytherapy, radical prostatectomy, high-dose external beam radiation therapy and combined therapies produced similar cure rates. The study was conducted by Dr. Patrick Kupelian, Dr. Louis Potters, et al. and included 2,991 patients with Stage T1 or T2 prostate cancer. Of these patients, 35% of patients underwent surgery, 16% received low-dose EBRT, 10% received high-dose EBRT, 7% received combination therapy and 32% received brachytherapy. After five years, the biochemical relapse-free survival rate was 83% for brachytherapy, 81% for radical prostatectomy, 81% for high-dose EBRT, 77% for combination therapy and 51% for low-dose EBRT.

· A nine-year clinical study published in the March 2000 issue of the *International Journal of Radiation Oncology, Biology and Physics*, reported that 83.5% of patients treated with the Pd-103 device were cancer-free at nine years. The study was conducted by Dr. John Blasko of the Seattle Prostate Institute and included 230 patients with clinical stage T1 and T2 prostate cancer. Only 3% experienced cancer recurrence in the prostate.

· Results from a 10-year study conducted by Dr. Datolli and Dr. Wallner published in the *International Journal of Radiation Oncology, Biology and Physics* in September 2002, were presented at the October 2002 American Society for Therapeutic Radiology and Oncology (ASTRO) conference confirming the effectiveness of the Pd-103 seed in patients with aggressive cancer who previously were considered poor candidates for brachytherapy. The 10-year study was comprised of 175 patients with Stage T2-T3 prostate cancer treated from 1991 through 1995. Of these patients, 79 percent remained completely free of cancer without the use of hormonal therapy or chemotherapy.

· A study by the Northwest Prostate Institute in Seattle, Washington reported 79% disease-free survival at 12 years for brachytherapy in combination with external beam radiation (Ragde, *et al.*, *Cancer,* July 2000). The chance of cure from brachytherapy is nearly 50% higher than for other therapies for men with large cancers (PSA 10-20) and over twice as high as other therapies for men with the largest cancers (PSA 20+) (K. Wallner, *Prostate Cancer: A Non-Surgical Perspective,* Smart Medicine Press, 2000).

Reduced Incidence of Side Effects. Sexual potency and urinary incontinence are two major concerns men face when choosing among various forms of treatment for prostate cancer. Because the IsoRay ^{131}Cs seed delivers a highly concentrated and confined dose of radiation directly to the prostate, healthy surrounding tissues and organs typically experience less radiation exposure. Management believes, and initial results appear to support, that this should result in lower incidence of side effects and complications than may be incurred with other conventional therapies, and when side effects do occur, they should resolve more rapidly than those experienced with I-125 and Pd-103 isotopes.

Favorable Market Factors

Lower Treatment Cost. The total one-time cost of brachytherapy ranges from $10,000 to $17,000 per procedure. This is less than the cost of a radical prostatectomy or RP, which ranges from $17,000 to $20,000, excluding treatment for side effects and post-operative complications. Brachytherapy cost is comparable to the cost of EBRT (external beam radiation), which is approximately $14,000 up to $35,000 for a seven to nine week course of treatment.

Favorable Demographics. Prostate cancer incidence and mortality increase with age. Prostate cancer is found most often in men who are over the age of 50. The National Cancer Institute has reported that the incidence of prostate cancer increases dramatically in men over the age of 55. Currently, one out of every six men is at lifetime risk of developing prostate cancer. More than seven out of ten men diagnosed with prostate cancer are over the age of 65. At

the age of 70, the chance of having prostate cancer is 12 times greater than at age 50. According to the American Cancer Society, prostate cancer incidence rates increased between 1988 and 1992 due to earlier diagnosis in men who otherwise had no sign of symptoms. Early screening has fostered a decline in the prostate cancer death rate since 1990.

The number of prostate cancer cases in the U.S. is expected to increase due to the expanding population of men over the age of 55. The U.S. Census Bureau estimates this segment of the population will increase from 25.9 million men in 2000 to 32 million men by 2008 - a 24% increase. Extrapolating that data, management believes that the U.S. will provide over 180,000 candidates annually for prostate brachytherapy by 2008.

Increased PSA Screening. Early PSA screening and testing leads to early diagnosis. The American Cancer Society recommends that men without symptoms or risk factors and who have a life expectancy of at least ten years, should begin regular annual medical exams at the age of 50, and believes that health care providers should offer as part of the exam the prostate-specific antigen blood test. The PSA blood test determines the amount of prostate specific antigen present in the blood. PSA is found in a protein secreted by the prostate, and elevated levels of PSA can be associated with either prostatitis (a noncancerous inflammatory condition) or a proliferation of cancer cells in the prostate. Industry studies have shown that the PSA test can detect prostate cancer up to five years earlier than the digital rectal exam. Ultrasound tests and biopsies are typically performed on patients with elevated PSA readings to confirm the existence of cancer.

Our Strategy

The key elements of IsoRay Medical’s strategy include:

· *Continue to introduce the IsoRay ^{131}Cs seed into the U.S. brachytherapy market*. Utilizing a direct sales organization and selected channel partners, IsoRay Medical intends to capture a leadership position by expanding overall use of the brachytherapy procedure for prostate cancer, capturing much of the incremental market growth and taking market share from existing competitors.

· *Create a state-of-the-art manufacturing process*. IsoRay Medical has constructed a state-of- the-art manufacturing facility in Richland, Washington in its newly leased facility, to implement our proprietary manufacturing process which is designed to improve profit margins and provide adequate manufacturing capacity to support future growth and ensure quality control. If Initiative 297 presents a strategic roadblock to the Company, IsoRay plans to construct a permanent manufacturing facility in another state. Working with leading scientists, IsoRay Medical intends to design and create a proprietary separation process to manufacture enriched barium, a key source material for ^{131}Cs, to ensure adequate supply and greater manufacturing efficiencies. Also planned is a value-added repackaging service to supply pre-loaded needles, stranded seeds and pre-loaded cartridges used in the implant procedure. IsoRay Medical plans to enter into a long-term program with a leading brachytherapy seed automation design and engineering company to design and build a highly automated manufacturing process to help ensure consistent quality and improve profitability.

· *Introduce Cesium-131 therapies for other solid cancer tumors*. IsoRay Medical intends to partner with other companies to develop the appropriate delivery technology and therapeutic delivery systems for treatment of other solid cancer tumors such as breast, lung, liver, pancreas, neck, and brain cancer. IsoRay Medical’s management believes that the first major opportunities may be for the use of Cesium-131 in adjunct therapy for the treatment of residual lung and breast cancers.

· *Introduce other isotope products to the U.S. market*. IsoRay Medical plans to introduce its Yttrium-90 radioisotope in 2006. Currently, FDA approved ^{90}Y manufactured by other suppliers is used in the treatment of non-Hodgkin’s lymphoma and is in clinical trials for other applications. Other products may be added in the future as they are developed. IsoRay Medical has the ability to make several different isotopes for multiple medical and industrial applications. During 2005 the Company has identified and prioritized additional market opportunities for these isotopes.

· *Support clinical research and sustained product development*. The Company plans to structure and support clinical studies on the therapeutic benefits of Cs-131 for the treatment of solid tumors and other patient benefits. We are and

will continue to support clinical studies with several leading radiation oncologists to clinically document patient outcomes, provide support for our product claims and compare the performance of our seeds to competing seeds. IsoRay Medical plans to sustain long-term growth by implementing research and development programs with leading medical institutions in the U.S. to identify and develop other applications for IsoRay Medical’s core radioisotope technology.

Management believes there is a large and growing addressable market for IsoRay Medical's products. Several factors appear to contribute to the increasing popularity of the brachytherapy procedure. Long-term survival data are now available for brachytherapy (other than with respect to treatment from Cs-131 seeds). Brachytherapy has become the treatment of choice for not only early-stage prostate cancer but is now being considered for treatment of fast growing, aggressive tumors. Brachytherapy is now more common than surgery (prostatectomy). Brachytherapy has significant advantages over competing treatments including lower cost, better survival data, fewer side effects, a faster recovery time and the convenience of an outpatient procedure that generally lasts 45 minutes. Over 60,000 procedures were forecasted to occur in the U.S. in 2005. At the October 6, 2005 Cs-131 seed price of $55, this represents a potential $330 million seed market that is forecast to grow substantially by 2009 according to a recent market survey performed by Frost & Sullivan, a nationally recognized market research firm. IsoRay Medical's management believes that the ^{131}Cs seed will add incremental growth to the existing brachytherapy seed market as physicians who are currently reluctant to recommend brachytherapy for their prostate patients due, in part, to side effects caused by longer-lived isotopes, become comfortable with the shorter half-life of ^{131}Cs, and the anticipated reduction of side effects.

Products

IsoRay Medical markets the Cesium-131 seed and intends to market Yttrium-90 and other radioactive isotopes in the future. Additionally, it will attempt to create a market, primarily in clinical trials, for the liquid Cs-131 isotope, which is created in the production of IsoRay Medical's ^{131}Cs seed.

Cs-131 Seed Product Description and Use in Cancer Treatment

Brachytherapy seeds are small devices that deliver therapeutic radiation directly to tumors. Each seed contains a radioisotope sealed within a welded titanium case. In prostate cancer procedures, approximately 85 to 135 seeds are permanently implanted in a 45-minute outpatient procedure. The isotope decays over time, and the seeds become inert. The seeds may be used as a primary treatment or in conjunction with other treatment modalities such as external beam radiation therapy, chemotherapy, or as treatment for residual disease after excision of primary tumors.

Significant advantages of brachytherapy over competing treatments include: fewer side effects (the likelihood of impotence and incontinence is reduced when seeds are used to treat prostate cancer); short, convenient outpatient procedure (typically 45 minutes); faster recovery time (days vs. weeks); lower cost than other treatment modalities; higher cure rates for solid tumors; less pain; and overall considerably better quality of life. The primary disadvantage of brachytherapy is subjecting the human body to radiation and the side effects of radiation. Physician errors in seed placement and the number of seeds implanted may also result in the failure to eradicate the cancer or in negative side effects from over-radiation of certain tissues in the body.

A diagram of the IsoRay seed appears in Figure 1. The seed contains an x-ray opaque marker surrounded by a ceramic substrate to which the isotope is chemically attached. The seed core is placed in a titanium tube and precision laser welded to form a hermetically sealed source of therapeutic radiation suitable for permanent implantation. The x-ray marker allows the physician to accurately determine seed placement within the tumor.

Figure 1: Cross section of ^{131}Cs seed

Competitive Advantages of Cs-131

^{131}Cs has specific clinical advantages for treating cancer over I-125 and Pd-103, the other isotopes currently used in brachytherapy seeds. The table below highlights the key differences of the three seeds. The Company believes that the short half-life, high-energy characteristics of ^{131}Cs will increase industry growth and facilitate meaningful penetration into the treatment of other forms of cancer such as breast cancer.

Brachytherapy Isotope Comparison

	Cesium-131	**Palladium-103**	**Iodine-125**
Half Life	9.7 Days	17.5 days	60 days
Energy	29 KeV^{+}	22 KeV^{+}	28 KeV^{+}
Dose Delivery	90% in 33 days	90% in 58 days	90% in 204 days
Total Dose	100 Gy	125 Gy	145 Gy
Anisotropy Factor*	.969	.877 (TheraSeed® 2000)	.930 (OncoSeed® 6711)
*Degree of symmetry of therapeutic dose, a factor of 1.00 indicates symmetry. $^{+}$KeV = kiloelectron volt, a standard unit of measurement for electrical energy.			

Shorter half-life. The Company believes that Cesium-131's shorter half-life of 9.7 days will prove to have greater biological effectiveness, will mitigate the negative effects of long radiation periods on healthy tissue and will reduce the duration of any side effects. A shorter half-life produces more intense therapeutic radiation over a shorter period of time and may reduce the potential for cancer cell survival and tumor recurrence. Radiobiological studies indicate that shorter-lived isotopes are more effective against faster growing tumors (Dicker, et. al., *Semin. Urol. Onc.* 18:2, May 2000). Other researchers conclude that "half-lives in the approximate range 4-17 days are likely to be significantly better for a wide range of tumor types for which the radiobiologic characteristics may not be precisely known in advance." (Armpilia CI, et. al., *Int. J. Rad. Oncol. Biol. Phys.* 55:2, February 2003).

High energy. The Cs-131 isotope decay energy of 29 KeV (versus 22 KeV for Pd-103 and 28 KeV for I-125) generates a therapeutic radiation field that extends beyond the current dosimetry reference point of 1 cm. Pd-103 seeds emit radiation that does not penetrate as far in tissue (up to 40% lower than Cs-131). To compensate for this more Pd-103 seeds are required to attain the equivalent dose as if Cs-131 seeds were used. This increase in the number of seeds implanted increases the time and cost required to perform Pd-103-based procedures. The lower energy from ^{103}Pd seeds may also result in greater non-uniformity of the implant dose as dose rates near the surface of each seed must be higher to compensate for lower doses at greater distances from each seed. The high energy of Cs-131 can result in radiation toxicity if the dosage is not properly calculated by the implanting physician and staff.

Reduced side effects. Because the IsoRay ^{131}Cs seed device delivers a highly concentrated and confined dose of radiation directly to the prostate, healthy surrounding tissues and organs are exposed to less radiation than with other treatments. This should result in fewer and less severe side effects and complications than may be incurred with other conventional therapies.

Figure 2. Cs-131 seed Autoradiograph

Shape of radiation field. The shape of the radiation field generated by a ^{131}Cs seed is uniform, and this uniformity may result in better radiation dose coverage and improved therapeutic effectiveness. The adjacent picture is an autoradiograph (film exposed by radiation from the seed itself) of an IsoRay seed, which shows this uniformity of the radiation field that is expected to result in better radiation dose coverage. IsoRay Medical has conducted extensive computer modeling and testing of the seed design. The IsoRay seed has passed all Nuclear Regulatory Commission ("NRC") requirements for sealed radioactive sources. Dose uniformity was tested and the results compared well to those predicted by industry standard computer modeling techniques. In the third quarter of 2002, seeds were sent to the National Institute for Standards and Technology for calibration, and have undergone dosimetry testing according to American Association of Physicists in Medicine ("AAPM") protocols. The results of these tests were compiled in IsoRay Medical's 510(k) submission to the FDA and were subsequently published in the June 2004 issue of *Medical Physics*. The results of these tests showed superior dose characteristics relative to the leading I-125 and Pd-103 seeds.

Reduced costs. The characteristics of ^{131}Cs seeds described above may result in the use of 10%-30% less seeds per procedure, compared to other isotopes, thereby reducing the total physical radiation dose to the patient and reducing the costs of the procedure for the third party payers and the patient.

Yttrium-90

Y-90 and Cs-131 are short-lived isotopes that are well suited to treatment of tumors by cell-directed therapy. The Company plans to introduce its second product, Yttrium-90, in 2006. Y-90 is already available from other companies. When used in combination with molecular targeting agents, Y-90 is proving to be an ideal isotope to provide localized radiation therapy for various types of cancer, such as non-Hodgkin's lymphoma, leukemia, ovarian and prostate cancers, osteosarcomas, and tumors of the breast, lung, kidney, colon, and brain. Y-90's properties of short half-life, high specific activity, high energy and pure beta-emissions can be chemically attached to targeting agents that are highly selective for specific tumors. These targeting agents may include monoclonal antibodies, molecules derived from antibodies, peptides, or other tumor-specific molecules. Most Y-90 currently used in the U.S. is imported with varying degrees of quality. IsoRay Medical has developed a proprietary separation process that produces Y-90 that management believes will meet or exceed the purity and quality required for clinical trials and medical applications.

Y-90 is a significant component of several commercially available products. These products use radiopharmaceutical grade Y-90 derived using manufacturing methods and techniques that conform to current cGMP (current Good Manufacturing Practices), allowing them to be used invasively in commercially available healthcare products.

We intend to initially target the clinical trial market. Currently there are several clinical trials and medical applications involving Y-90 underway around the world that represent a potential market for Y-90. These customers hold significant growth potential, as products undergoing successful trials become approved for general use. Our strategy will be to attempt to develop exclusive sales arrangements with companies that are close to FDA approval or foreign companies authorized to commercially sell their products in various overseas markets.

Y-90 is a pure-beta particle emitter with a physical half-life of 64.1 hours (2.7 days) that decays to stable Zirconium-90. The average energy of the beta emissions from Y-90 is 2.37 MeV, with an effective path-length in tissue of 5.3 mm. This means that 90% of the energy is absorbed within a 5.3-mm radius.

Y-90 is manufactured by chemical separation from a long-lived Strontium-90 (Sr-90) generator stock. We intend to purchase or lease the Sr-90 feedstock from the U.S. DOE and international suppliers. Due to the radiological characteristics of Sr-90, initial processing will occur under stringent radiological controls in a highly shielded isolator or "hot cell" using remote manipulators. Following preliminary separation, the Y-90 may be further purified and converted to pharmaceutical grade material in a shielded environmentally-controlled glove box. After completing the separation process every two weeks (e.g., collecting or "milking" the therapeutic Y-90), the residual Sr-90 generator is recycled for subsequent separations. In theory, the Sr-90 generator can continue to generate Y-90 for decades. However, the process periodically requires infusion of new Sr-90. In addition to acquiring Sr-90, we will need to

acquire equipment and develop manufacturing procedures for the Y-90 isotope that meet cGMP criteria. While we initially plan to produce solely radiochemical purity Y-90, which does not need to meet the more stringent manufacturing standards required for radiopharmaceutical purity Y-90, we intend to develop our manufacturing methods to this higher level and produce radiopharmaceutical purity Y-90 in the future.

IsoRay Medical has identified four principal suppliers of Y-90: MDS Nordion (a division of MDS, Inc.), Perkin-Elmer, Inc., Amersham (part of General Electric Company) and Iso-Tex Diagnostics, Inc. If we begin marketing Y-90, these companies will be our principal competitors within this market.

Cs-131 Manufacturing Process

Cs-131 is a radioactive isotope that can be produced by the neutron bombardment of Barium-130. When Ba-130 is put into a nuclear reactor it becomes Ba-131, the radioactive material that is the parent of Cs-131. The process includes the following:

· *Isotope Generation*. The radioactive isotope Cs-131 is normally produced by placing a quantity of stable non-radioactive barium (ideally pure Ba-130) into the neutron flux of a nuclear reactor. The irradiation process converts a small fraction of this material into a radioactive form of barium (Ba-131). The Ba-131 decays by electron capture to the radioactive isotope of interest (Cs-131). IsoRay Medical has evaluated several international nuclear reactors and a few potential facilities in the United States. Due to the short half-life of both the Ba-131 and Cs-131 isotopes, these facilities must be capable of removing irradiated materials from the reactor core on a routine (e.g. weekly) basis. Reactor personnel will ship the irradiated barium on a pre-determined schedule to our facilities for subsequent separation, purification and seed assembly. The Company has identified more than five reactors in the U.S., Europe and the former Soviet Union that are capable of meeting these requirements. This routine isotope generation cycle at supplier reactors will allow significant quantities of Ba-131 to be on hand at our facilities for the completion of the rest of the manufacturing process. To ensure reliability of supply, we intend to seek agreements with multiple facilities to produce Ba-131. As of the date of this report, IsoRay Medical has agreements in place with two suppliers of irradiated Ba-131. The Company's agreement with Russia's Institute of Nuclear Materials for irradiated Ba-131 has a seven year term (ending August 25, 2012) and allows the Company to purchase irradiated Ba-131 for $300.00 per Curie of the isotope. The projected value of the agreement over its term is $30,000,000, with $300,000 worth of irradiated Ba-131 projected to be delivered in the first year. In addition, the Company is engaged in the development of a barium enrichment device that, if successful, should reduce the cost of producing Cs-131 while maintaining the purity and consistency required in the end product.

· *Isotope Separation and Purification*. Upon irradiation of the barium feedstock, the Ba-131 begins decaying to Cs-131. At pre-determined intervals the Cs-131 produced is separated from the barium feedstock and purified using a proprietary radiochemical separations process (patent applied for). Due to the high-energy decay of Ba-131, this process is performed under stringent radiological controls in a highly shielded isolator or "hot cell" using remote manipulators. After separating Cs-131 from the energetic Ba-131, subsequent seed processing may be performed in locally shielded fume hoods or glove boxes. If enriched barium feedstock is used, the residual barium remaining after subsequent Cs-131 separation cycles ("milkings") will be recycled back to the reactor facility for re-irradiation. This material will be recycled as many times as economically feasible, which should make the process more cost effective. As an alternative to performing the Cs-131 separation in our own facilities, IsoRay may enter into agreements with other entities to supply "raw" Cs-131 by performing the initial barium/cesium separation at their facilities, followed by final purification at IsoRay's facility.

· *Internal Seed Core Technology*. The purified Cs-131 isotope will be incorporated into an internal assembly that contains a binder, spacer and X-ray marker. This internal core assembly is subsequently inserted into a titanium case. The dimensional tolerance for each material is extremely important. Several carrier materials and placement methods have been evaluated, and through a process of elimination, we have developed favored materials and methods during our laboratory testing. The equipment necessary to produce the internal core includes accurate cutting and gauging devices, isotope incorporation vessels, reaction condition stabilization and monitoring systems, and tools for placing the core into the titanium tubing prior to seed welding.

- *Seed Welding*. Following production of the internal core and placement into the titanium capsule, a seed is hermetically sealed to produce a sealed radioactive source and biocompatible medical device. This manufacturing technology requires: accurate placement of seed components with respect to the welding head, accurate control of welding parameters to ensure uniform temperature and depth control of the weld, quality control assessment of the weld integrity, and removal of the finished product for downstream processing or rejection of unacceptable materials to waste. Inspection systems will be capable of identifying and classifying these variations for quality control ensuring a minimal amount of material is wasted. Finally, the rapid placement and removal of components from the welding zone will affect overall product throughput.

- *Quality Control*. We have established procedures and controls to meet all FDA and ISO 9001:2000 Quality Standards. Product quality and reliability will be secured by utilizing multiple sources of irradiation services, feedstock material, and other seed manufacturing components. An intensive production line preventive maintenance and spare parts program will be implemented. Also, an ongoing training program will be established for customer service to ensure that all regulatory requirements for the FDA, DOT and applicable nuclear radiation and health authorities are fulfilled.

The Company intends to implement a just-in-time production capability that is keenly responsive to customer input and orders to ensure that individual customers receive a higher level of customer service from us than from existing seed suppliers who have the luxury of longer lead times due to longer half-life products. Time from order to completion of product manufacture can be reduced to three to five days, including receipt of irradiated barium (from a supplier’s reactor), separation of Cs-131 (at our facilities), isotope labeling of the core, and loading of cores into pre-welded titanium “cans” for final welding, testing, quality assurance and shipping.

It is up to each physician to determine the dosage necessary for implants and acceptable dosages vary among physicians. Many of the physicians who order our seeds order more seeds than necessary but wish to assure themselves that they have a sufficient amount. Upon receipt of an order, the Company either delivers the seeds from its facility directly to the physician using Federal Express or sends the order to an independent third party with expertise in seed delivery who delivers the seeds prior to implant. If the implant is postponed or rescheduled, the short half-life of the seeds makes them unsuitable for use and therefore they must be re-ordered. The Company's historical profit margin on seeds has been sufficient to justify unusable inventory and management has monitored the amount of unused inventory carefully to review its calculations of wastage in its business plans.

Automated Manufacturing Process

IsoRay Medical has begun discussions with a leading designer and manufacturer of automated seed manufacturing equipment that developed an automated line in the US for manufacturing Iodine-125 that was sold to a competitor in early 2003. In addition, IsoRay Medical is engaged in preliminary discussions with another seed manufacturer regarding obtaining an existing automated production line. An automated production line may benefit IsoRay because of potentially reduced labor costs, and help ensure consistent manufacturing quality.

Manufacturing Facility

The initial production of the IsoRay Cs-131 brachytherapy seed commenced at PNNL in 2004. IsoRay Medical has signed a lease agreement and completed construction (tenant improvements) of a new interim production facility in Richland, Washington that received final regulatory approval on October 6, 2005 and will begin radioactive production operations shortly thereafter. The Company is also considering another state as a location for a future facility, either as the Company’s sole manufacturing facility or as a secondary facility. No agreements have been reached for any possible facilities outside of Washington.

Repackaging Services

Most brachytherapy manufacturers offer their seed product to the end user packaged in four principal packing configurations provided in a sterile or non-sterile package depending on the customer's preference. These include:

14

· *Loose seeds*

· *Pre-loaded needles* (loaded with 3 to 5 seeds and spacers)

· *Strands of seeds* (consists of seeds and spacers in a biocompatible "shrink wrap")

· *Pre-loaded Mick cartridges* (fits the Mick applicator - seed manufacturers usually load and sterilize Mick cartridges in their own manufacturing facilities)

No single package configuration dominates the market at this point. Market share estimates, based on internal management studies of the market, for each of the four packaging types are: loose seeds (negligible amount) Mick cartridges (30%), pre-loaded needles (20%) and strands (50%). Market trends indicate significant movement toward the stranded configuration, as there are some clinical data suggesting less potential for post-implant seed migration when a stranded configuration is used

The role of the repackaging service is to package, assay and certify the contents of the final product configuration shipped to the customer. A commonly used method of providing this service is through independent radiopharmacies such as Anazao Healthcare and Advanced Care Pharmacy. Manufacturers send loose seeds along with the physician's instructions to the radiopharmacy who, in turn, loads needles and/or strands the seeds according to the doctor's instructions. These pharmacies then sterilize the product and certify the final packaging prior to shipping directly to the end user.

IsoRay Medical has held discussions with the major independent radiopharmacies and determined the shortest achievable turnaround time from delivery of loose seeds to the radiopharmacy to delivery of the final assayed and packaged seeds to the end user is 3 - 4 days. Because of the short half-life of Cs-131, management believes adding 3 - 4 days to the product delivery schedule is prohibitive on a long-term basis. However, to increase sales in the near-term we are using one of these services on an interim basis until our own custom preloading operation comes on-line late in 2005. The Company intends to market its seeds to the end user in all four of the commonly used packaging configurations, and has retained an experienced consultant to assist in the development of this value-added repacking service.

Prior to the establishment of a custom preloading service, IsoRay Medical is offering loose seeds which will require the implant center to load the seeds into their preferred implant configuration. IsoRay is currently loading Mick cartridges in its new facility for those implant centers using the Mick applicator as their method of injecting the seeds into the prostate. The Company currently offers non-sterile, pre-loaded Mick cartridges. As soon as the Company acquires the proper sterilization equipment, loose seeds and pre-loaded Mick cartridges will be offered in a sterile package. When the custom preloading service is operational, the Company will add pre-loaded needles and strands in sterile and non-sterile package configurations. Management believes the custom preloading service will be operational by the end of 2005.

Independent radiopharmacies usually provide the final packaging of the product delivered to the end user. This reduces an opportunity for reinforcing the "branding" of the seed product. By providing its own repackaging service, the Company preserves the product branding opportunity and eliminates any concerns related to the handling of its product by a third party prior to delivery to the end user.

Providing different packaging configurations adds significant value to the product while providing an additional revenue stream and incremental margins to the Company through the pricing premiums that can be charged. The end users of these packaging options are willing to pay a premium because of the savings realized by eliminating the need for loose seed handling and loading capabilities on site, eliminating the need for additional staffing to load and sterilize seeds and needles, and eliminating the expense of additional assaying of the seeds.

Management estimates the cost of establishing a custom preloading service in its new, leased facility to be approximately $250,000. Space for this custom preloading operation has been reserved in the facility and most of the necessary equipment has been delivered and installed. Preloading procedures have been drafted, staff are being trained, and process validation activities are scheduled for the 4th quarter of 2005. One or more technicians will be added to the staff to handle the seed loading, stranding and assaying operations. Our customer service staff will provide assistance with shipping, documentation and tracking of all orders from the repackaging service to the end user.

Barium Enrichment Device

Barium-130 is the original source material for Cs-131. When Ba-130 is put into a nuclear reactor it becomes Ba-131, the radioactive material that is the parent of Cs-131. Barium metal found in nature contains only 0.1% of Ba-130 with six other isotopes making up the other 99.9%. As part of its manufacturing process the Company intends to develop a barium enrichment device that should create "enriched barium" with a higher concentration of the Ba-130 isotope than is found in naturally occurring barium. In addition to creating a higher purity Ba-130, which translates into higher purity Cs-131, a barium enrichment device will result in higher yields of Cs-131. The Company has identified sources of enriched barium, including in the former Soviet Union, that we believe we can use until the barium enrichment device is developed.

Marketing and Sales

Marketing Strategy

The Company intends to position Cs-131 as the isotope of choice for prostate brachytherapy. Management believes there is no apparent clinical reason to use other isotopes when Cesium-131 is available. The advantages associated with a high energy and short half-life isotope are generally accepted within the clinical community and the Company intends to help educate potential patients about the clinical benefits a patient would experience from the use of Cs-131 for his brachytherapy seed treatment. The potential negative effects of the prolonged radiation times associated with the long half-life of Iodine-125 make this isotope less attractive than Cesium-131.

We intend to target these competing isotopes as our principal competition rather than the various manufacturers and distributors of these products. In this way, the choice of brachytherapy isotopes will be less dependent on the name and distribution strengths of the various Iodine and Palladium manufacturers and distributors and more dependent on the therapeutic benefits of Cs-131. The Company will focus the purchasing decision on the advantages and functionality of the Cs-131 isotope while seeking to educate the prostate cancer patient about these clinical benefits.

The professional and patient market segments each play a unique and important role in the ultimate choice of prostate cancer treatment and the specific isotope chosen for seed brachytherapy treatment. The Company will tailor its marketing message to each audience. IsoRay Medical has retained an advertising agency in the Seattle area to assist with its marketing communication program. The agency will coordinate the creation and distribution of all advertising material and work with the print and visual media.

The advantages of Cs-131's unique combination of high energy and short half-life will be heavily promoted within the clinical market. Because we believe there is no apparent clinical reason to choose other isotopes over Cesium, we have and will continue to target those high volume users of other isotopes as our first implant sites. We will also emphasize the prolonged radiation times and the high doses of radiation given to the patient by the Iodine isotope and the possible negative effects of this prolonged radiation to the adjacent healthy tissues. We believe that this is an important marketing message because clinicians generally agree the radiation given by Iodine has little or no clinical benefit after 120 to 150 days.

To promote our products to the clinical and professional audience, we will use a combination of marketing messages to appear in print and visual media. Planned marketing activities include: attendance at the major brachytherapy-related clinical conferences to exhibit our products and provide marketing information for annual meetings, conferences and other forums of the various professional societies; print advertising in brachytherapy clinical journals; and promoting clinical presentations by experts in the field at major conferences.

In today's U.S. health care market patients are more informed and involved in the management of their health and any treatments required. Many physicians relate incidents of their patients coming for consultations armed with articles researched on the Internet and other sources describing new treatments and medications. In many cases, these patients

are demanding a certain therapy or drug and the physicians are complying when medically appropriate.

Because of this market factor, we will also promote our products directly to the general population. The audience targeted will be the prostate cancer patient, his spouse, family and care givers. The marketing message to this segment of the market will emphasize the specific advantages of Cs-131, including fewer side effects, less total radiation, and shorter period of radiation. The Company plans to reach this market through its website, located at www.isoray.com, advertising in magazines read by prostate cancer patients and their care givers, and through patient advocacy efforts.

Another key element of our strategy will be to validate and support all product claims with well-designed and executed clinical studies that support the efficacy and positive patient outcomes of our Cs-131 seed. We intend to sponsor physician-directed studies that will compare the performance of our seeds to Pd-103 and I-125 seeds. During the remainder of 2005 and into 2006, IsoRay Medical plans to continue its collaboration with leading physicians to develop clinical data on the efficacy of Cs-131 seeds. Noted contributors from the medical physics community will be consulted regarding the benefits of brachytherapy using shorter half-life, improved dosimetry, and higher decay energy seeds. Articles will be submitted to professional journals such as *Medical Physics* and the *International Journal of Radiation Oncology, Biology, and Physics*.

Sales and Distribution

According to a recent industry survey, approximately 2,000 hospitals and free standing clinics are currently offering radiation oncology services in the United States. Not all of these facilities offer seed brachytherapy services. These institutions are staffed with radiation oncologists and medical physicists who provide expertise in radiation therapy treatments and serve as consultants for urologists and prostate cancer patients. We will target the radiation oncologists and the medical physicists as well as urologists as key clinical decision makers in the type of radiation therapy offered to prostate cancer patients.

IsoRay Medical has started to build a direct sales organization to introduce Cs-131 to radiation oncologists and medical physicists. In August 2004 IsoRay Medical hired two highly successful sales professionals from the brachytherapy industry that bring well established relationships with key radiation oncologists and medical physicists, and in 2005, IsoRay Medical expanded its sales force to four experienced individuals. By hiring experienced and successful brachytherapy sales people, the Company reduces the risk of delay in penetrating the market due to a lack of knowledge of the industry or unfamiliarity with the key members of the brachytherapy community.

The initial response to our new isotope from prominent radiation oncologists, medical physicists and urologists in the US has been very positive. As of October 6, 2006, the Company had supplied the ^{131}Cs seed to thirteen well-known implant centers strategically located throughout the U.S. Implant centers are currently located in the states of Arizona, California, Illinois, Pennsylvania, Tennessee, New York, Texas, Washington and Wisconsin, which have implanted our seed into 75 patients as of October 6, 2005. As production increases, additional centers will be added. Clinical results from the patients implanted through October 6, 2005, while perhaps not a large enough group to draw statistically significant conclusions, have been consistent with the reduced side effects expected from the shorter half-life of Cs-131.

The Company will expand its U.S. sales force as it increases production capacity and expands the customer base. If the Company expands outside the U.S. market, it plans to use established distributors in the key markets in these other countries. This strategy should reduce the time and expense required to identify, train and penetrate the key implant centers and establish relationships with the key opinion leaders in these markets. Using established distributors also should reduce the time spent acquiring the proper radiation handling licenses and other regulatory requirements of these markets.

Pricing

Payment for IsoRay Medical products comes from third-party payers including Medicare/Medicaid and private insurance groups. These payers reimburse the hospitals and clinics via well-established payment procedures. On October 31, 2003, as a result of IsoRay Medical's predecessor's filing for an Additional Device Category, CMS (Centers for Medicare and Medicaid Services) approved a HCPCS/CPT code for Cs-131 brachytherapy seeds of $44.67 per seed. This is the same price as awarded to Pd-103 seeds, and compares favorably to the $37.34 price granted to I-125 seeds. Medicare is the most significant U.S. payor for prostate brachytherapy services, and is the payor in close to 70% of all U.S. prostate brachytherapy cases. CMS reviews and adjusts outpatient reimbursement on a periodic and ad hoc basis, but no changes are expected for 2006. As of July 31, 2005, the price for our loose seeds

was $55 per seed.

Prostate brachytherapy is typically performed in the outpatient setting, and as such, is covered by the CMS Outpatient Prospective Payment System. In January 2004, brachytherapy procedure prices were unbundled by CMS, allowing itemized invoicing for seeds with no limit on the number of seeds used per procedure, and CMS currently reimburses hospitals and clinics for their seed purchases on a cost basis. Other insurance companies have followed these CMS changes. With the new reimbursement structure and industry consolidation, prices of brachytherapy seeds are expected to stabilize and increase over the next few years.

Pricing premiums for pre-loaded needles, strands and pre-loaded Mick cartridges will be added as these packaging alternatives are offered to our customers. When charges for the seeds are correctly submitted in the appropriate format to CMS, 100% of the total cost of the seeds is reimbursed to the hospital or clinic by CMS.

Other Information

Customers

Customers representing ten percent or more of total Company sales for the twelve months ended June 30, 2005 include:

Chicago Prostate Cancer Center	Westmont, IL	18.5% of revenue
Western Cancer Center	San Diego, CA	30.6% of revenue
Texas Cancer Center	San Antonio, TX	21.8% of revenue

The loss of any of these significant customers would have a temporary adverse effect on the Company's revenues, which would continue until the Company located new customers to replace them.

Proprietary Rights

The Company relies on a combination of patent, copyright and trademark laws, trade secrets, software security measures, license agreements and nondisclosure agreements to protect its proprietary rights. Some of the Company's proprietary information may not be patentable.

The Company intends to vigorously defend its proprietary technologies, trademarks, and trade secrets. Members of management, employees, and certain equity holders have previously signed non-disclosure, non-compete agreements, and future employees, consultants, advisors, with whom the Company engages, and who are privy to this information, will be required to do the same. A patent for the Cesium separation and purification process has been granted on May 23, 2000 by the U.S. Patent and Trademark Office (USPTO) under Patent Number 6,066,302, with an expiration date of May 23, 2020. The process was developed by Lane Bray, a shareholder of the Company, and has been assigned exclusively to IsoRay Medical. IsoRay's predecessor also filed for patent protection in four European countries under the Patent Cooperation Treaty. Those patents have been assigned to IsoRay Medical.

Our management believes that certain aspects of the IsoRay seed design and construction techniques are patentable innovations. These innovations have been documented in IsoRay laboratory records, and a patent application was filed with the USPTO on November 12, 2003. Certain methodologies regarding isotope production, separation, and seed manufacture are retained as trade secrets and are embodied in IsoRay Medical's procedures and documentation. In June and July of 2004, three patent applications were filed relating to methods of deriving Cs-131 and Y-90 developed by IsoRay Medical employees. The Company is currently working on developing and patenting additional methods of deriving Cs-131 and Y-90, and other isotopes.

There are specific conditions attached to the assignment of the Cs-131 patent from Lane Bray. In particular, the associated Royalty Agreement provides for 1% of gross profit payment from seed sales (gross seed sales price minus direct production cost) to Lane Bray and 1% of gross profit from any use of the Cs-131 process patent for non-seed products. If IsoRay Medical reassigns the Royalty Agreement to another company, these royalties increase to 2%. The Royalty Agreement has an anti-shelving clause which requires IsoRay Medical to return the patent if IsoRay Medical permanently abandons sales of products using the invention.

Effective August 1, 1998, Pacific Management Associates Corporation (PMAC) transferred its entire right, title and interest in an exclusive license agreement with Donald Lawrence to IsoRay, LLC in exchange for a membership interest. The license agreement was transferred to IsoRay, Inc. (WA domiciled) effective May 1, 2002 in connection with the tax-free reorganization.

The terms of the license agreement require the payment of a royalty based on the Net Factory Sales Price, as defined in the agreement, of licensed product sales. Because the licensor's patent application was ultimately abandoned, only a 1% "know-how" royalty based on Net Factory Sales Price, as defined, remains applicable. To date, there have been no product sales incorporating the licensed technology and there is no royalty due pursuant to the terms of the agreement. Management believes that because this technology is not presently being used and believes it will not be used in the future that no royalties will be paid under this agreement.

Research And Development

From inception (December 17, 2001) through June 30, 2005, IsoRay Medical and its predecessor companies incurred more than $1.8 million in costs related to research and development activities. The Company expects to continue to have employees working on activities that will be classified as research or development for the foreseeable future.

Government Regulation

The Company's present and future intended activities in the development, manufacture and sale of cancer therapy products are subject to extensive laws, regulations, regulatory approvals and guidelines. Within the United States, the Company's therapeutic radiological devices must comply with the U.S. Federal Food, Drug and Cosmetic Act, which is enforced by the FDA. The Company is also required to adhere to applicable FDA regulations for Good Manufacturing Practices, including extensive record keeping and periodic inspections of manufacturing facilities. IsoRay Medical's predecessor obtained FDA 510(k) clearance in March 2003 to market the IsoRay ^{131}Cs seed for the treatment of localized solid tumors. The Company has not applied for clearance from the FDA to market its second product (currently in development), Yttrium-90, but management believes that it will not be difficult to obtain clearance for Y-90, since other manufacturers of this product have already obtained clearance for it.

Specifically, in the United States, the FDA regulates, among other things, new product clearances and approvals to establish the safety and efficacy of these products. We are also subject to other federal and state laws and regulations, including the Occupational Safety and Health Act and the Environmental Protection Act.

The Federal Food, Drug, and Cosmetic Act and other federal statutes and regulations govern or influence the research, testing, manufacture, safety, labeling, storage, record keeping, approval, distribution, use, reporting, advertising and promotion of such products. Noncompliance with applicable requirements can result in civil penalties, recall, injunction or seizure of products, refusal of the government to approve or clear product approval applications, disqualification from sponsoring, or conducting clinical investigations, prevent us from entering into government supply contracts, withdrawal of previously approved applications and criminal prosecution.

Approval of new medical devices is a lengthy procedure and can take a number of years and the expenditure of significant resources. There is a shorter FDA review and clearance process, the premarket notification process, or the 510(k) process, whereby a company can market certain medical devices that can be shown to be substantially equivalent to other legally marketed devices. We have been able to achieve market clearance for our ^{131}Cs seed using the 510(k) process.

In the United States, medical devices are classified into three different categories over which FDA applies increasing levels of regulation: Class I, Class II and Class III. Most Class I devices are exempt from premarket notification (510(k)); most Class II devices require premarket notification (510(k)) and most Class III devices require premarket approval. Our ^{131}Cs seed is a Class II device and has received 510(k) clearance.

As a registered medical device manufacturer with the FDA, we are subject to inspection to ensure compliance with their current Good Manufacturing Practices, or cGMP. These regulations require that we and any of our contract manufacturers' design, manufacture and service products and maintain documents in a prescribed manner with respect to manufacturing, testing, distribution, storage, design control and service activities. Modifications or enhancements that could significantly affect the safety or effectiveness of a device or that constitute a major change to the intended use of the device require a new 510(k) notice for any product modification. We may be prohibited from marketing the modified product until the 510(k) notice is cleared by the FDA.

The Medical Device Reporting regulation requires that we provide information to the FDA on deaths or serious injuries alleged to be associated with the use of our devices, as well as product malfunctions that are likely to cause or contribute to death or serious injury if the malfunction were to recur. Labeling and promotional activities are regulated by the FDA and, in some circumstances, by the Federal Trade Commission.

As a medical device manufacturer, we are also subject to laws and regulations administered by governmental entities at the federal, state and local levels. For example, our facility is licensed as a medical product manufacturing facility in the State of Washington and is subject to periodic state regulatory inspections. Our customers are also subject to a wide variety of laws and regulations that could affect the nature and scope of their relationships with us.

In the United States, as a manufacturer of medical devices and devices utilizing radioactive by product material, we are subject to extensive regulation by not only federal governmental authorities, such as the FDA, but also by state and local governmental authorities, such as the Washington State Department of Health, to ensure such devices are safe and effective. In Washington State, the Department of Health, by agreement with the federal Nuclear Regulatory Commission ("NRC"), regulates the possession, use, and disposal of radioactive byproduct material as well as the manufacture of radioactive sealed sources to ensure compliance with state and federal laws and regulations. Our ^{131}Cs brachytherapy seeds constitute both medical devices and radioactive sealed sources and are subject to these regulations.

Moreover, our use, management and disposal of certain radioactive substances and wastes are subject to regulation by several federal and state agencies depending on the nature of the substance or waste material. We believe that we are in compliance with all federal and state regulations for this purpose.

Washington voters approved Initiative 297 in late 2004, which may impose additional restrictions on sites at which mixed radioactive and hazardous wastes are generated and stored, including PNNL, as it prohibits additional mixed radioactive and hazardous waste from being brought to sites, such as PNNL, until the existing on-site waste conforms to all state and federal environment laws. The constitutionality of this initiative has been challenged, but if it were enforced it could impact our ability to manufacture our seeds, whether at PNNL or elsewhere in the State of Washington.

Seasonality

The Company is not aware of any significant seasonal influences on its business. The composition of certain products and services changes modestly with shifts in weather with no material impact on total revenues.

Employees

As of September 30, 2005, IsoRay Medical employed twenty-four full-time individuals, one occasional individual and one part-time individual. The Company's future success will depend, in part, on its ability to attract, retain, and motivate highly qualified technical and management personnel. From time to time, the Company may employ independent consultants or contractors to support its research and development, marketing, sales and support and administrative organizations. Neither the Company's nor IsoRay Medical's employees are represented by any collective bargaining unit. IsoRay Medical estimates that successful implementation of its growth plan would result in up to 30 additional employees by the end of 2006.

Competition

The Company competes in a market characterized by technological innovation, extensive research efforts and significant competition. In general, the IsoRay seed competes with conventional methods of treating localized cancer, including, but not limited to, radical prostatectomy and external beam radiation therapy which includes intensity modulated radiation therapy, as well as competing permanent brachytherapy devices. RP has historically represented

the most common medical treatment for early-stage, localized prostate cancer. EBRT is also a well-established method of treatment and is widely accepted for patients who represent a poor surgical risk or whose prostate cancer has advanced beyond the stage for which surgical treatment is indicated. Management believes that if general conversion from these treatment options (or other established or conventional procedures) to the IsoRay seed does occur, such conversion will likely be the result of a combination of equivalent or better efficacy, reduced incidence of side effects and complications, lower cost, quality of life issues and pressure by health care providers and patients.

History has shown the advantage of being the first to market a new brachytherapy product. For example, ONCURA, now part of General Electric Company, currently claims nearly 50% of the market with the original I-125 seed. Theragenics Corp., which introduced the original Pd-103 seed, is second with a nearly 30% market share. The Company believes it will obtain a similar and significant advantage by being the first to introduce a Cs-131 seed.

The Company's patented Cs-131 separation process is likely to provide us a sustainable competitive advantage in this area. Production of Cs-131 also requires specialized facilities (hot cells) that represent high cost and long lead time if not readily available. In addition, a competitor would need to develop a method for isotope attachment and seed assembly, would need to conduct testing to meet NRC and FDA requirements, and would need to obtain regulatory approvals before marketing a competing device.

Several companies have obtained regulatory approval to produce and distribute Palladium-103 and Iodine-125 seeds, which compete directly with our seed. Ten of those companies represent nearly 100% of annual brachytherapy seed sales worldwide: ONCURA (part of General Electric Company), Theragenics Corp., North American Scientific, Inc., Mentor Corp., Implant Sciences Corp., International Brachytherapy S.A., Cardinal Health, Inc., C.R. Bard, Inc., DRAXIMAGE (a division of DRAXIS Health, Inc.) and Best Medical International, Inc. The top three - ONCURA, Theragenics, and North American Scientific - currently garner nearly 90% of annual sales.

It is possible that three or four of the current I-125 or Pd-103 seed manufacturers (i.e., ONCURA, Theragenics, North American Scientific, etc.) are capable of producing and marketing a Cs-131 seed, but none have reported efforts to do so. Best Medical obtained a seed core patent in 1992 that named 10 different isotopes, including Cs-131, for use in their seeds. Best Medical received FDA 510(k) approval to market a Cs-131 seed on June 6, 1993 but has failed to produce any products for sale.

Additional Growth Opportunities

The Cs-131 isotope has the performance characteristics to be a technological platform for sustained long-term growth. The most immediate opportunities are introducing Cs-131 to Canada, Europe and other international markets, introducing Cs-131-based therapies for other forms of solid tumors focusing first on breast tumors, and through the marketing of other radioactive isotopes. These growth initiatives are in the early stages of planning and appear to be significant incremental opportunities.

The Company plans to introduce Cs-131 initially into Europe and later into other international markets through partnerships and strategic alliances with channel partners for manufacturing and distribution. Another advantage of the Cs-131 isotope is its potential applicability to other cancers and other diseases. Cs-131 has FDA approval to be used for treatments for a broad spectrum of cancers including breast, brain, lung, and liver cancer, and the Company believes that a major opportunity exists as an adjunct therapy for the treatment of breast cancer. Preliminary discussions have begun with prominent physicians regarding the use of Cs-131-based therapies for the treatment of lung, pancreatic and brain cancer. In addition to Y-90, there is the opportunity to develop and market other radioactive isotopes to the US market, and to market the Cs-131 isotope itself, separate from its use in our seeds. The Company is also in the preliminary stages of exploring alternate methods of delivering our isotopes to various organs of the body, as it may be advantageous to use delivery methods other than a titanium-encapsulated seed to deliver radiation to certain organs.

Risk Factors

Our Subsidiary's Independent Accountants Have Expressed Doubt About Its Ability To Continue As A Going Concern. IsoRay Medical has generated material operating losses since inception and has a shareholders' deficit. We expect to continue to experience net operating losses. Our ability to continue as a going concern is subject to our ability to obtain necessary funding from outside sources, including obtaining additional funding from the sale of our securities or obtaining loans and grants from various financial institutions where possible. The doubt expressed by

IsoRay Medical's auditors about its ability to continue as a going concern increases the difficulty in meeting such goals. IsoRay Medical began generating revenue in October 2004, has generated revenue of approximately $410,000 through September 30, 2005, and is in the early stages of marketing its IsoRay ^{131}Cs seed. IsoRay Medical and the Company have limited historical, operating or financial information upon which to evaluate their performance. There can be no assurance that the Company will attain profitability.

Our Revenues Depend Upon One Product. Until such time as we develop additional products, our revenues depend upon the successful production, marketing, and sales of the IsoRay ^{131}Cs seed. The rate and level of market acceptance of this product may vary depending on the perception by physicians and other members of the healthcare community of its safety and efficacy as compared to that of competing products, if any; the clinical outcomes of the patients treated; the effectiveness of our sales and marketing efforts in the United States and Europe; any unfavorable publicity concerning our product or similar products; our product's price relative to other products or competing treatments; any decrease in current reimbursement rates from the Centers for Medicare and Medicaid Services or third party payers; regulatory developments related to the manufacture or continued use of the product; availability of sufficient supplies of enriched barium for ^{131}Cs seed production; ability to produce sufficient quantities of this product; and the ability of physicians to properly utilize the device and avoid excessive levels of radiation to patients. Because of our reliance on this product as the sole source of our revenue, any material adverse developments with respect to the commercialization of this product may cause us to continue to incur losses rather than profits in the future.

Although Approved To Treat Any Malignant Tissue, Our Sole Product Is Currently Used To Treat One Type Of Cancer. Currently, the IsoRay ^{131}Cs seed is used exclusively for the treatment of prostate cancer. We believe the ^{131}Cs seed will be used to treat cancers of other sites as well, as is currently the case with our competitors' ^{125}I and ^{103}Pd seeds. However, we believe that clinical data gathered by select groups of physicians under treatment protocols specific to other organs, will be needed prior to widespread acceptance of our product for treating other cancer sites. If our current and future products do not become accepted in treating cancers of other sites, our sales will depend solely on treatment of prostate cancer and will require ever increasing market share to increase revenues.

We Have Limited Data On The Clinical Performance Of ^{131}Cs. As of October 6, 2005, the IsoRay ^{131}Cs seed has been implanted in 75 patients. While this limited number of patients may prevent us from drawing statistically significant conclusions, the side effects experienced by these patients were less severe than side effects observed in seed brachytherapy with ^{125}I and ^{103}Pd and in other forms of treatment such as radical prostatectomy These early results indicate that the onset of side effects generally occurs between one and three weeks post-implant, and the side effects are resolved between five and eight weeks post-implant, indicating that, at least for these initial patients, side effects resolved more quickly than the side effects that occur with competing seeds or with other forms of treatment. These limited findings support management's belief that the ^{131}Cs seed will result in less severe side effects than competing treatments, but we may have to gather data on outcomes from additional patients before we can establish statistically valid conclusions regarding the incidence of side effects from our seeds.

We Will Need To Raise Additional Capital. The hiring of upper level sales executives, entry into capital lease agreements for a glove box and a hot cell, and entry into executive contracts requiring payments upon reaching certain milestones significantly increased IsoRay Medical's monthly cash requirements since August 2004. Monthly operating cash requirements as of the date of this filing were approximately $500,000, excluding capitalized items. Capital expenditures typically include the purchase or capital lease of equipment, with a life-expectancy of more than 12 months, costing in excess of $2,500, which would include among other things: analytical systems, improved packaging for final products and, new production systems which increase manufacturing throughput. Ongoing requirements to meet greater payroll obligations coupled with legal and accounting fees related to completing the recent merger with IsoRay, Inc. and public reporting status have resulted in greater amounts of short-term cash demands. IsoRay Medical was actively raising capital prior to the merger and we will need to continue to raise capital.

We will also need substantial funds to complete the development, manufacturing, and marketing of our current and future products. Consequently, we will seek to raise additional capital through not only public and private offerings of equity and debt securities, but also collaborative arrangements, strategic alliances, or from other sources. We will need to raise at least $5.5 million of additional capital to fund working capital needs through the end of 2006. IsoRay Medical has entered into a lease agreement and has constructed a manufacturing and production facility located in Richland, Washington that its management believes will provide adequate space to manufacture the ^{131}Cs seed product for the prostate and other organ cancer markets until late 2007.

22

We may be unable to raise additional capital on commercially acceptable terms, if at all, and if we raise capital through additional equity financing, existing shareholders may have their ownership interests diluted. Our failure to be able to generate adequate funds from operations or from additional sources would harm our business.

The Passage Of Initiative 297 In Washington May Result In The Relocation Of Our Manufacturing Operations. Washington voters approved Initiative 297 in late 2004, which may impose restrictions on sites at which mixed radioactive and hazardous wastes are generated and stored, including the PNNL, which is where our ^{131}Cs seed product has been manufactured to date. We are currently in the process of transitioning from PNNL to full production in our new, leased facility outside of PNNL. IsoRay has been assured by the Attorney General's office of the State of Washington that medical isotopes are not included in Initiative 297 and that manufacturing in IsoRay's new production facility would not be interrupted, but there is no assurance that this interpretation of Initiative 297 by the Attorney General's Office will continue to exclude medical isotopes. The U.S. Secretary of Energy is a party to litigation challenging the constitutionality of Initiative 297 in U.S. District Court. Due to this litigation, the State of Washington and the U.S. Justice Department have agreed to delay any implementation of Initiative 297 for an indefinite period of time. Thus, we have the ability to continue manufacturing seeds at PNNL for some period of time if needed as a back-up to our new IsoRay production facility, or to conduct further development activities there. If the State of Washington begins enforcement of the initiative, we may be unable to conduct any future activities at PNNL that would generate mixed radioactive and hazardous wastes.

Management believes that we will be able to continue our manufacturing operations in the State of Washington for the foreseeable future, whether at PNNL or at our new leased facility, which is now operational. In the event Initiative 297 is enforced against us, management may consider establishing an alternate manufacturing facility outside of Washington, and we may consider moving all or part of our operations to another state even if Initiative 297 is not enforced against us.

We Have Limited Manufacturing Experience And May Not Be Able To Meet Demand. The existing management team and staff of IsoRay Medical and the Company have experience primarily in research and development of products and our experience in commercial-scale manufacturing is limited. IsoRay Medical began commercial production of the ^{131}Cs seed in the fourth quarter of 2004 and has completed 45 production-scale ^{131}Cs separation runs as of October 3, 2005. IsoRay Medical recently demonstrated production of ^{90}Y using a process suitable for weekly production of commercial-scale quantities of this isotope. Although IsoRay Medical's management team has significant radiochemistry experience, there is a possibility that production demands may result in challenges that may be too difficult or expensive to overcome. IsoRay Medical has developed and deployed semi-automated laser welding equipment that can produce seeds faster than a certain fully-automated line of equipment the Company has reviewed that would cost several million dollars to design and fabricate. IsoRay Medical believes it will continually find more efficient means of welding the titanium seeds; however, there is a possibility that future demand will outstrip our ability to produce seeds using the semi-automated process. We cannot ensure that either IsoRay Medical's manufacturing processes or its ability to sustain ongoing production of its products will be able to meet demand.

Sales And Marketing Experience. IsoRay Medical's sales and marketing team has extensive experience in successfully establishing and training domestic and international sales forces as well as successfully introducing new medical devices to the market, but we have limited specific experience with commercial sales and marketing of the Cesium-131 radioisotope. IsoRay Medical has employed marketing professionals with extensive experience selling medical devices, including radioisotopes for large, international companies. Our initial marketing activities have been targeted to a limited number of physicians and treatment centers, and we will need to recruit additional employees to assist in expanding our customer base. We have developed in-house customer service, order entry, shipping, billing, and sales support. In addition, the Company has engaged a nationally recognized reimbursement specialist Kathy Francisco, of the Pinnacle Health Group, with over 25 years of healthcare reimbursement experience, to assist with reimbursement questions and to provide reimbursement guidelines and appropriate insurance coding numbers needed to obtain reimbursement for seed costs and the implant procedure by our customers. This consulting project was completed by the spring of 2005 and cost IsoRay approximately $7,500 plus travel-related expenses. Although, this

group and other consultants continue to be available to support the Company in its reimbursement and marketing programs, we cannot be certain that our products will be marketed and distributed in accordance with our expectations or that our market research will be accurate. We also cannot be certain that we will be able to develop our own sales and marketing capabilities to the extent anticipated by management. We may choose to add third-party distribution channels, but we may not be able to maintain satisfactory arrangements with the third parties upon whom we rely.

We Are Subject To The Risk That Certain Third Parties May Mishandle Our Product. We rely on third parties, such as Federal Express, to deliver our ^{131}Cs seed, and on other third parties, including various radiopharmacies, to package our ^{131}Cs seed in certain specialized packaging forms that, as of the date of this report, we do not provide at our own facilities. We are subject to the risk that these third parties may mishandle our product, which could result in adverse effects, particularly given the radioactive nature of our product.

Our Operating Results Will Be Subject To Significant Fluctuations. Our quarterly revenues, expenses, and operating results are likely to fluctuate significantly in the future. Fluctuation may result from a variety of factors, which are discussed in detail throughout this "RISK FACTORS" section, including:

· our achievement of product development objectives and milestones;

· demand and pricing for the Company's products;

· effects of aggressive competitors;

· hospital, clinic and physician buying decisions;

· research and development and manufacturing expenses;

· patient outcomes from our therapy;

· physician acceptance of our products;

· government or private healthcare reimbursement policies;

· our manufacturing performance and capacity;

· incidents, if any, that could cause temporary shutdown of our manufacturing facilities;

· the amount and timing of sales orders;

· rate and success of future product approvals;

· timing of FDA approval, if any, of competitive products and the rate of market penetration of competing products;

· seasonality of purchasing behavior in our market;

· overall economic conditions; and

· the successful introduction or market penetration of alternative therapies.

We Rely Heavily On A Limited Number Of Suppliers. Some materials used in our products are currently available only from a limited number of suppliers. For example, virtually all titanium tubing used in brachytherapy seed manufacture comes from a single source, Accellent Corporation. We currently obtain a key component of our seed core from a single supplier. We do not have formal written agreements with either this key supplier or with Accellent Corporation. Any interruption or delay in the supply of materials required to produce our products could harm our business if we were unable to obtain an alternative supplier or substitute equivalent materials in a cost-effective and timely manner. Additional factors that could cause interruptions or delays in our source of materials include limitations on the availability of raw materials or manufacturing performance experienced by our suppliers and a breakdown in our commercial relations with one or more suppliers. Some of these factors may be completely out of our control and our

suppliers' control.

Future Production Increases Will Depend on Our Ability to Acquire Larger Quantities of ^{131}Cs and Hire More Employees. IsoRay currently obtains ^{131}Cs through reactor irradiation of natural barium and subsequent separation of cesium from the irradiated barium targets. The amount of ^{131}Cs that can be produced from a given reactor source is limited by the power level and volume available within the reactor for irradiating targets. This limitation can be overcome by utilizing barium feedstock that is enriched in the stable isotope ^{130}Ba. However, the number of suppliers of enriched barium is limited and they may be unable to produce this material in sufficient quantities at a reasonable price.

IsoRay has entered into an exclusive agreement with the Institute of Nuclear Materials in the former Soviet Union to provide irradiated barium and ^{131}Cs in quantities sufficient to supply a significant percentage of future demand for ^{131}Cs. IsoRay believes this supplier may also provide access to sufficient quantities of enriched barium that may be recycled for use in other reactors to increase the production of ^{131}Cs. Although the agreement provides for supplying ^{131}Cs in significant quantities, there is no assurance that this will result in IsoRay gaining access to a sufficient supply of enriched barium feedstock and if sufficient supplies are attained we will need to increase our manufacturing staff.

We Are Subject To Uncertainties Regarding Reimbursement For Use Of Our Products. Hospitals and freestanding clinics may be less likely to purchase our products if they cannot be assured of receiving favorable reimbursement for treatments using our products from third-party payers, such as Medicare, Medicaid and private health insurance plans. Currently, Medicare reimburses hospitals, clinics and physicians for the cost of seeds used in brachytherapy procedures on a per seed basis. Historically, private insurers have followed Medicare guidelines in establishing reimbursement rates. However, third-party payers are increasingly challenging the pricing of certain medical services or devices, and we cannot be sure that they will reimburse our customers at levels sufficient for us to maintain favorable sales and price levels for our products. There is no uniform policy on reimbursement among third-party payers, and we can provide no assurance that our products will continue to qualify for reimbursement from all third-party payers or that reimbursement rates will not be reduced. A reduction in or elimination of third-party reimbursement for treatments using our products would likely have a material adverse effect on our revenues.

In 2003, IsoRay applied to the Centers for Medicare and Medicaid Services (CMS) and received reimbursement codes for use of our ^{131}Cs seed (HCPCS code C2633 and APC code 2633). However, since January 1, 2004 hospitals and clinics ordering brachytherapy seeds have been reimbursed for the cost of the seeds plus a fixed mark-up at a rate prescribed by CMS. Reimbursement amounts are reviewed and revised periodically, and on an ad hoc basis. Although the Company is not currently aware of any changes to CMS reimbursement rates that would have a material effect on our ability to maintain our pricing structure, adjustments could be made to these reimbursement amounts or policies, which could result in reduced reimbursement for brachytherapy services, which could negatively affect market demand for our products.

Furthermore, any federal and state efforts to reform government and private healthcare insurance programs could significantly affect the purchase of healthcare services and products in general and demand for our products in particular. We are unable to predict whether potential healthcare reforms will be enacted, whether other healthcare legislation or regulations affecting the business may be proposed or enacted in the future or what effect any such legislation or regulations would have on our business, financial condition or results of operations.

It Is Possible That Other Treatments May Be Deemed Superior To Brachytherapy. Our ^{131}Cs seed faces competition not only from companies that sell other radiation therapy products, but also from companies that are developing alternative therapies for the treatment of cancers. It is possible that advances in the pharmaceutical, biomedical, or gene therapy fields could render some or all radiation therapies, whether conventional or brachytherapy, obsolete. If alternative therapies are proven or even perceived to offer treatment options that are superior to brachytherapy, physician adoption of our product could be negatively affected and our revenues from our product could decline.

Our Industry Is Intensely Competitive. The medical products industry is intensely competitive. We compete with both public and private medical device, biotechnology and pharmaceutical companies that have been established longer

than we have, have a greater number of products on the market, have greater financial and other resources, and have other technological or competitive advantages. We also compete with academic institutions, government agencies, and private research organizations in the development of technologies and processes and in acquiring key personnel. Although we have patents granted and patents applied for to protect our isotope separation processes and ^{131}Cs seed manufacturing technology, we cannot be certain that one or more of our competitors will not attempt to obtain patent protection that blocks or adversely affects our product development efforts. To minimize this potential, we have entered into exclusive agreements with key suppliers of isotopes and isotope precursors.

We May Be Unable To Adequately Protect Or Enforce Our Intellectual Property Rights Or Secure Rights To Third-Party Patents. Our ability and the abilities of our partners to obtain and maintain patent and other protection for our products will affect our success. We are assigned, have rights to, or have exclusive licenses to patents and patents pending in the U.S. and numerous foreign countries. The patent positions of medical device companies can be highly uncertain and involve complex legal and factual questions. Our patent rights may not be upheld in a court of law if challenged. Our patent rights may not provide competitive advantages for our products and may be challenged, infringed upon or circumvented by our competitors. We cannot patent our products in all countries or afford to litigate every potential violation worldwide.

Because of the large number of patent filings in the medical device and biotechnology field, our competitors may have filed applications or been issued patents and may obtain additional patents and proprietary rights relating to products or processes competitive with or similar to ours. We cannot be certain that U.S. or foreign patents do not exist or will not be issued that would harm our ability to commercialize our products and product candidates.

One Of Our Licensed Patents May Be Terminated Under Certain Conditions. Our ^{131}Cs separation patent is essential for the production of Cesium-131. The owner of the patent, Lane Bray, a shareholder of the Company and Chief Chemist of IsoRay Medical, has the right to terminate the license agreement that allows the Company to use this patent if we discontinue production for any consecutive 18 month period. The Company has no plans to discontinue production, and management considers it highly unlikely that production will be discontinued for any significant period at any time in the future.

Failure To Comply With Government Regulations Could Harm Our Business. As a medical device and medical isotope manufacturer, we are subject to extensive, complex, costly, and evolving governmental rules, regulations and restrictions administered by the FDA, by other federal and state agencies, and by governmental authorities in other countries. Compliance with these laws and regulations is expensive and time-consuming, and changes to or failure to comply with these laws and regulations, or adoption of new laws and regulations, could adversely affect our business.

In the United States, as a manufacturer of medical devices and devices utilizing radioactive by-product material, we are subject to extensive regulation by federal, state, and local governmental authorities, such as the FDA and the Washington State Department of Health, to ensure such devices are safe and effective. Regulations promulgated by the FDA under the U.S. Food, Drug and Cosmetic Act, or the FDC Act, govern the design, development, testing, manufacturing, packaging, labeling, distribution, marketing and sale, post-market surveillance, repairs, replacements, and recalls of medical devices. In Washington State, the Department of Health, by agreement with the federal Nuclear Regulatory Commission ("NRC"), regulates the possession, use, and disposal of radioactive byproduct material as well as the manufacture of radioactive sealed sources to ensure compliance with state and federal laws and regulations. Our ^{131}Cs brachytherapy seeds constitute both medical devices and radioactive sealed sources and are subject to these regulations.

Under the FDC Act, medical devices are classified into three different categories, over which the FDA applies increasing levels of regulation: Class I, Class II, and Class III. Our ^{131}Cs seed has been classified as a Class II device and has received clearance from the FDA through the 510(k) pre-market notification process. Although not anticipated, any modifications to the device that would significantly affect safety or effectiveness, or constitute a major change in intended use, would require a new 510(k) submission. As with any submittal to the FDA, there is no assurance that a 510(k) clearance would be granted.

In addition to FDA-required market clearances and approvals for our products, our manufacturing operations are required to comply with the FDA's Quality System Regulation, or QSR, which addresses requirements for a company's quality program such as management responsibility, good manufacturing practices, product and process design controls, and quality controls used in manufacturing. Compliance with applicable regulatory requirements is monitored through periodic inspections by the FDA Office of Regulatory Affairs ("ORA"). We anticipate both announced and unannounced inspections by the FDA. Such inspections could result in non-compliance reports (Form

483) which, if not adequately responded to, could lead to enforcement actions. The FDA can institute a wide variety of enforcement actions, ranging from public warning letters to more severe sanctions such as fines, injunctions, civil penalties, recall of our products, operating restrictions, suspension of production, non-approval or withdrawal of pre-market clearances for new products or existing products, and criminal prosecution. There can be no assurance that we will not incur significant costs to comply with these regulations in the future or that the regulations will not have a material adverse effect on our business, financial condition and results of operations.

The marketing of our products in foreign countries will, in general, be regulated by foreign governmental agencies similar to the FDA. Foreign regulatory requirements vary from country to country. The time and cost required to obtain regulatory approvals could be longer than that required for FDA clearance in the United States and the requirements for licensing a product in another country may differ significantly from FDA requirements. We will rely, in part, on foreign distributors to assist us in complying with foreign regulatory requirements. We may not be able to obtain these approvals without incurring significant expenses or at all, and the failure to obtain these approvals would prevent us from selling our products in the applicable countries. This could limit our sales and growth.

Our Business Exposes Us To Product Liability Claims. Our design, testing, development, manufacture, and marketing of products involve an inherent risk of exposure to product liability claims and related adverse publicity. Insurance coverage is expensive and difficult to obtain, and, although we currently have a five million dollar policy, in the future we may be unable to obtain or renew coverage on acceptable terms, if at all. If we are unable to obtain or renew sufficient insurance at an acceptable cost or if a successful product liability claim is made against us, whether fully covered by insurance or not, our business could be harmed.

Our Business Involves Environmental Risks. Our business involves the controlled use of hazardous materials, chemicals, biologics, and radioactive compounds. Manufacturing is extremely susceptible to product loss due to radioactive, microbial, or viral contamination; material or equipment failure; vendor or operator error; or due to the very nature of the product's short half-life. Although we believe that our safety procedures for handling and disposing of such materials comply with state and federal standards there will always be the risk of accidental contamination or injury. In addition, radioactive, microbial, or viral contamination may cause the closure of the respective manufacturing facility for an extended period of time. By law, radioactive materials may only be disposed of at state-approved facilities. We currently dispose of our radioactive waste through the Battelle managed PNNL site under a one year renewable agreement. At our new, leased facility we intend to use commercial disposal contractors. We may incur substantial costs related to the disposal of these materials. If we were to become liable for an accident, or if we were to suffer an extended facility shutdown, we could incur significant costs, damages, and penalties that could harm our business.

We Rely Upon Key Personnel. Our success will depend, to a great extent, upon the experience, abilities and continued services of our executive officers and key scientific personnel. IsoRay, Inc. has an employment agreement with Roger Girard, its Chief Executive Officer, and IsoRay Medical has employment agreements with most of its executive officers and key scientific personnel. If we lose the services of several of these officers or key scientific personnel, our business could be harmed. Our success also will depend upon our ability to attract and retain other highly qualified scientific, managerial, sales, and manufacturing personnel and their ability to develop and maintain relationships with key individuals in the industry. Competition for these personnel and relationships is intense and we compete with numerous pharmaceutical and biotechnology companies as well as with universities and non-profit research organizations. We may not be able to continue to attract and retain qualified personnel.

The Value Of Our Granted Patent, and Our Patents Pending, Is Uncertain. Although our management strongly believes that our patent on the process for producing ^{131}Cs, our patent pending on the manufacture of the brachytherapy seed, our patent applications on additional methods for producing ^{131}Cs and ^{90}Y which have been filed, and anticipated future patent applications, which have not yet been filed, have significant value, we cannot be certain that other like-kind processes may not exist or be discovered, that any of these patents is enforceable, or that any of our patent applications will result in issued patents.

Our Ability To Expand Into Foreign Markets Is Uncertain. Our future growth will depend in part on our ability to establish, grow and maintain product sales in foreign markets, particularly in Europe and Asia. However, we have limited experience in marketing and distributing products in other countries. Any foreign operations would subject us to additional risks and uncertainties, including our customers' ability to obtain reimbursement for procedures using our products in foreign markets; the burden of complying with complex and changing foreign regulatory requirements; language barriers and other difficulties in providing long-range customer service; potentially longer accounts

receivable collection times; significant currency fluctuations, which could cause third party distributors to reduce the number of products they purchase from us because the cost of our products to them could fluctuate relative to the price they can charge their customers; reduced protection of intellectual property rights in some foreign countries; and the possibility that contractual provisions governed by foreign laws would be interpreted differently than intended in the event of a contract dispute. Any future foreign sales of our products could also be adversely affected by export license requirements, the imposition of governmental controls, political and economic instability, trade restrictions, changes in tariffs and difficulties in staffing and managing foreign operations. Many of these factors may also affect our ability to import enriched barium from Russia under our contract with the Institute of Nuclear Materials.

Our Ability To Initiate Operations And Manage Growth Is Uncertain. Our efforts to commercialize our medical products will result in new and increased responsibilities for management personnel and will place a strain upon the entire company. To compete effectively and to accommodate growth, if any, we may be required to continue to implement and to improve our management, manufacturing, sales and marketing, operating and financial systems, procedures and controls on a timely basis and to expand, train, motivate and manage our employees. There can be no assurance that our personnel, systems, procedures, and controls will be adequate to support our future operations. If the IsoRay ^{131}Cs seed were to rapidly become the “seed of choice,” it is unlikely that we could meet demand. We could experience significant cash flow difficulties and may have difficulty obtaining the working capital required to manufacture our products and meet demand. This would cause customer discontent and invite competition.

Our Reporting Obligations As A Public Company Are Costly. Operating a public company involves substantial costs to comply with reporting obligations under federal securities laws that are continuing to increase as provisions of the Sarbanes Oxley Act of 2002 are implemented. These reporting obligations will increase our operating costs. We may not reach sufficient business volume to justify our public reporting status.

There Is A Limited Market For Our Common Stock. Currently only a limited trading market exists for our common stock. Our common stock currently trades on the Pink Sheets, a market with very limited liquidity and minimal listing standards, under the symbol “ISRY.PK.” Any broker/dealer that makes a market in our stock or other person that buys or sells our stock could have a significant influence over its price at any given time, and quotations are limited and sporadic. We have applied for a listing on the Over-the Counter Bulletin Board, but there can be no assurance that such a listing will be obtained. Even if we are listed on the Over-the-Counter Bulletin Board, shareholders may experience more difficulty in attempting to sell their shares than if the shares were listed on a national stock exchange or quoted on the NASDAQ Stock Market. We cannot assure our shareholders that a market of our stock will be sustained. There is no assurance that our shares will have any greater liquidity than shares that do not trade on a public market.

Our Stock Price Is Likely To Be Volatile. There is generally significant volatility in the market prices and limited liquidity of securities of early stage companies, and particularly of early stage medical product companies. Contributing to this volatility are various events that can affect our stock price in a positive or negative manner. These events include, but are not limited to: governmental approvals, refusals to approve, regulations or actions; market acceptance and sales growth of our products; litigation involving the Company or our industry; developments or disputes concerning our patents or other proprietary rights; changes in the structure of healthcare payment systems; departure of key personnel; future sales of our securities; fluctuations in our financial results or those of companies that are perceived to be similar to us; investors’ general perception of us; and general economic, industry and market conditions. If any of these events occur, it could cause our stock price to fall.

Our Common Stock May Be Subject To Penny Stock Regulation. If the market price of our shares declines below $5.00 per share, our shares would be subject to the provisions of Section 15(g) and Rule 15g-9 of the Securities Exchange Act of 1934, as amended, commonly referred to as the “penny stock” rule. Section 15(g) sets forth certain requirements for transactions in penny stocks and Rule 15g-9(d)(1) incorporates the definition of penny stock as that used in Rule 3a51-1 of the Exchange Act. The SEC generally defines penny stock to be any equity security that has a market price less than $5.00 per share, subject to certain exceptions. Rule 3a51-1 provides that any equity security is considered to be penny stock unless that security is: registered and traded on a national securities exchange meeting specified criteria set by the SEC; authorized for quotation on The NASDAQ Stock Market; issued by a registered investment company; excluded from the definition on the basis of price (at least $5.00 per share) or the registrant’s net tangible assets; or exempted from the definition by the SEC. If our shares were deemed to be “penny stocks”, trading in the shares would be subject to additional sales practice requirements on broker-dealers who sell penny stocks to persons other than established customers and accredited investors.

ITEM 2 - DESCRIPTION OF PROPERTY

The Company leased, prior to July 2005, approximately 1,941 square feet of office space at 4701 IDS Center, Minneapolis, Minnesota 55402. This space was sub-leased to a separate company owned by the Company's then-CEO. The Company incurred no expense related to this lease during any period reflected in this Transitional Report on Form 10-KSB.

Subsequent to June 2005, the Company's executive offices are now located at 350 Hills Street, Suite 106, Richland, WA 99354, (509) 375-1202, where IsoRay Medical currently leases approximately 3,100 square feet of office and laboratory space for $4,196 per month from Energy Northwest. The lease expires December 31, 2005, but is renewable. The Company is not affiliated with its lessor. Additional office space will be needed as employees are hired, and is currently available at this location. The Company believes that its current facilities will be adequate until the end of 2005, but it will need additional facilities at that time. In the future, due to business growth, the Company may elect to combine administrative services and production in one building which the Company may lease or build depending on market conditions.

In April 2004, IsoRay Medical's predecessor signed a contract with PNNL, permitting IsoRay Medical to subcontract certain of its manufacturing needs to PNNL, use PNNL facilities to produce the Cs-131 brachytherapy seeds, and ship them to customers from the PNNL facilities. Using PNNL's facilities has reduced the immediate need for IsoRay Medical to purchase specialized capital-intensive equipment. The contract allows it to manufacture Cs-131 seeds in PNNL until it expires in December 2006. Management believes that IsoRay will have sufficient time prior to this contract's expiration to shift production to IsoRay's new facility, described below.

We have entered into a lease, which commenced as of regulatory licensing approval on October 6, 2005, for a facility located in Richland, Washington that management believes will provide adequate space to manufacture the Cs-131 product for the prostate cancer markets until late 2007. The lease is for a term of twelve months following regulatory licensing approval, and payment for the lease term is the issuance of 25,800 shares of IsoRay Medical (pre-merger) common stock. The lease may be extended on a month-to-month basis by mutual agreement of the parties. The lessor is Pacific EcoSolutions Incorporated, and the Company is not affiliated with this lessor.

The Company's management believes that all facilities occupied by the Company are adequate for present requirements, and that the Company's current equipment is in good condition and is suitable for the operations involved.

ITEM 3 - LEGAL PROCEEDINGS

The Company is not involved in any material legal proceedings.

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

No matter was submitted to a vote of the Company's security holders during the fourth quarter of the fiscal year covered by this Transitional Report.

PART II

ITEM 5 - MARKET FOR COMMON EQUITY, RELATED STOCKHOLDERS' MATTERS AND SMALL BUSINESS ISSUER PURCHASES OF EQUITY SECURITIES

The Company's Articles of Incorporation provide that the Company has the authority to issue 200,000,000 shares of capital stock, which are currently divided into two classes as follows: 194,000,000 shares of common stock, par value of $0.001 per share; and 6,000,000 shares of preferred stock, par value of $0.001 per share. Immediately prior to the

Merger, and following its recent 30:1 reverse stock split, the Company had approximately 2,498,000 shares of common stock outstanding, and no shares of preferred stock outstanding.

Our common stock is quoted on the Pink Sheets under the symbol "ISRY.PK." We resumed trading on the Pink Sheets on August 18, 2005, after a period of no trading activity (under our prior symbol "CPPC.PK") from February 18, 2005 until August 18, 2005. We also had a period of no trading activity from July 2003 until February 7, 2005. Prior to August 18, 2005, there was an absence of an established trading marking for the Company's common stock, the market was very limited and sporadic, and no quotations from October 1, 2003 through July 2005 exceeded $0.01 per share.

On October 3, 2005, the last reported bid price of our common stock as reported on the Pink Sheets was $5.50 per share. This quotation represents an inter-dealer price without retail mark-up, mark-down or commissions, and may not necessarily represent an actual transaction.

As of September 30, 2005, we had approximately 811 shareholders of record, exclusive of shares held in street name.

Equity Compensation Plans

On May 27, 2005, the Company adopted the 2005 Stock Option Plan (the "Option Plan") and the 2005 Employee Stock Option Plan (the "Employee Plan"), pursuant to which it may grant equity awards to eligible persons. The Option Plan allows the Board of Directors to grant options to purchase up to 1,500,000 shares of common stock to directors, officers, key employees and service providers of the Company, and the Employee Plan allows the Board of Directors to grant options to purchase up to 1,500,000 shares of common stock to officers and key employees of the Company. Options granted under either Plan have a ten year maximum term, an exercise price equal to at least the fair market value of the Company's common stock (based on the trading price on the Pink Sheets or OTC Bulletin Board) on the date of the grant, and with varying vesting periods as determined by the Board. IsoRay Medical, Inc.'s option plans were cancelled and replaced in the merger with the Plans described above, and new options were issued without any change in the material terms of the options, other than acceleration of all unvested options (other than those issued to Mr. Griffiths, Mr. Hrobsky and Mr. Hutchinson which retained their original vesting terms). As of June 30, 2005, no options had been granted under either plan.

Plan Category	Number of securities to be issued on exercise of outstanding options, warrants and rights #	Weighted-average exercise price of outstanding options, warrants, and rights $	Number of securities remaining available for future issuance under equity compensation plans
Equity compensation plans approved by shareholders	N/A	N/A	N/A
Equity compensation plans not approved by shareholders	N/A	N/A	3,000,000
Total	N/A	N/A	3,000,000

The Company has never paid any cash dividends on its Common Stock and does not plan to pay any cash dividends in the foreseeable future.

Pursuant to the Merger Agreement, all rights and privileges granted to IsoRay shareholders owning common and preferred stock were converted into substantially similar rights and privileges when the shareholders received IsoRay, Inc. shares of common and preferred stock subject solely to the differences between Delaware (IsoRay Medical) and Minnesota (IsoRay) laws.

Preferred Stock

30

On May 27, 2005, the Company's Board of Directors created two series of shares of Preferred Stock designated as Series A Convertible Preferred Stock and Series B Convertible Preferred Stock. The Series A Convertible Preferred Stock (the Series A Stock) consists of an aggregate of 1,000,000 shares, $0.001 par value, and the Series B Convertible Preferred Stock (Series B Stock) consists 5,000,000 shares, $0.001 par value (collectively, "Preferred Stock"). The Preferred Stock has preferences, limitations and relative rights in preference to the holders of any other stock of the Company. The Preferred Stock may be converted into common stock at a rate of one share of common stock for each one share of Preferred Stock being converted. Holders of Preferred Stock are also entitled to receive certain annual dividends, and no dividends of any type may be paid on the common stock unless all dividends to which the holders of Preferred Stock shall have been entitled shall have been paid or declared and a sum of money sufficient for the payment thereof set apart.

Sales of Unregistered Securities

During the nine months ended June 30, 2005 the following sales of unregistered securities were completed by IsoRay Medical, Inc.:

- Between January 31, 2005 and July 10, 2005, IsoRay Medical, Inc. sold approximately $4,137,875 in principal amount of 8% convertible debentures (less commissions of ten percent (10%) on securities placed by broker/dealers), in reliance on the exemption from registration provided by Rule 506 of Regulation D of the Securities Act, that subsequent to the merger between the Registrant and IsoRay Medical, Inc. were convertible into 995,882 shares of common stock of the Registrant.

- On March 31, 2005, IsoRay Medical, Inc. issued, in reliance on the exemption from registration provided by Section 4(2) of the Securities Act, 30,303 shares of its common stock and paid $40,000 of cash to Intellegration LLC in full satisfaction of the $90,000 purchase price of three laser welding stations. Pursuant to the merger with the Registrant, these 30,303 shares were converted into 25,526 shares of the Registrant's common stock.

- In January 2005 IsoRay Medical, Inc. issued, in reliance on the exemption from registration provided by Section 4(2) of the Securities Act, 211,140 shares of its common stock under §83(b) (subject to a substantial risk of forfeiture) to certain shareholders as an inducement for their guarantee of the Columbia River Bank line of credit and the note payable to Benton-Franklin Economic Development District. The transactions were recorded at the fair value of the shares, estimated to be $348,381. Pursuant to the merger with the Registrant, these 211,140 shares were converted into 177,854 shares of the Registrant's common stock.

- Between October 15, 2004 and January 21, 2005, IsoRay Medical, Inc. sold 765,500 shares of common stock and issued 229,650 warrants to purchase shares of common stock for $.50 per share, for a total of $1,531,000 to accredited individual investors, (less commissions of ten percent (10%) on securities placed by broker/dealers), in reliance on Rule 506 of Regulation D of the Securities Act. All 229,650 warrants were subsequently exercised prior to the completion of the merger on July 28, 2005. Pursuant to the merger, all 995,150 shares of IsoRay Medical, Inc. were converted into 838,230 shares of the Registrant.

- In connection with the October 15, 2004 private placement, IsoRay Medical, Inc. granted, in reliance on the exemption from registration provided by Section 4(2) of the Securities Act, the selling broker-dealers warrants to purchase 4.23 units at $20,000 per unit. These units represented 42,300 shares of IsoRay Medical, Inc. common stock to purchase 12,690 common shares at $.50 per share. These units were converted into 35,631 shares of the Registrant's common stock and warrants to purchase 10,689 shares of the Registrant's common stock at $.59 per share.

ITEM 6 - MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION

Results of Operations

We have had no revenue for the nine months ended June 30, 2005 or for either of the years ended September 30, 2004 and 2003.

Nine months ended June 30, 2005 compared to the Year ended September 30, 2004

On July 28, 2005, the Company entered into a reverse merger transaction with IsoRay Medical, Inc. whereby IsoRay Medical, Inc. became a wholly-owned subsidiary of the Company.

The acquisition of IsoRay Medical on July 28, 2005 by the Company effected a change in control and was accounted for as a "reverse acquisition" whereby IsoRay is the accounting acquirer for financial statement purposes. Accordingly, for all periods subsequent to July 28, 2005, the financial statements of the Company reflect the historical financial statements of IsoRay from the inception of each respective entity composing IsoRay Medical, Inc. at the July 28, 2005 change in control transaction and the operations of the Company subsequent to the July 28, 2005 transaction.

The Company originally had a September 30 year end. As a result of the July 28, 2005 reverse acquisition transaction, the Company's Board of Directors changed IsoRay, Inc.'s (formerly Century Park Pictures Corporation) year-end to June 30 to correspond to the year end of its newly acquired subsidiary, IsoRay Medical, Inc.

Accordingly, the reported financial results of the Company in this Transitional Report on Form 10-KSB will not be representative of the reported (and/or anticipated) results of operations in future periods.

General and administrative expense for the nine months ended June 30, 2005 and the year ended September 30, 2003 were $30,128 and $9,095, respectively. The increase was directly related to various professional fees incurred in the consummation of the July 2005 business combination transaction with IsoRay Medical, Inc. Net loss for the nine months ended June 30, 2005 was ($30,128) as compared to net income of $75,757 for the year ended September 30, 2004. The $75,757 income in the year ended 2004 was primarily the result of the statutory cancellation of notes payable and accrued interest of $86,956.

In conjunction with a May 2005 sale of equity securities for approximately $85,000, the Company, the Company's then-CEO and the purchasing shareholders negotiated a settlement whereby all outstanding debt owed to the then-CEO in the form of accrued compensation and working capital advances was settled in full for approximately $50,000. The Company recognized a reversal of accrued compensation of approximately $304,500 as a result of this negotiation. This reversal was included in "additional paid-in-capital" for the nine months ended June 30, 2005.

Year ended September 30, 2004 compared to Year ended September 30, 2003

General and administrative expenses for the years ended September 30, 2004 and September 30, 2003 were $9,095 and $19,022, respectively. Net income for the year ended September 30, 2004 was $75,757 as compared to a net loss of ($60,027) for the year ended September 30, 2003. The principal components of the loss for the year ended September 30, 2004 were the accrual of interest expense of $41,005 on outstanding notes payable and operating expenses of $19,022 related to maintaining the Company's compliance with the Securities Exchange Act of 1934. Included in interest expense for fiscal 2004 and 2003 is approximately $2,100 and $41,000, respectively, in imputed interest charged to operations as a component of interest expense with an offset to contributed additional paid-in capital to recognize the economic effect of the suspended and forgiven interest on certain notes payable. This accounting is the result of the respective noteholders agreeing to discontinue their rights to interest subsequent to July 31, 2002.

The Company's expenditures consist solely of items necessary to comply with the Company's periodic reporting obligations under the Securities Exchange Act of 1934 and are not necessarily reflective of what may be expected in future periods when the Company either commences more extensive business operations or acquires another operating entity through either acquisition or merger.

Year ended September 30, 2003 compared to Year ended September 30, 2002

General and administrative expenses for the years ended September 30, 2002 and 2001 were approximately $60,000 and $59,000, respectively. The principal component of these expenditures was the accrual of interest on $400,000 in outstanding notes payable. Interest expense for the years ended September 30, 2003 and 2002 was approximately $41,000 and $51,500, respectively. Included in interest expense is approximately $41,000 and $8,585 in imputed interest calculated as a result of the respective noteholders agreeing to discontinue their rights to interest subsequent to July 31, 2002.

The Company's expenditures consist solely of items necessary to comply with the Company's periodic reporting obligations under the Securities Exchange Act of 1934 and are not necessarily reflective of what may be expected in future periods when the Company either commences more extensive business operations or acquires another operating entity through either acquisition or merger.

Liquidity and Capital Resources

On or about May 2, 2005, the Company sold an aggregate 83,334 post-reverse split shares of unregistered, restricted common stock (2,500,000 pre-reverse split shares) for cash proceeds of approximately $85,000 to three (3) separate individuals, including 4,933 post-reverse split shares to the Company's former President. The Company relied upon Section 4(2) of the Securities Act of 1933, as amended, for an exemption from registration of these shares and no underwriter was used in this transaction. The Company granted "piggy-back" registration rights to the holders of the shares of common stock which would entitle a holder to request that the Company register the common stock if the Company files a registration statement at any time prior to three years from the date the Company sold such shares of common stock. The Company has agreed to keep such registration statement current for up to 270 days. The Company has agreed to pay all expenses associated with any registration of the common stock except any underwriter's commissions or fees or any fees of others employed by a selling shareholder, including attorneys' fees, which shall be the responsibility of the selling shareholder.

Cash used by operating activities for the nine months ended June 30, 2005 and for each of the respective years ended September 30, 2004 and 2003 was approximately $59,000, $9,800 and $19,000, respectively. These cash requirements have been provided by either the proceeds from the May 2005 stock sale or advances from the Company's former Chief Executive Officer. For all periods prior to October 1, 2001, these advances have been treated as additional paid-in capital. Commencing October 1, 2001, the Company's former Chief Executive Officer made these advances as working capital advances which were repayable upon demand at some undesignated future date and were non-interest bearing. In June 2005, concurrent with the May 2005 equity sale transaction and the July 2005 reverse acquisition transaction with IsoRay Medical, the Company's former Chief Executive Officer forgave the repayment of these advances and the Company recognized the forgiveness as additional contributed capital in the Company's financial statements.

Going Concern Issues

IsoRay Medical, Inc., on the date of the reverse acquisition transaction was classified as a development stage enterprise, which was in the process of implementing its respective business plan to achieve a sustainable revenue stream. As of the date of the reverse merger transaction, IsoRay Medical, Inc. had a limited operating history and its future success was subject to the expenses, risks and uncertainties frequently encountered by companies in similar stages of development. These potential risks include failure to acquire adequate financing to fund further development of its products; failure to obtain and operate a production facility; failure to successfully create a market for its products; and other risks and uncertainties.

Management's plans to raise additional financing include the sale of additional equity or borrowings. Management expects to obtain the necessary financing; however, no assurance can be given that such financing will be completed on terms acceptable to the Company. If the Company is not able to obtain additional financing, the development of the Company's products could be delayed or suspended.

Inflation

Inflation and changing prices are not anticipated to have a significant impact on the future operations of the Company.

ITEM 7 - FINANCIAL STATEMENTS

The required accompanying financial statements begin on page F-1 of this document.

ITEM 8 - CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

ITEM 8A - CONTROLS AND PROCEDURES

As required by Rule 13a-15 under the Exchange Act, within the 90 days prior to the filing date of this report, the Company carried out an evaluation of the effectiveness of the design and operation of the Company's disclosure controls and procedures. This evaluation was carried out under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer. Based upon that evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective. There have been no significant changes in the Company's internal control over financial reporting or in other factors, which could significantly affect internal control over financial reporting subsequent to the date the Company carried out its evaluation.

Disclosure controls and procedures are controls and other procedures that are designed to ensure that information required to be disclosed in Company reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the Securities and Exchange Commission's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed in Company reports filed under the Exchange Act is accumulated and communicated to management, including the Company's Chief Executive Officer and Chief Financial Officer as appropriate, to allow timely decisions regarding required disclosure.

PART III

ITEM 9 - DIRECTORS, EXECUTIVE OFFICERS, PROMOTERS AND CONTROL PERSONS; COMPLIANCE WITH SECTION 16(a) OF THE EXCHANGE ACT

In conjunction with the Merger, and effective as of July 28, 2005 (the closing date of the Merger), Thomas Scallen resigned from his positions as Chief Executive Officer and Chairman of the Board, Philip Rogers resigned from his position as President and a director, and Wally Bietak resigned from his position as a director of the Registrant.

Effective as of July 28, 2005, Roger Girard and David Swanberg were appointed as directors by the resigning Board, and, also effective as of July 28, 2005, they appointed Robert Kauffman, Thomas LaVoy and Stephen Boatwright to fill the remaining three vacant Board positions. The Board has established an Audit Committee consisting of Thomas LaVoy (Chairman) and Robert Kauffman. No other committees have been formed.

The Audit Committee is responsible for assisting the Board of Directors in monitoring and oversight of (1) the integrity of the Company's financial statements and its systems of internal accounting and financial controls and (2) the independence and performance of the Company's independent auditors. The Board of Directors has determined that Mr. LaVoy and Mr. Kauffman are each an "audit committee financial expert" as defined in Item 401 of Regulation S-B

promulgated by the Securities and Exchange Commission, and are each independent. The Board's conclusions regarding the qualifications of Mr. LaVoy as an audit committee financial expert were based on his service as a chief financial officer of a public company, his experience as a certified public accountant and his degree in accounting. The Board's conclusions regarding the qualifications of Mr. Kauffman as an audit committee financial expert were based on his service as a chief executive officer of multiple public companies, his active supervision of the principal financial and accounting officers of the public companies for which he served as chief executive officer, and his M.B.A. in Finance.

Further information about the new Board members may be found below.

Effective as of July 28, 2005, Roger Girard was appointed as Chief Executive Officer and President of the Registrant and Michael Dunlop was appointed as Chief Financial Officer and Treasurer of the Company. Also effective July 28, 2005, John Hrobsky was appointed Vice President, Sales and Marketing and David Swanberg was appointed Secretary and Vice President-Operations. Further information about these officers may be found below.

The Company entered into an employment agreement with Roger Girard, its Chief Executive Officer, effective October 6, 2005 (the “Girard Agreement”). The term of the Girard Agreement is through October 6, 2009, and will automatically extend for an additional one year term on each anniversary date unless the term is modified or terminated in accordance with the terms of the Girard Agreement at least ninety days prior to a given anniversary date. The Girard Agreement provides for a base salary of $180,000, an automatic increase to $220,000 effective January 1, 2006, and an increase to $300,000 effective July 1, 2006 if certain performance goals set by the Board of Directors are met. Mr. Girard is also entitled to participate in any benefit plans provided to key executives of the Company, and to a bonus if certain performance goals set by the Board of Directors are met. These performance goals have not yet been set by the Board. The Registrant has not entered into employment agreements with any other officers as of the date of this filing.

The directors and executive officers serving the Company as of October 11, 2005 were as follows:

Name	Age	Position Held
Roger Girard	62	Chairman, President, CEO
John Hrobsky	58	Vice President-Marketing
Michael Dunlop	53	Chief Financial Officer-Treasurer
David J. Swanberg	49	Vice President-Operations Corporate Secretary, Director
Robert Kauffman	64	Director
Thomas LaVoy	45	Director
Stephen Boatwright	41	Director

Roger E. Girard- In addition to serving as President, Chairman and CEO for the Company, Mr. Girard is also the CEO, President and Chairman of the Board of IsoRay Medical, Inc., and has served in these positions since the formation of IsoRay Medical, Inc. Mr. Girard was CEO and Chairman of IsoRay Medical's predecessor company from August of 2003 until October 1, 2004. Mr. Girard has been actively involved in the management and the development of the management team at IsoRay Medical, and his experienced leadership has helped drive IsoRay's development to date. From June 1998 until August of 2003, Mr. Girard served as President of Strategic Financial Services, a business consulting company based in Seattle, Washington designed to help wealthy individuals and companies with strategic planning and financial strategy. Strategic Financial Services previously provided its services to a medical device company. Mr. Girard served as its sole employee. Mr. Girard also served as the managing partner for the Northwest office of Capital Consortium, another business consulting company based in Seattle, during this time. Capital Consortium employed four people and analyzed business market potential for start-ups and early stage companies. Mr. Girard has knowledge, experience and connections to private, institutional and public sources of capital and is experienced in managing and designing capital structures for business organizations as well as organizing and managing the manufacturing process, distribution, sales, and marketing, based on his 35 years of experience.

John Hrobsky - Prior to joining IsoRay’s predecessor company as Executive Vice President of Sales and Marketing in 2004, Mr. Hrobsky was President, CEO and a director of Advanced Cochlear Systems, positions he held beginning in 2001. From 1999 to 2001, Mr. Hrobsky served as President, CEO and a director of Zaxis International, Inc., a biotechnology company. Prior to 1999, Mr. Hrobsky served as a senior executive with a number of biotech and

medical device companies. Mr. Hrobsky’s sales and marketing experience with medical devices includes a device for restoring neuro-control after spinal cord injury, the worldwide leading cochlear implant as well as various radiology, imaging and diagnostic equipment products. Notably, Mr. Hrobsky served as Vice President of Sales for Cochlear Corporation, the U.S. subsidiary of Cochlear Ltd., an Australian based manufacturer of cochlear implants where he was responsible for its introduction to the markets in the US, Canada and South America. Cochlear Ltd. is the world’s leading provider of cochlear implants commanding approximately 60% of the market. Mr. Hrobsky earned a Bachelor of Science in Medical Technology in 1971 from the University of Wisconsin - Eau Claire, and has earned credits toward an MBA from Regis University, Denver, CO.

Michael Dunlop - Mr. Dunlop has been responsible for IsoRay Medical and its predecessor companies' financial and accounting operations and administrative services in his position as CFO since April 2001. Mr. Dunlop has over 18 years of financial and administrative experience in the healthcare industry. As Director of Contracting and Marketing for Community Choice, PHCO, an organized healthcare delivery system, from October 1997 to December 2003, he assisted in developing the strategic direction and business plan of the PHCO, negotiated and maintained contractual relations with state-wide major health insurance plans, increased compensation for 80+ independent providers and 6 area hospitals, and enhanced PHCO provider membership through development of programs that lowered clinic and hospital operating costs. He was granted the Pentad Industry Council, Chelan-Douglas Counties' 'Employer of the Year' award in 1996, while administrator of Lake Chelan Clinic. Mr. Dunlop holds an M.B.A. from California State University and B.M. Education from Walla Walla College.

David J. Swanberg - Mr. Swanberg has more than 22 years experience in engineering and materials science, nuclear waste and chemical processing, aerospace materials and processes, and environmental technology development and environmental compliance. Until January 2004, Mr. Swanberg was employed full time as Sr. Chemical/Environmental Engineer for Science Applications International Corporation working on a variety of projects including nuclear waste research and development. Mr. Swanberg joined IsoRay Medical's predecessor company in March of 1999 and has held management positions in the IsoRay companies since 2000. He has been instrumental in development of IsoRay Medical's initial product, the Cs-131 brachytherapy seed, including interfaces with technical, regulatory, and quality assurance requirements. With IsoRay Medical and its predecessor companies, he has managed the development and production of radioactive seeds to support testing to meet NRC and FDA requirements, provided technical guidance for characterization of the IsoRay seed to meet AAPM Task Group 43 protocols, and coordinated production and testing of non-radioactive seeds to conform to ISO standards for brachytherapy devices. He is President of the Nuclear Medicine Research Council. He holds an MS in Chemical Engineering, is a licensed Chemical Engineer, and a certified Level II Radiation Worker.

Robert Kauffman - Mr. Kauffman has served as Chief Executive Officer and Chairman of the Board of Alanco Technologies, Inc. (NASDAQ: ALAN), an Arizona-based information technology company, since July 1, 1998. Mr. Kauffman was formerly President and Chief Executive Officer of NASDAQ-listed Photocomm, Inc., from 1988 until 1997 (since renamed Kyocera Solar, Inc.). Photocomm was the nation's largest publicly owned manufacturer and marketer of wireless solar electric power systems with annual revenues in excess of $35 million. Prior to Photocomm, Mr. Kauffman was a senior executive of the Atlantic Richfield Company (ARCO) whose varied responsibilities included Senior Vice President of ARCO Solar, Inc., President of ARCO Plastics Company and Vice President of ARCO Chemical Company. Mr. Kauffman earned an M.B.A. in Finance at the Wharton School of the University of Pennsylvania, and holds a B.S. in Chemical Engineering from Lafayette College, Easton, Pennsylvania.

Thomas C. Lavoy - Mr. Lavoy has served as Chief Financial Officer of SuperShuttle International, Inc., since July 1997 and as Secretary since March 1998. SuperShuttle is one of the largest providers of shuttle services in major cities throughout the West and Southwest regions of the United States. He has also served as a director of Alanco Technologies, Inc. (NASDAQ: ALAN) since 1998. From September 1987 to February 1997, Mr. Lavoy served as Chief Financial Officer of NASDAQ-listed Photocomm, Inc. Mr. Lavoy was a Certified Public Accountant with the firm of KPMG Peat Marwick from 1980 to 1983. Mr. Lavoy has a Bachelor of Science degree in Accounting from St. Cloud University, Minnesota, and is a Certified Public Accountant.

Stephen Boatwright - Mr. Boatwright has been a member of Keller Rohrback, PLC in Phoenix, Arizona since January 2005. From 1997 through January 2005, Mr. Boatwright was a partner at Gammage & Burnham, PLC, also in Phoenix, Arizona. Throughout his career, he has provided legal counsel to both private and public companies in many diverse industries. In recent years, Mr. Boatwright's legal practice has focused on representing technology, biotechnology, life science and medical device companies for their securities, corporate and intellectual property licensing needs. Mr. Boatwright earned both a J.D. and an M.B.A. from the University of Texas at Austin, and holds a B.A. in Philosophy from Wheaton College.

Significant Employees

Certain significant employees of our subsidiary, IsoRay Medical, Inc., and their respective ages as of the date of this report are set forth in the table below. Also provided is a brief description of the experience of each significant employee during the past five years.

Name	Age	Position Held and Tenure
Lane Bray	77	Chemist
Garrett Brown	42	Chief Technology Officer
Keith Welsch	58	Chief Quality Officer

Lane Bray - Mr. Bray is known nationally and internationally as a technical expert in separations, recovery, and purification of isotopes and is a noted authority in the use of cesium and strontium ion exchange for Department of Energy's West Valley and Hanford nuclear waste cleanup efforts. In 2000, Mr. Bray received the 'Radiation Science and Technology' award from the American Nuclear Society. Mr. Bray has authored or co-authored over 110 research publications, 12 articles for 9 technical books, and holds 24 U.S. and foreign patents. Mr. Bray patented the USDOE/PNNL process for purifying medical grade Yttrium-90 that was successfully commercialized in 1999. Mr. Bray also recently invented and patented the proprietary isotope separation and purification process that is assigned to IsoRay. Mr. Bray was elected 'Tri-Citian of the Year' in 1988, nominated for 'Engineer of the Year' by the American Nuclear Society in 1995, and was elected 'Chemist of the Year for 1997' by the American Chemical Society, Eastern Washington Section. Mr. Bray retired from the Pacific Northwest National Laboratory in 1998. Since retiring in 1998, Mr. Bray worked part time for PNNL on special projects until devoting all of his efforts to IsoRay in 2004. Mr. Bray has been a Washington State Legislator, a Richland City Councilman, and a Mayor of Richland. Mr. Bray has a B.A. in Chemistry from Lake Forest College.

Garrett Brown - Dr. Brown was Manager of Radiochemistry - Hot Cell Operations for International Isotopes, Inc., a major radiopharmaceutical and medical device startup company, from January 1998 until May 1999 and was instrumental in bringing a new brachytherapy seed implant device to commercialization. Dr. Brown's responsibilities included hands-on radiological work in fume hoods, glove boxes and remote manipulator hot cells, process definition, research, development, installation, optimization, waste minimization, procedure documentation, facility design and training. Dr. Brown also served as the technical interface to executive management for business development, shipping/receiving, QA/QC, facilities and marketing/sales. Prior to that, Dr. Brown, as a Senior Research Scientist at the Pacific Northwest National Laboratory, was responsible for the weekly production of multi-Curie quantities of medical grade Y-90, and research programs to develop high tech sorbents for separation of Cs-137, Sr-90 and Tc-99 from high-level radioactive wastes stored at the Hanford Nuclear Reservation. From May 1999 to the present, Dr. Brown has been a technical consultant with GNB Technical Consultants. Dr. Brown has co-authored numerous technical publications in the field. Dr. Brown has a Ph.D. in Analytical Chemistry and BS in Chemistry, cum laude. He has served as IsoRay Medical's Chief Technical Officer since May of 2000. In March 2004, Dr. Brown was certified as a Radiological Safety Officer.

Keith Welsch - Mr. Welsch is a quality control professional with experience in a wide range of organizations and disciplines including the nuclear, aerospace, environmental restoration, construction, tubing, steel and aluminum industries. Mr. Welsch managed the registration of a plant to ISO 9002:1994 and subsequently transitioned the facility

to ISO 9001:2000 and conducted continuous improvement actions. These included statistical process control, six sigma, lean manufacturing, and total preventive maintenance programs. Mr. Welsch's other significant achievements include facilitation of quality improvement and stand down teams, innovative education training manager, management of records review for two nuclear sites, management of audit programs and corrective-action systems, and teaching safety, technical, and quality courses. He has earned the Certified Quality Auditor, Certified Quality Technician and Certified Quality Improvement Associate certifications from the American Society for Quality. Prior to joining IsoRay in 2004, Mr. Welsch served as Quality Assurance Manager for Kaiser Aluminum Products of Richland, Washington since 1997. Mr. Welsch received a BA in Business Administration from Washington State University.

The Company's Directors, as named above, will serve until the next annual meeting of the Company's stockholders or until their successors are duly elected and have qualified. Directors will be elected for one-year terms at the annual stockholders meeting. Officers will hold their positions at the pleasure of the board of directors, absent any employment agreement, of which none currently exists or is contemplated. There is no arrangement or understanding between any of the directors or officers of the Company and any other person pursuant to which any director or officer was or is to be selected as a director or officer, and there is no arrangement, plan or understanding as to whether non-management shareholders will exercise their voting rights to continue to elect the current directors to the Company's board. There are also no arrangements, agreements or understandings between non-management shareholders that may directly or indirectly participate in or influence the management of the Company's affairs.

There are no agreements or understandings for any officer or director to resign at the request of another person, and none of the officers or directors are acting on behalf of, or will act at the direction of, any other person.

Section 16(a) Beneficial Ownership Reporting Compliance

Section 16(a) of the Securities Exchange Act of 1934 (the "Exchange Act") requires the Company's directors and executive officers, and persons who beneficially own more than ten percent of a registered class of our equity securities, to file with the Securities and Exchange Commission (the "Commission") initial reports of beneficial ownership and reports of changes in beneficial ownership of our Common Stock. The rules promulgated by the Commission under Section 16(a) of the Exchange Act require those persons to furnish us with copies of all reports filed with the Commission pursuant to Section 16(a). The information in this section is based solely upon a review of Forms 3, Forms 4, and Forms 5 received by us.

During the transition period ended June 30, 2005, Philip Rogers, our former President and a former director, failed to file one Form 4. To our knowledge, we believe that no other reports were required and not filed during the transition period ended June 30, 2005.

Code of Ethics

We have adopted a Code of Conduct and Ethics that applies to all of our officers, directors and employees and a separate Code of Ethics for Chief Executive Officer and Senior Financial Officers that supplements our Code of Conduct and Ethics. The Code of Conduct and Ethics was previously filed as Exhibit 14.1 to this Transition Report, and the Code of Ethics for Chief Executive Officer and Senior Financial Officers was previously filed as Exhibit 14.2 to this Transition Report. Each of these policies comprises written standards that are reasonably designed to deter wrongdoing and to promote the behavior described in Item 406 of Regulation S-B promulgated by the Securities and Exchange Commission. Each of these policies was adopted after the end of the transition period ended June 30, 2005.

ITEM 10 - EXECUTIVE COMPENSATION

The following summary compensation table sets forth information concerning compensation for services rendered in all capacities during our past three fiscal years awarded to, earned by or paid to each of the following executive officers (the "Executive Officers"). None of the Company's executive officers, other than those listed below, received compensation in fiscal year 2005, in excess of $100,000.

Name and Principal Position	Fiscal Year[1]	Annual Compensation Salary	Long-Term Compensation Awards Restricted Stock Awards	Securities Underlying Options	All Other Compensation
Thomas Scallen, Former Chief Executive Officer[2]	2005	--	--	--	$ 50,000[3]
	2004	--	$ 7,871[4]	--	--
	2003	--	--	--	--
Roger Girard, Chief Executive Officer[5]	2005	$ 113,958	--	--	--
	2004	$ 71,031	$ 9,900	513,840	--
	2003	$ 4,000	$ 49,900	--	--

[1] Fiscal year 2005 consisted of the period from October 1, 2004 through June 30, 2005; fiscal year 2004 consisted of the year ended September 20, 3004; and fiscal year 2003 consisted of the year ended September 30, 2003.

[2] Mr. Scallen served as our Chief Executive Officer during the listed fiscal years and until his resignation effective July 28, 2005.

[3] Represents a $50,000 cash payment in June 2005 to Mr. Scallen in settlement of all accrued but unpaid compensation.

[4] Represents the issuance of 787,100 shares of restricted common stock as compensation associated with the conversion of the outstanding notes payable and accrued interest payable. This transaction was valued at approximately $7,781, which was equal to the "fair value" of the Company's common stock on the conversion date. The Company relied upon Section 4(2) of the Securities Act of 1933, as amended, for an exemption from registration for this issuance.

[5] Mr. Girard did not begin serving as our CEO until July 28, 2005, but he has served as CEO of our subsidiary and its predecessor company since August 2003. The compensation listed was paid to Mr. Girard by IsoRay Medical or its predecessor company.

Aggregated Option Exercises in Last Fiscal Year and Fiscal Year End Option Values

The following table sets forth the number of shares covered by unexercised stock options held by the Executive Officers as of June 30, 2005, and the value of "in-the-money" stock options, which represents the positive spread between the exercise price of a stock option or warrant and the market price of the shares subject to such option or warrant as of June 30, 2005.

			Number of Securities Underlying Unexercised Options at Fiscal Year-End(#)		Value of Unexercised In-the-Money Options at Fiscal Year-End($)	
Name	Number of Shares Acquired on Exercise (#)	Value Realized ($)	Exercisable	Unexercisable	Exercisable	Unexercisable
Roger Girard[1]	0	0	513,841	0	$ 39,650	Nn/a
Thomas Scallen						

(19,362

)

(17,395

)

(44,288
)
Financing activities

4,630

9,731

(1,121
)

10,715

4,678

Capital expenditures

$
1,926

$
2,790

$
4,182

$
12,545

$
19,003

Number of colleges at end of period

35

37

44

56

	61
Student population at end of period	
	13,992
	16,012
	19,464
	25,626
	34,221
Starts during the period [3]	
	18,261
	21,008
	24,660
	33,252
	43,427
Balance Sheet Data:	
Cash, cash equivalents and restricted cash [4]	
$	3,162
$	1,797
$	4,896
$	19,748

$	41,028
Marketable investments	
	14,501
	24,107
	9,699
	25,706
Working capital	
	606
	19,108
	29,069
	39,722
	60,064
Total assets	
	59,905
	73,857
	95,233
	138,636

	207,806
Long-term debt, net of current maturities	
	31,535
	3,396
	2,230
	2,138
	1,515
Redeemable preferred stock	
	2,167
Convertible preferred stock	
	5,174

Total stockholders equity	$ 977	$ 53,536	$ 69,003	$ 105,563	$ 151,054

(1) Represents student tuition and fees and bookstore sales, net of refunds.

(2) EBITDA equals earnings before interest, taxes, depreciation and amortization, including amortization of deferred financing costs and other income. For the year ended June 30, 1999, EBITDA excludes the extraordinary loss from early extinguishment of debt which amounted to $2.0 million (net of $1.5 million tax benefit). EBITDA is presented because we believe it allows for a more complete analysis of our results of operations. EBITDA should not be considered as an alternative to, nor is there any implication that it is more meaningful than, any measure of performance or liquidity as promulgated under GAAP.

(3) Represents the new students starting school during the periods presented.

(4) Includes approximately $760,000, $10,000, $10,000, $10,000 and $267,000 of restricted cash at June 30, 1998, 1999, 2000, 2001 and 2002, respectively.

(5) All share and per share amounts have been restated to reflect two-for-one stock splits effected in the form of stock dividends in December 2000 and May 2002.

Table of Contents

ITEM 7. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion and analysis should be read in conjunction with the Selected Financial Data and the Company s Consolidated Financial Statements and Notes thereto appearing elsewhere in this Report on Form 10-K.

Background and Overview

As of June 30, 2002, we operated 61 colleges, with more than 34,200 students, in 20 states. During the fiscal year ended June 30, 2002, our Company had net revenues of $338.1 million. Our revenues consist principally of student tuition, enrollment fees and bookstore sales, and are presented as net revenues after adjustments related to students who do not complete their courses. We recognize revenue on a pro-rata basis over the expected duration of the students enrollment for diploma programs and over the quarter for students enrolled in degree programs.

Net revenues increased 38.5% to $338.1 million in 2002 from $244.2 million in 2001. The increase is largely the result of a 33.5% increase in the student population and a 7.9% increase in the average tuition rate per student during the period. Tuition revenues, which represented 94.0% of fiscal 2002 total net revenues, fluctuate with the aggregate enrolled student population and the average program or credit hour charge. The student population varies depending on, among other factors, the number of (i) continuing students at the beginning of a fiscal period, (ii) new student enrollments during the fiscal period, (iii) students who have previously withdrawn but who reenter during the fiscal period, and (iv) graduations and withdrawals during the fiscal period. New student starts occur on a monthly basis in the diploma-granting colleges. In the degree-granting colleges, the majority of new student starts occur in the first month of each calendar quarter with an additional mini-start in the second month of each quarter in most colleges. The tuition charges vary by college depending on the local market, the program level, such as diploma, or associate s, bachelor s or master s degree, and the specific curriculum.

The majority of students at our colleges rely on funds received under various government sponsored student financial aid programs to pay a substantial portion of their tuition and other education-related expenses. In fiscal 2002, approximately 82.1% of our net revenues, on a cash basis, were derived from federal student financial aid programs.

We categorize our expenses as educational services, general and administrative, and marketing and advertising. Educational services expense is primarily comprised of those costs incurred to deliver and administer the education programs at the colleges, including faculty and college administration compensation; education materials and supplies; college facility rent and other occupancy costs; bad debt expense; depreciation and amortization of college property and equipment; and default management expenses and financial aid processing costs.

General and administrative expense consist principally of those costs incurred at the corporate and regional level in support of college operations, except for marketing and advertising related costs. Included in general and administrative costs are expenses relating to executive management, corporate staff and regional operations management compensation; rent and other occupancy costs for corporate

Table of Contents

headquarters; depreciation and amortization of corporate property and equipment and certain intangibles; bonus expenses; and other expenses incurred at corporate headquarters.

Marketing and advertising expense includes compensation for college admissions staff, regional admissions directors, compensation paid at corporate for marketing and advertising management, and all direct advertising and production costs. We expense advertising costs as incurred.

Critical Accounting Policies and Estimates

Our discussions and analysis of our financial condition and results of operations is based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts on those financial statements. On an on-going basis, we evaluate our estimates including those related to allowance for doubtful accounts, intangible assets, income taxes, and litigation. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different conditions or if our assumptions change.

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

Revenue Recognition. We maintain a revenue recognition policy. Revenues consist primarily of tuition and fees derived from courses taught in our colleges. Revenue from tuition and fees are recognized pro-rata (on a straight-line basis) over the term of the applicable course or program. If a student withdraws from a course or program, the paid but unearned portion of the student tuition is refunded. Textbook sales and other revenues are recognized as sales occur or services are performed and represent less than 10% of total revenues. Prepaid tuition is the portion of payments received but not earned and is reflected as a current liability in the accompanying consolidated balance sheets as such amount is expected to be earned within the next year.

Marketing and Advertising Expense. We maintain an advertising expense recognition policy. Marketing and advertising costs are expensed as incurred. We have significant marketing and advertising expenses consisting primarily of payroll and payroll related expenses, direct-response and other advertising, promotional materials and other related marketing costs.

Allowance for Doubtful Accounts. We maintain an allowance for doubtful accounts for estimated losses resulting from the inability, failure or refusal of our students to make required payments. We offer a variety of payment plans to help students pay that portion of their education expense not covered by financial aid programs. These balances are unsecured and not guaranteed. We believe our reserves are adequate, however, losses related to unpaid student balances could exceed the amounts we have reserved for bad debts.

Intangible Assets. We have significant intangible assets, including goodwill. The determination of related estimated useful lives and whether or not these assets are impaired involves significant judgments. Although we believe our intangible assets are fairly stated, changes in strategy or market conditions could significantly impact these judgments and require adjustments to record asset balances.

Deferred Taxes. We currently have deferred tax assets which are subject to periodic recoverability assessments. Realization of our deferred tax assets is principally dependent upon achievement of projected future taxable income. We evaluate the realizability of our deferred tax assets at least annually.

Acquisitions

Since our inception, we have completed the following acquisitions, each of which was accounted for using the purchase method of accounting, and the results of their operations are included in our consolidated results of operations since their respective dates of acquisition:

On June 30, 1995, we acquired five colleges from National Education Corporation. As part of the same transaction, we subsequently acquired from National Education Corporation a second group of five colleges on September 30, 1995 and an additional six colleges on December 31, 1995. The adjusted purchase price for all 16 colleges was approximately $4.7 million in cash.

On July 1, 1996, we acquired one college from Repose, Inc., for a purchase price of $250,000 in cash.

On August 31, 1996, we acquired one college from Concorde Career Colleges, Inc., for a purchase price of $350,000 in cash.

On October 17, 1996, we acquired 18 colleges from Phillips Colleges, Inc., for an adjusted purchase price of approximately $23.6 million in cash.

On January 18, 2000, we acquired substantially all of the assets of Harbor Medical College, which operated one college in Torrance, California, for approximately $300,000 in cash.

On April 1, 2000, we acquired substantially all of the assets of the Georgia Medical Institute, which operated three colleges in the greater Atlanta, Georgia metropolitan area, for approximately $7.0 million in cash.

On June 1, 2000, we acquired substantially all of the assets of Academy of Business College, Inc. which operated one college in Phoenix, Arizona, for approximately $1.0 million in cash.

On October 23, 2000, we acquired substantially all of the assets of Educorp, Inc. which operated four colleges in California, for approximately $12.6 million in cash.

On November 1, 2000, we acquired substantially all of the assets of Computer Training Academy, Inc. which operated two colleges in northern California, for approximately $6.1 million in cash.

Table of Contents

On February 1, 2001, we acquired all of the outstanding stock of Grand Rapids Educational Center, Inc., which operated three campuses in Michigan and Illinois, for approximately $2.8 million in cash.

On April 1, 2002, we acquired all of the outstanding stock of National School of Technology, Inc., which operated three campuses in the greater Miami, Florida area, for approximately $14.4 million in cash.

Subsequent to fiscal 2002 year end, on July 1, 2002 we acquired all of the outstanding stock of Wyo-Tech Acquisition Corp., which operates two campuses in Laramie, Wyoming and Blairsville, Pennsylvania, for approximately $84.4 million in cash, funded from available cash and $43 million of debt. The results of Wyo-Tech are not included in the consolidated financial statements for the fiscal year ended June 30, 2002.

Results of Operations

Comparisons of results of operations between fiscal year ended June 30, 2002, and fiscal years ended June 30, 2001 and 2000, are difficult due to the opening of four branch campuses and the acquisition of three campuses in fiscal 2002, the opening of four branch campuses and the acquisition of nine campuses in fiscal 2001, and the opening of two branch campuses and the acquisition of five campuses in fiscal 2000.

The following table summarizes our operating results as a percentage of net revenues for the periods indicated.

	Years Ended June 30,		
	2000	**2001**	**2002**
Statement of Operations Data:			
Net revenues	100.0%	100.0%	100.0%
Operating expenses:			
Educational services	54.3	53.9	51.8
General and administrative	9.6	8.0	8.8
Marketing and advertising	21.8	21.4	20.9
Total operating expenses	85.7	83.3	81.5
Income from operations	14.3	16.7	18.5
Interest expense (income), net	(1.0)	(0.8)	(0.5)
Other (income)	(0.1)		(0.2)
Income before income taxes	15.4	17.5	19.2
Provision for income taxes	6.4	7.0	7.7
Net income	9.0%	10.5%	11.5%

Year Ended June 30, 2002 Compared to Year Ended June 30, 2001

Net Revenues. Net revenues increased $93.9 million, or 38.5%, from $244.2 million in fiscal 2001 to $338.1 million in fiscal 2002 due primarily to a 33.5% increase in the student population during the year and a 7.9% increase in the average tuition rate per student during the period. At June 30, 2002,

Table of Contents

the total student population was 34,221, compared with 25,626 at June 30, 2001. Same school student population increased 22.7% as of June 30, 2002 when compared to the prior year. Net revenues also increased as a result of opening four branch campuses and acquiring three additional campuses during fiscal 2002.

Educational Services. As a percentage of net revenues, educational services expense decreased from 53.9% in fiscal 2001 to 51.8% in fiscal 2002. Educational services expense increased $43.6 million, or 33.1%, from $131.5 million in fiscal 2001 to $175.1 million in fiscal 2002. The increase was due primarily to the 33.5% increase in the student population, wage increases for employees, increase in bad debt expense, and increase in bookstore cost of sales and course materials. Due to initiatives begun in fiscal 2002 to reduce bad debt expense, bad debt expense decreased to 5.5% of revenue or $18.5 million in fiscal 2002 as compared to $14.0 million, or 5.7% of revenue in fiscal 2001. Bad debt expense, as a percentage of revenue improved to 4.7% for the fourth quarter of fiscal 2002 compared to 6.3% in the fourth quarter of fiscal 2001. Additionally, 44 programs were adopted by our schools during fiscal 2002, compared to 75 program adoptions in fiscal 2001 and 36 programs were adopted in fiscal 2000. We expect to complete between 40-50 program adoptions during fiscal 2003. During fiscal 2002, seventeen of our colleges were relocated, enlarged, or remodeled, four new branch campuses were opened, and three campuses were acquired.

General and Administrative. As a percentage of net revenues, general and administrative expense increased from 8.0% in fiscal 2001 to 8.8% in fiscal 2002. General and administrative expense increased $10.0 million, or 51.4%, from $19.6 million in fiscal 2001 to $29.6 million in fiscal 2002. The increase was primarily a result of higher incentive compensation, an increase in the number of employees required to support the increased revenues, student population and the number of campuses and wage increases for employees, increased professional fees, and increased campus relocation expenses.

Marketing and Advertising. As a percentage of net revenues, marketing and advertising expense decreased from 21.4% in fiscal 2001 to 20.9% in fiscal 2002. Marketing and advertising expense increased $18.4 million, or 35.1%, from $52.3 million in fiscal 2001 to $70.7 million in fiscal 2002, primarily due to the increased volume of advertising required to support the acquired campuses and new branch campus openings and additional admissions staff necessary to support the 30.6% increase in new student enrollments. Also contributing to the increase was advertising cost inflation, wage increases for employees, and increased travel expense.

Income From Operations. Income from operations in fiscal 2002 increased 53.9% to $62.7 million, or 18.5% of revenues, compared to $40.8 million, or 16.7% of revenues in fiscal 2001.

Interest Income, net. Interest income (net of interest expense of $0.2 million) amounted to $1.5 million in fiscal 2002 compared to interest income (net of interest expense of $0.3 million) of $2.1 million in fiscal 2001.

Provision for Income Taxes. The effective income tax rate was 40.0% of income before taxes in fiscal 2002 and 39.9% of income before taxes in fiscal 2001.

Net Income. Net income for fiscal 2002 increased 51.4% to $38.9 million, or 11.5% of revenues, compared to net income of $25.7 million, or 10.5% of revenues, for fiscal 2001.

Income per Share. Diluted earnings per share for fiscal 2002 amounted to $0.87 compared to $0.59 for fiscal 2001. The weighted average number of diluted shares outstanding was 44.7 million in fiscal 2002 and 43.5 million in fiscal 2001.

Year Ended June 30, 2001 Compared to Year Ended June 30, 2000

Net Revenues. Net revenues increased $73.5 million, or 43.0%, from $170.7 million in fiscal 2000 to $244.2 million in fiscal 2001 due primarily to a 31.7% increase in the student population during the year and a 9.1% increase in the average tuition rate per student. At June 30, 2001, the total student population was 25,626, compared with 19,464 at June 30, 2000. Same school student population increased 14.0% as of June 30, 2001 when compared to prior year.

Educational Services. Educational services expense increased $38.7 million, or 41.8%, from $92.8 million in fiscal 2000 to $131.5 million in fiscal 2001. The increase was due primarily to the 31.7% increase in student population, wage increases for employees, bad debt expense, and expenses incurred to adopt curricula at the schools. During fiscal 2001, we adopted 75 programs, during fiscal 2000 we adopted 36 programs and in fiscal 1999 we adopted 24 programs. Bad debt expense was negatively impacted from the October 2000 required adoption of the Department of Education s new methodology for calculating refunds of federal student financial aid previously disbursed to students who have since withdrawn from an institution. This new regulation results in an increase in the student s obligation to the institution from which they have withdrawn and a decrease in the amount of student federal financial aid received by the institution on behalf of the students who withdraw. Bad debt expense amounted to $14.0 million, or 5.7% of revenue in fiscal 2001, compared to $8.8 million, or 5.1% of revenue in fiscal 2000. Additionally, 13 of our colleges were relocated, enlarged, or remodeled, four new branch campuses were opened, and nine campuses were acquired. As a percentage of net revenues, educational services expense decreased from 54.3% to 53.9%.

General and Administrative. General and administrative expense increased $3.3 million, or 19.7%, from $16.3 million in fiscal 2000 to $19.6 million in fiscal 2001. The increase was primarily a result of (i) additional headquarters staff and related relocation costs to support operations, (ii) wage increases for employees, and (iii) higher incentive compensation. As a percentage of net revenues, general and administrative expense decreased from 9.6% to 8.0%.

Marketing and Advertising. Marketing and advertising expense increased $15.1 million, or 40.6%, from $37.2 million in fiscal 2000 to $52.3 million in fiscal 2001, primarily due to the increased volume of advertising required to support the acquired campuses and new branch campus openings and additional admissions staff necessary to support the 33.6% increase in new student enrollments. Also contributing to the increase was advertising cost inflation and wage increases for employees. As a percentage of net revenues, marketing and advertising expense decreased from 21.8% to 21.4%.

Income From Operations. Income from operations increased 67.0% to $40.8 million, or 16.7% of revenues in fiscal 2001, compared to $24.4 million, or 14.3% of revenues in fiscal 2000.

Interest Income, net. Interest income (net of interest expense of $0.3 million) amounted to $2.1 million in fiscal 2001 compared to interest income (net of interest expense of $0.4 million) of $1.7 million in fiscal 2000.

Provision for Income Taxes. The effective income tax rate for fiscal 2001 decreased to 39.9% of income before taxes compared to 41.3% of income before taxes in fiscal 2000.

Net Income. Net income for fiscal 2001 increased 66.8% to $25.7 million, or 10.5% of revenues, compared to net income of $15.4 million, or 9.0% of revenues, for fiscal 2000.

Income per Share. Diluted earnings per share for fiscal 2001 amounted to $0.59 compared to $0.37 for fiscal 2000. The weighted average number of diluted shares outstanding was 43.5 million in fiscal 2001 and 41.7 million in fiscal 2000.

Seasonality

Our revenues normally fluctuate as a result of seasonal variations in our business, principally in total student population. Student population varies as a result of new student enrollments and student attrition. Historically, our colleges have had lower student populations in the first fiscal quarter than in the remainder of the year. Our expenses, however, do not vary as significantly as student population and revenues. We expect quarterly fluctuations in operating results to continue as a result of seasonal enrollment patterns. Such patterns may change, however, as a result of acquisitions, new school openings, new program introductions and increased high school enrollments. The operating results for any quarter are not necessarily indicative of the results for any future period. See the footnote entitled Quarterly Financial Summary (unaudited) of the Consolidated Financial Statements included elsewhere herein.

Liquidity and Capital Resources

In June 2002, the Company entered into a Credit Agreement for $100.0 million with a syndication of seven financial institutions administered by Bank of America, N.A which expires in July 2005. This Credit Agreement replaced the Company s $20.0 million credit facility with Union Bank of California. The Credit Agreement has been established to provide available funds for business acquisitions, to fund general corporate purposes, and to provide for letter of credit issuances of up to $5.0 million. Borrowings under the agreement bear interest at several pricing alternatives available to the Company, including LIBOR and adjusted reference or base rates. The base rate is defined as the higher of the Federal Funds rate plus 1/2 of 1% or the Bank of America prime rate, plus a margin of 0.25% to 0.75% depending on the Company s consolidated leverage ratio as defined in the agreement. Fees associated with outstanding letters of credit issued under the terms of the agreement range from 1.5% to 2.0% and are also dependent on the Company s consolidated leverage ratio. The agreement contains customary affirmative and negative covenants including financial covenants requiring the maintenance of consolidated net worth, fixed charge coverage ratios, leverage ratios, pro forma adjusted EBITDA, DOE financial responsibility composite score ratio, and limitations on long term student notes receivables. As of June 30, 2002, the Company was in compliance with all of these covenants. As of June 30, 2002, there were no borrowings outstanding under the terms of this agreement. The Credit Agreement is secured by substantially all of the Company s real and personal property including the stock of its subsidiaries and guaranteed by the Company s present and future significant operating subsidiaries.

Table of Contents

Average daily borrowings outstanding amounted to $0 in fiscal 2002, compared to $35,000 in fiscal 2001. As of June 30, 2002 we had $2.1 million of letters of credit issued and outstanding.

On July 1, 2002, the Company borrowed $43.0 million under the terms of the Credit Agreement to acquire all of the outstanding stock of Wyo-Tech Acquisition Corp. The aggregate purchase price was approximately $84.4 million (subject to certain working capital adjustments), of which approximately $41.4 million was paid in cash by the Company.

Working capital amounted to $60.1 million as of June 30, 2002, and $39.7 million as of June 30, 2001 and the current ratio was 2.2:1 and 2.4:1 for fiscal 2002 and 2001, respectively.

Cash flows provided by operating activities amounted to $60.6 million in fiscal 2002 compared to $21.5 million in fiscal 2001 and $23.6 million in 2000. The increase in cash provided by operating activities in fiscal 2002, when compared to fiscal 2001, was due to increased earnings, a decrease in student receivables and an increase in accounts payable, accrued expenses and prepaid tuition, partially offset by increased prepaid expenses and other assets and other long term liabilities. The decrease in cash provided by operating activities in fiscal 2001, when compared to fiscal 2000, was due to increases in student receivables and prepaid expenses and other assets, partially offset by increased earnings, accounts payable, accrued expenses and prepaid tuition.

Cash flows used in investing activities amounted to $44.3 million in fiscal 2002, $17.4 million in fiscal 2001 and $19.4 million in fiscal 2000. The change in cash flows used in investing activities is due primarily to the acquisition of colleges, increased capital expenditures, net of proceeds from asset dispositions, and from increases in restricted cash and in marketable investments. During fiscal 2002, we completed the acquisition of NST and its three colleges in the greater Miami area for a purchase price of $14.4 million and assumed net liabilities of $0.6 million. The amount paid in excess of the fair market value of the assets acquired, net of liabilities assumed, was $15.0 million and was allocated to goodwill. During fiscal 2001, we completed the acquisition of nine colleges in three separate transactions for a combined purchase price of $22.1 million, including $2.8 million of liabilities assumed or paid. The amount paid in excess of the fair market value of the assets acquired, net of liabilities assumed, was $18.4 million, of which $17.0 million was allocated to goodwill and was being amortized over 40 years. The remaining $1.4 was allocated to curriculum and non-compete agreements with the former owners. During fiscal 2000, we completed the acquisition of substantially all of the assets of five colleges in three separate transactions for a combined purchase price of $8.3 million in cash, including $0.7 million of liabilities assumed or paid. The amount paid in excess of the fair market value of the assets acquired, net of liabilities assumed, was $7.9 million and was allocated to goodwill and was being amortized over 40 years. These acquisitions were accounted for using the purchase method of accounting and their respective results of operations are included in our consolidated results of operations since their respective acquisition dates.

Capital expenditures amounted to $19.0 million in fiscal 2002, $12.5 million in fiscal 2001 and $4.2 million in fiscal 2000. Capital expenditures were incurred to open four new branch campuses in fiscal 2002, four new branch campuses in fiscal 2001, and two new branch campuses in fiscal 2000, and for the purchases of classroom equipment to accommodate the increased student population and to continue to upgrade existing schools and classroom equipment. Capital expenditures were also incurred to relocate, remodel and enlarge campuses. During fiscal 2002, we incurred capital expenditures of approximately $10.0 million to open four new branch campuses, to relocate six campuses and to enlarge

or remodel ten campuses. During fiscal 2001, three campuses were relocated and nine campuses and our corporate headquarters were enlarged or remodeled. During fiscal 2000, two campuses were relocated and two campuses were remodeled. Capital expenditures of approximately $5.7 million and $2.4 million were incurred to purchase information technology equipment and to integrate software in fiscal 2002 and fiscal 2001, respectively. In fiscal 2002, the Company sold its Colorado Springs facility and subsequently leased the facility back at rents which we believe approximate fair market rents. The gain on sale of the facility was approximately $0.2 million and will be amortized into income over the term of the lease. In fiscal 2000, the Company sold its Aurora, Colorado facility and subsequently leased the facility back at rents which we believe approximate fair market rents. The gain on the sale of the facility was approximately $1.0 million and was amortized into income over the term of the lease. During fiscal 2002, the Company relocated its Colorado facility and recognized the unamortized portion of the deferred gain of approximately $0.6 million. We believe that our capital expenditures for fiscal 2003 will approximate $24.0 million.

During fiscal 2002, marketable investments increased by $16.0 million, while in fiscal 2001 marketable investments decreased by $14.4 million. Marketable investments increased by $9.6 million in fiscal 2000.

Net cash provided by financing activities amounted to $4.7 million in fiscal 2002. Net cash provided by financing activities amounted to $10.7 million in fiscal 2001 and net cash used in financing activities amounted to $1.1 million in fiscal 2000. During fiscal 2002, net cash provided by financing activities consisted of proceeds from the exercise of stock options of $6.5 million, partially offset by the payments on long-term debt of $1.9 million. During fiscal 2001, net cash provided by financing activities consisted primarily of net proceeds of $8.8 million from the secondary public stock offering of approximately 800,000 shares of common stock and proceeds from the exercises of stock options, including tax benefits, of $2.0 million. During fiscal 2000, net cash used in financing activities consisted primarily of payments on long-term debt.

We believe that our working capital, cash flow from operations, access to operating leases and borrowings from our Credit Agreement will provide us with adequate resources for ongoing operations through fiscal 2003 and our currently identified facility relocations, remodels and expansions and other planned capital expenditures.

New Accounting Pronouncements

In March 2000, the Financial Accounting Standards Board (FASB) issued Interpretation No. 44, (FIN 44), Accounting for Certain Transactions Involving Stock Compensation an Interpretation of APB 25. This Interpretation clarifies (a) the definition of employee for purposes of applying Opinion 25, (b) the criteria for determining whether a plan qualifies as a non-compensatory plan, (c) the accounting consequence of various modifications to the terms of a previously fixed stock option or award, and (d) the accounting for an exchange of stock compensation awards in a business combination. The adoption of FIN 44 did not have a material effect on the Company s financial position or results of operations.

For fiscal 2001, we were required to adopt Statements of Financial Accounting Standards (SFAS) No. 133, Accounting for Derivative Instruments and Hedging Activities. The adoption of SFAS No. 133 did not have a material effect on our financial position or results of operations.

For fiscal 2001, we adopted Staff Accounting Bulletin (SAB) 101. SAB 101 required the Company to change the accounting method of revenue recognition of certain one-time non-refundable fees from immediate recognition, to amortizing the fees into revenues over the period of active enrollment of the student. The adoption of SAB 101 did not have a material impact on the Company s financial position or results of operations.

In June 2001, FASB issued SFAS No. 141, Business Combinations and SFAS No. 142, Goodwill and Other Intangible Assets. SFAS No. 141 addresses financial accounting and reporting for business combinations and is effective for all business combinations after June 30, 2001. SFAS No. 142 addresses financial accounting and reporting for acquired goodwill and other intangible assets. The Company adopted SFAS No. 142, Accounting for Business Combinations, Goodwill and Other Intangible Assets, in its entirety effective July 1, 2002. Under SFAS 142, goodwill is no longer amortized on a periodic basis, but instead is subject to an impairment test to be performed at least on a annual basis. If the test indicates that goodwill is impaired, the goodwill will be written down to its fair value and a corresponding change to earnings will be recorded. Separable intangible assets that are not deemed to have indefinite lives will continue to be amortized over their useful lives. Goodwill amortization expense for fiscal 2002 was $824,000 compared to $636,000 for fiscal 2001, and $252,000 for fiscal 2000. As of June 30, 2002, goodwill totaled $45.3 million.

In June 2001, the FASB issued SFAS No. 143, Accounting for Asset Retirement Obligations. SFAS 143 addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. SFAS 143 will be effective for financial statements issued for fiscal years beginning after June 15, 2002, and we expect the adoption will not have a material impact on our consolidated financial condition or results of operations.

In August 2001, the FASB issued SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets , which addresses financial accounting and reporting for the impairment or disposal of long-lived assets. SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, retains the fundamental provisions of existing generally accepted accounting principles with respect to the recognition and measurement of long-lived asset impairment contained in the SFAS No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of. However, SFAS No. 144 provides new guidance intended to address certain significant implementation issues associated with SFAS No. 121, including expanded guidance with respect to appropriate cash flows to be used to determine whether recognition of any long-lived asset impairment is required, and if required, how to measure the amount of the impairment. SFAS No. 144 also requires that any net assets to be disposed of by sale be reported at the lower of carrying value or fair value less cost to sell, and expands the reporting of discontinued operations to include any component of any entity with operations and cash flows that can be clearly distinguished from the rest of the entity. The Company adopted SFAS 144 as of July 1, 2002 and the adoption will not have a significant impact on the Company s consolidated financial position and results of operations.

Table of Contents

In April 2002, the FASB issued Statement of Financial Accounting Standards No. 145 Rescission of FASB Statements No. 4, 44, and 64 Amendment of FASB Statement No. 13, and Technical Corrections . SFAS 145 rescinds FASB Statement No. 4, Reporting Gains and Losses from Extinguishment of Debt, which required all gains and losses from extinguishment of debt to be aggregated and, if material, classified as an extraordinary item, net of related income tax effect. SFAS 145 requires that gains or losses from extinguishment of debt be classified as extraordinary items only if they meet the criteria of ABP Opinion No. 30 and is effective beginning after May 15, 2002.

In June 2002, the FASB issued Statement of Financial Accounting Standards No. 146, Accounting for Costs Associated with Exit or Disposal Activities. SFAS 146 nullifies Emerging Issues Task Force (EITF) Issue No. 94-3, Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (Include Certain Costs Incurred in a Restructuring) in its entirety and addresses the significant issues relating to recognition, measurement, and reporting costs associated with an exit or disposal activity, including restructuring activities. Pursuant to SFAS 146, a liability is recorded on the date on which the obligation is incurred and should be initially measured at fair value. Under EITF Issue No. 94-3, a liability for such costs is recognized as of the date of an entity s commitment to an exit plan as well as its measurement and reporting. SFAS 146 is effective for exit or disposal activities initiated after December 31, 2002. Currently, SFAS 146 is not expected to significantly impact the assessment of such liability by the Company.

Subsequent Event

Effective July 1, 2002, we acquired all of the outstanding stock of Wyo-Tech Acquisition Corporation. The cash purchase price was $84.4 million and is subject to certain post closing working capital adjustments. The cash purchase price was funded through cash on hand and approximately $43 million provided from our recently completed three year, $100 million credit facility. Wyo-Tech had approximately 1,500 students as of July 1, 2002 and operates two colleges in Laramie, Wyoming and Blairsville, Pennsylvania that offer both degree and diploma programs with concentrations of study in automotive repair, diesel technician and collision repair. For fiscal 2003, we expect Wyo-Tech to generate revenues of between $38 million and $40 million and to contribute EBITDA of between $9.9 million and $11.6 million. Additionally, we expect Wyo-Tech, after giving effect to acquisition integration costs, the incurrence of interest expense and the reduction of interest income, to be accretive to diluted earnings per share by between $0.04 and $0.06 for fiscal 2003.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We do not utilize interest rate swaps, forward or option contracts on foreign currencies or commodities, or other types of derivative financial instruments. As of June 30, 2002, our only assets or liabilities subject to risks from interest rate changes are (i) mortgage debt in the aggregate amount of $1.6 million, (ii) notes receivable from students in the net aggregate amount of $1.9 million, and (iii) marketable investments of $25.7 million. Our mortgage debt, student notes receivable, and marketable investments are all at fixed interest rates. We do not believe we are subject to material risks from reasonably possible near-term changes in market interest rates.

Table of Contents

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The following financial statements of the company and its subsidiaries are included below on pages 53-76 and page 85 of this report:

	Page
Report of Independent Auditors	53
Report of Independent Public Accountants	54
Consolidated Balance Sheets at June 30, 2001 and 2002	55
Consolidated Statements of Operations for the years ended June 30, 2000, 2001, and 2002	56
Consolidated Statements of Stockholders Equity for the years ended June 30, 2000, 2001, and 2002	57
Consolidated Statements of Cash Flows for the years ended June 30, 2000, 2001, and 2002	58
Notes to Consolidated Financial Statements	59
Schedule II Valuation and Qualifying Accounts	85

Table of Contents

Report of Independent Auditors

Board of Directors and Shareholders
Corinthian Colleges, Inc.

We have audited the accompanying consolidated balance sheet of Corinthian Colleges, Inc. and subsidiaries as of June 30, 2002 and the related consolidated statements of operations, stockholders equity, and cash flows for the year ended June 30, 2002. 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 States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. 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 consolidated financial position of Corinthian Colleges, Inc. and subsidiaries at June 30, 2002, and the consolidated results of their operations and their cash flows for the year ended June 30, 2002, in conformity with accounting principles generally accepted in the United States.

/s/ Ernst & Young LLP

Orange County, California
August 16, 2002

Table of Contents

The following report of Arthur Andersen LLP (Andersen) is a copy of the original report dated August 15, 2001, rendered on the prior years financial statements. The SEC has recently provided regulatory relief designed to allow public companies to dispense with the requirement that they file a consent of Andersen in certain circumstances. After reasonable efforts we have not been able to obtain a re-issued report or consent from Andersen.

REPORT OF INDEPENDENT PUBLIC ACCOUNTANTS

To Corinthian Colleges, Inc.:

We have audited the accompanying consolidated balance sheets of CORINTHIAN COLLEGES, INC. (a Delaware corporation) and subsidiaries as of June 30, 2000 and 2001 and the related consolidated statements of operations, stockholders equity and cash flows for each of the three years in the period ended June 30, 2001. 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. 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 consolidated financial statements referred to above present fairly, in all material respects, the financial position of Corinthian Colleges, Inc. and subsidiaries, as of June 30, 2000 and 2001, and the results of their operations and their cash flows for each of the three years in the period ended June 30, 2001, in conformity with accounting principles generally accepted in the United States.

/s/ ARTHUR ANDERSEN LLP

Orange County, California
August 15, 2001

CORINTHIAN COLLEGES, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(In thousands)

	As of June 30,	
	2001	**2002**
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 19,738	$ 40,761
Restricted cash	10	267
Marketable investments	9,699	25,706
Accounts receivable, net of allowance for doubtful accounts of $7,191 and $7,297 at June 30, 2001 and 2002, respectively	24,368	24,043
Student notes receivable, net of allowance for doubtful accounts of $106 and $320 at June 30, 2001 and 2002, respectively	577	726
Deferred income taxes	4,089	6,142
Prepaid expenses and other current assets	9,675	11,482
Total current assets	68,156	109,127
PROPERTY AND EQUIPMENT, net	22,921	36,956
OTHER ASSETS:		
Goodwill, net	31,239	45,340
Other intangibles, net	12,931	12,085
Student notes receivable, net of allowance for doubtful accounts of $319 and $434 at June 30, 2001 and 2002, respectively	1,730	1,218
Deposits and other assets	1,659	3,080
TOTAL ASSETS	$ 138,636	$ 207,806
LIABILITIES AND STOCKHOLDERS EQUITY		
CURRENT LIABILITIES:		
Accounts payable	$ 7,587	$ 14,371
Accrued compensation and related liabilities	9,254	15,800
Accrued expenses	1,305	2,671
Income tax payable	1,280	2,304
Prepaid tuition	7,962	13,332
Current portion of long-term debt	1,046	585
Total current liabilities	28,434	49,063
LONG-TERM DEBT, net of current portion	2,138	1,515
DEFERRED INCOME	655	147
DEFERRED INCOME TAXES	1,283	5,920
OTHER LIABILITIES	563	107
COMMITMENTS AND CONTINGENCIES (Note 9)		
STOCKHOLDERS EQUITY:		
Common Stock, $0.0001 par value:		
Common Stock, 80,000 shares authorized, 42,446 shares and 42,954 shares issued and outstanding at June 30, 2001 and 2002, respectively	4	4
Nonvoting Common Stock, 2,500 shares authorized and no shares issued and outstanding at June 30, 2001 and no shares authorized and no shares issued and outstanding at June 30, 2002		
Additional paid-in capital	60,480	67,023

Retained earnings	45,079	84,027
Total stockholders equity	105,563	151,054
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$ 138,636	$ 207,806

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

Table of Contents

CORINTHIAN COLLEGES, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share data)

	Years Ended June 30,		
	2000	**2001**	**2002**
NET REVENUES	$ 170,734	$ 244,163	$ 338,146
OPERATING EXPENSES:			
Educational services (including a provision for bad debt expense of $8,760, $13,965 and $18,527 for the years ended June 30, 2000, 2001 and 2002, respectively)	92,757	131,501	175,088
General and administrative	16,346	19,562	29,614
Marketing and advertising	37,225	52,349	70,741
Total operating expenses	146,328	203,412	275,443
INCOME FROM OPERATIONS	24,406	40,751	62,703
Interest income, net	(1,681)	(2,078)	(1,538)
Other income	(175)		(662)
INCOME BEFORE PROVISION FOR INCOME TAXES	26,262	42,829	64,903
Provision for income taxes	10,840	17,098	25,955
NET INCOME	$ 15,422	$ 25,731	$ 38,948
INCOME PER SHARE:			
Basic	$ 0.37	$ 0.61	$ 0.91
Diluted	$ 0.37	$ 0.59	$ 0.87
Weighted average number of common shares outstanding:			
Basic	41,386	42,064	42,692
Diluted	41,698	43,462	44,694

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

CORINTHIAN COLLEGES, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY

(In thousands)

	Common Stock		Nonvoting Common Stock				
	Shares	**Par Value**	**Shares**	**Par Value**	**Additional Paid-in Capital**	**Retained Earnings**	**Total Stockholders Equity**
Balance at June 30, 1999	36,676	$ 4	4,706	$	$ 49,606	$ 3,926	$ 53,536
Exercise of Stock Options, including tax benefits	14				45		45
Net income and comprehensive income						15,422	15,422
Balance at June 30, 2000	36,690	4	4,706		49,651	19,348	69,003
Conversion of Nonvoting Common Stock to Common Stock	4,706		(4,706)				
Issuance of Common Stock from secondary public stock offering, net	800				8,821		8,821
Exercise of Stock Options, including tax benefit	250				2,008		2,008
Net income and comprehensive income						25,731	25,731
Balance at June 30, 2001	42,446	4			60,480	45,079	105,563
Issuance of Common Stock from Employee Stock Purchase Plan	23				396		396
Exercise of Stock Options, including tax benefit	485				6,147		6,147
Net income and comprehensive income						38,948	38,948
Balance at June 30, 2002	42,954	$ 4		$	$ 67,023	$ 84,027	$ 151,054

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

CORINTHIAN COLLEGES, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

	Years Ended June 30,		
	2000	**2001**	**2002**
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net income	$ 15,422	$ 25,731	$ 38,948
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	3,798	4,860	6,653
Deferred income taxes	(98)	(1,260)	2,549
(Gain) loss on disposal of assets	(175)		37
Changes in assets and liabilities, net of effects from acquisitions:			
Accounts receivable	(2,192)	(9,150)	645
Student notes receivable	3,058	1,769	363
Prepaid expenses and other assets	(397)	(5,509)	(3,015)
Accounts payable	463	1,901	6,428
Accrued expenses	2,068	1,463	3,876
Income tax payable	(687)	119	1,024
Prepaid tuition	1,732	1,085	3,999
Other long-term liabilities	590	523	(874)
Net cash provided by operating activities	23,582	21,532	60,633
CASH FLOWS FROM INVESTING ACTIVITIES:			
Acquisitions of schools and colleges, net of cash acquired	(7,588)	(19,258)	(9,826)
Increase in restricted cash			(257)
Capital expenditures, net	(4,182)	(12,545)	(19,003)
Proceeds from sale of assets	2,014		805
Sales of (investment in) marketable investments	(9,606)	14,408	(16,007)
Net cash (used in) investing activities	(19,362)	(17,395)	(44,288)
CASH FLOWS FROM FINANCING ACTIVITIES:			
Principal repayments on long-term debt	(1,166)	(114)	(1,865)
Proceeds from secondary public offering		8,821	
Proceeds from exercise of stock options and Employee Stock Purchase Plan, including tax benefit	45	2,008	6,543
Net cash provided by (used in) financing activities	(1,121)	10,715	4,678
NET INCREASE IN CASH AND CASH EQUIVALENTS	3,099	14,852	21,023
CASH AND CASH EQUIVALENTS, beginning of year	1,787	4,886	19,738
CASH AND CASH EQUIVALENTS, end of year	$ 4,886	$ 19,738	$ 40,761
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:			
Cash paid during the year for:			
Income taxes	$ 11,526	$ 16,979	$ 24,931

Interest	$ 392	$ 275	$ 239
SUPPLEMENTAL DISCLOSURE OF NON CASH INVESTING AND FINANCING ACTIVITIES:			
Acquisitions of various schools and colleges			
Fair value of assets acquired	$ 9,051	$ 20,754	$ 16,094
Net cash used in acquisitions	7,588	19,258	9,826
Liabilities assumed or incurred	$ 1,463	$ 1,496	$ 6,268

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

Table of Contents

CORINTHIAN COLLEGES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 DESCRIPTION OF THE BUSINESS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Description of the Business

Corinthian Colleges, Inc. (the Company), a Delaware corporation, was formed in October 1996 during a reorganization transaction with a predecessor company which was accounted for as a recapitalization. Prior to October 1996 and since 1995, the Company operated under the name of its predecessor, Corinthian Schools, Inc.

The Company s primary business is the operation of degree and diploma granting for-profit, post-secondary schools devoted to career program training primarily in the healthcare, information technology, business, and criminal justice fields. As of June 30, 2002, we operated 61 colleges in 20 states: Virginia, West Virginia, Texas, Michigan, Massachusetts, Louisiana, California, Oregon, Colorado, Nevada, Utah, Missouri, Pennsylvania, New York, Washington, Arizona, Georgia, Florida, Indiana, and Illinois. Revenues generated from these schools consist primarily of tuition and fees paid by students. To pay for a substantial portion of their tuition, the majority of students rely on funds received from federal financial aid programs under Title IV (Title IV Programs) of the Higher Education Act of 1965, as amended (HEA). For further discussion see Concentration of Risk below and the footnote describing Governmental Regulation.

Fiscal Year

Our fiscal year ends June 30 of each year.

Principles of Consolidation

The accompanying consolidated financial statements include the accounts of Corinthian Colleges, Inc. and each of its wholly owned subsidiaries. All intercompany activity has been eliminated in consolidation.

Financial Statement Estimates

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

Reclassification

Certain amounts for the prior years have been reclassified to conform to fiscal 2002 financial statement presentation.

Cash and Cash Equivalents

The Company considers all highly liquid investments purchased with an original maturity of three months or less to be cash equivalents.

Marketable Investments

Statements of Financial Accounting Standards (SFAS) No. 115, Accounting For Certain Debt and Equity Securities requires that all applicable investments be classified as trading securities, available-for-sale securities or held-to-maturity securities. The Company does not currently have any trading securities or held-to-maturity securities.

Securities classified as available-for-sale may be sold in response to changes in interest rates, liquidity needs and for other purposes. Available-for-sale securities are carried at fair value and include all debt and equity securities not classified as held-to-maturity or trading. Unrealized holding gains and losses for available-for-sale securities are excluded from earnings and reported, net of any income tax effect, as a separate component of stockholders equity. Realized gains and losses for securities classified as available-for-sale are reported in earnings.

The Company adopted SFAS No. 130, Reporting Comprehensive Income, in 1999. This statement requires that all items that meet the definition of components of comprehensive income be reported in a financial statement for the period in which they are recognized. Components of comprehensive income include revenues, expenses, gains and losses that under accounting principles generally accepted in the United States are included in comprehensive income, but excluded from net income. There are no differences between the Company s net income, as reported, and comprehensive income, as defined, for the periods presented.

Restricted Cash

Restricted cash consists of a $267,000 which consists of $10,000 deposit as required by the State of Pennsylvania Department of Education and $257,000 in certificates of deposit that collateralize outstanding letters of credit issued to the U.S. Department of Education (DOE).

Revenue Recognition

Revenues consist primarily of tuition and fees derived from courses taught in the Company s colleges. Tuition and fee revenues are recognized pro-rata (on a straight-line basis) over the term of the applicable course. If a student withdraws from a course or program, the paid but unearned portion of the student tuition is refunded. Textbook sales and other revenues are recognized as sales occur or services are performed and represent less than 10% of total revenues. Prepaid tuition is the portion of payments received but not yet earned and is reflected as a current liability in the accompanying consolidated balance sheets as such amount is expected to be earned within the next year.

Educational Services

Educational services include direct operating expenses of the schools consisting primarily of payroll and payroll related expenses, occupancy and supplies costs, bad debt expense and the amortization of goodwill.

Table of Contents

Marketing and Advertising

We maintain an advertising expense recognition policy. Marketing and advertising costs are expensed as incurred. We have significant marketing and advertising expenses consisting primarily of payroll and payroll related expenses, direct-response and other advertising, promotional materials and other related marketing costs.

Property and Equipment

Property and equipment are stated at cost and are being depreciated or amortized utilizing the straight-line method over the following estimated useful lives:

Furniture and equipment	7 years
Computer hardware and software	3-5 years
Leasehold improvements	Shorter of 7 years or term of lease
Buildings	39 years

Deferred Financing Costs

Costs incurred in connection with obtaining financing are capitalized and amortized over the maturity period of the debt and are included in deposits and other assets in the accompanying consolidated balance sheets.

Intangible Assets

Intangible assets consist of goodwill, trade names and course curriculum. Goodwill represents the excess of cost over the fair market value of net assets acquired, including identified intangible assets. Goodwill acquired prior to July 1, 2001 is being amortized using the straight-line method over 40 years. Course curriculum represents the cost of acquiring such curriculum and is amortized using the straight-line method over 3 to 15 years. Trade names represent the cost to acquire and use the names of the colleges acquired and are amortized using the straight line method over 40 years. Amortization of curriculum and trade names is included in general and administrative expenses while amortization of goodwill is included in education services in the accompanying statements of operations. The Company assesses the recoverability of its long-lived assets on an annual basis or whenever adverse events or changes in circumstances or business climate indicate that expected undiscounted future cash flows related to such long-lived assets may not be sufficient to support the net book value of such assets. If undiscounted cash flows are not sufficient to support the recorded assets, impairment is recognized to reduce the carrying value of the long-lived assets to the estimated fair value. Cash flow projections, although subject to a degree of uncertainty, are based on trends of historical performance and management s estimate of future performance, giving consideration to existing and anticipated competitive and economic conditions. Additionally, in conjunction with the review for impairment, the remaining estimated lives of certain of the Company s long-lived assets are assessed. See New Accounting Pronouncements below.

Deferred Income

In fiscal 2000, the Company sold one of its Colorado facilities and subsequently leased the facility back at rents which we believe approximate fair market rents. The gain on the sale of the facility was approximately $1.0 million and was amortized into income over the term of the lease. During fiscal

Table of Contents

2002, the Company relocated from the facility and recognized the unamortized portion of the deferred gain of approximately $0.6 million.

In fiscal 2002, the Company sold a facility and subsequently leased the facility back at rents which we believe approximate fair market rents. The gain on sale of the facility was approximately $0.2 million and is being amortized into income over the term of the lease.

Fair Value of Financial Instruments

The carrying value of cash and cash equivalents, restricted cash, marketable investments, receivables and accounts payable approximates their fair value at June 30, 2002 and 2001. In addition, the carrying value of all borrowings approximate fair value at June 30, 2002 and 2001.

Post Retirement Benefit Obligation

The Company provides certain post retirement benefits to certain key employees. In accordance with SFAS No. 106, the related expense did not have a material effect on the Company s financial position or results of operations.

Income Taxes

The Company accounts for income taxes as prescribed by SFAS No. 109, Accounting for Income Taxes. SFAS No. 109 prescribes the use of the asset and liability method to compute the differences between the tax basis of assets and liabilities and the related financial amounts, using currently enacted tax laws. Valuation allowances are established, when necessary, to reduce deferred tax assets to the amount that more likely than not will be realized.

Deferred Taxes

We currently have deferred tax assets which are subject to periodic recoverability assessments. Realization of our deferred tax assets is principally dependent upon achievement of projected future taxable income. We evaluate the realizability of our deferred tax assets at least annually.

Stock-Based Compensation

In accordance with SFAS No. 123 Accounting for Stock-Based Compensation, the Company accounts for stock option grants in accordance with Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees, and has adopted the disclosure only alternative allowed under SFAS No. 123.

Income Per Common Share

The Company accounts for income per common share in accordance with SFAS No. 128 Earnings Per Share and SFAS No. 129, Disclosure of Information about Capital Structure. Basic income (loss) per common share is computed by dividing income (loss) attributable to common stockholders by the weighted average number of common shares outstanding for the period. Diluted income (loss) per common share is computed by dividing income (loss) attributable to common stockholders by the weighted average number of common shares outstanding plus the effect of dilutive stock options, utilizing the treasury stock method.

Common Stock Splits

During fiscal 2001, on December 15, 2000, the Company completed a two-for-one stock split effected in the form of a stock dividend. During fiscal 2002, on May 28, 2002, the Company completed

a two-for-one stock split effected in the form of a stock dividend. All share and per share amounts have been restated to reflect the stock splits as of the beginning of the earliest period presented.

New Accounting Pronouncements

In March 2000, the Financial Accounting Standards Board (FASB) issued Interpretation No. 44, (FIN 44), Accounting for Certain Transactions Involving Stock Compensation - an Interpretation of APB 25. This Interpretation clarifies (a) the definition of employee for purposes of applying Opinion 25, (b) the criteria for determining whether a plan qualifies as a non-compensatory plan, (c) the accounting consequence of various modifications to the terms of a previously fixed stock option or award, and (d) the accounting for an exchange of stock compensation awards in a business combination. The adoption of FIN 44 did not have a material effect on our financial position or results of operations.

For fiscal 2001, we were required to adopt Statements of Financial Accounting Standards (SFAS) No. 133, Accounting for Derivative Instruments and Hedging Activities. The adoption of SFAS No. 133 did not have a material effect on our financial position or results of operations.

For fiscal 2001, we adopted Staff Accounting Bulletin (SAB) 101. SAB 101 required the Company to change the accounting method of revenue recognition of certain one-time non-refundable fees from immediate recognition, to amortizing the fees into revenues over the period of active enrollment of the student. The adoption of SAB 101 did not have a material impact on our financial position or results of operations.

In June 2001, FASB issued SFAS No. 141, Business Combinations and SFAS No. 142, Goodwill and Other Intangible Assets. SFAS No. 141 addresses financial accounting and reporting for business combinations and is effective for all business combinations after June 30, 2001. SFAS No. 142 addresses financial accounting and reporting for acquired goodwill and other intangible assets. We adopted SFAS No. 142, Accounting for Business Combinations, Goodwill and Other Intangible Assets, in its entirety effective July 1, 2002. Under SFAS 142, goodwill will no longer be amortized on a periodic basis, but instead is subject to an impairment test to be performed at least on a annual basis. If this test indicates that goodwill is impaired, it is written down to its fair value. Separable intangible assets that are not deemed to have indefinite lives will continue to be amortized over their useful lives. Goodwill amortization expense for fiscal 2002 was $824,000, $636,000 for fiscal 2001, and $252,000 for fiscal 2000. As of June 30, 2002, goodwill totaled $45.3 million. The adoption of SFAS 141 and SFAS 142 did not have a material effect on our financial position or results of operations.

In June 2001, the FASB issued SFAS No. 143, Accounting for Asset Retirement Obligations. SFAS 143 addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. SFAS 143 will be effective for financial statements issued for fiscal years beginning after June 15, 2002, and we expect the adoption will not have a material impact on our consolidated financial condition or results of operations.

In August 2001, the FASB issued SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets , which addresses financial accounting and reporting for the impairment or disposal of long-lived assets. SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, retains the fundamental provisions of existing generally accepted accounting principles with respect to

the recognition and measurement of long-lived asset impairment contained in the SFAS No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of. However, SFAS No. 144 provides new guidance intended to address certain significant implementation issues associated with SFAS No. 121, including expanded guidance with respect to appropriate cash flows to be used to determine whether recognition of any long-lived asset impairment is required, and if required, how to measure the amount of the impairment. SFAS No. 144 also requires that any net assets to be disposed of by sale be reported at the lower of carrying value or fair value less cost to sell, and expands the reporting of discontinued operations to include any component of any entity with operations and cash flows that can be clearly distinguished from the rest of the entity. We adopted SFAS 144 as of July 1, 2002 and the adoption did not have a significant impact on our consolidated financial position and results of operations.

In April 2002, the FASB issued Statement of Financial Accounting Standards No. 145 Rescission of FASB Statements No. 4, 44, and 64 Amendment of FASB Statement No. 13, and Technical Corrections . SFAS 145 rescinds FASB Statement No. 4, Reporting Gains and Losses from Extinguishment of Debt, which required all gains and losses from extinguishment of debt to be aggregated and, if material, classified as an extraordinary item, net of related income tax effect. SFAS 145 requires that gains or losses from extinguishment of debt be classified as extraordinary items only if they meet the criteria of ABP Opinion No. 30 and is effective beginning after May 15, 2002. We expect the adoption will not have a material impact on our consolidated financial condition or results of operations.

In June 2002, the FASB issued Statement of Financial Accounting Standards No. 146, Accounting for Costs Associated with Exit or Disposal Activities. SFAS 146 nullifies Emerging Issues Task Force (EITF) Issue No. 94-3, Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (Include Certain Costs Incurred in a Restructuring) in its entirety and addresses the significant issues relating to recognition, measurement, and reporting costs associated with an exit or disposal activity, including restructuring activities. Pursuant to SFAS 146, a liability is recorded on the date on which the obligation is incurred and should be initially measured at fair value. Under EITF Issue No. 94-3, a liability for such costs is recognized as of the date of an entity s commitment to an exit plan as well as its measurement and reporting. SFAS 146 is effective for exit or disposal activities initiated after December 31, 2002. We expect the adoption will not have a material impact on our consolidated financial condition or results of operations.

Concentrations of Risk

The Company maintains its cash and cash equivalents accounts in financial institutions. Accounts at these institutions are insured by the Federal Deposit Insurance Corporation (FDIC) up to $100,000. The Company performs ongoing evaluations of these institutions to limit its concentration risk exposure.

The Company extends credit for tuition to a majority of the students. A substantial portion is repaid through the student s participation in federally funded financial aid programs. Transfers of funds from the financial aid programs to the Company are made in accordance with the Department of Education (DOE) requirements. Approximately 77%, 81% and 82% of the Company s revenues, on a cash basis, were collected from funds distributed under Title IV Programs of the Higher Education Act

Table of Contents

of 1965, as amended (HEA) for the years ended June 30, 2000, 2001 and 2002, respectively. The financial aid and assistance programs are subject to political and budgetary considerations. There is no assurance that such funding will be maintained at current levels. Extensive and complex regulations govern the financial assistance programs in which the Company s students participate. The Company s administration of these programs is periodically reviewed by various regulatory agencies. Any regulatory violation could be the basis for the initiation of potential adverse actions including a suspension, limitation or termination proceeding which could have a material effect to our Company.

The Company has routinely provided installment payment plans to many of its students to supplement their federally funded financial aid. While these loans are unsecured, the Company believes it has adequate reserves against these loan balances. However, there can be no assurance that losses will not exceed reserves. Losses in excess of reserves could have a material adverse effect on the Company s business.

NOTE 2 DETAIL OF SELECTED BALANCE SHEET ACCOUNTS

Prepaid expenses and other current assets consist of the following:

	As of June 30,	
	2001	2002
	(In thousands)	
Prepaids	$ 5,028	$ 4,598
Course materials, net	2,694	3,762
Other current assets	1,953	3,122
	$ 9,675	$ 11,482

Property and equipment consist of the following:

	As of June 30,	
	2001	2002
	(In thousands)	
Furniture and equipment	$ 14,873	$ 19,521
Computer hardware and software	8,603	15,750
Leasehold improvements	8,329	15,630
Land	1,687	1,305
Buildings	884	684
	34,376	52,890
Less accumulated depreciation and amortization	(11,455)	(15,934)
	$ 22,921	$ 36,956

Depreciation and amortization expense associated with property and equipment was, $2,640,000, $3,231,000 and $4,746,000 for the years ended June 30, 2000, 2001 and 2002, respectively.

Table of Contents

Intangible assets consist of the following:

	As of June 30,	
	2001	2002
	(In thousands)	
Goodwill, net:		
Goodwill	$ 32,835	$ 47,761
Less accumulated amortization	(1,596)	(2,421)
Goodwill, net	$ 31,239	$ 45,340
Other Intangibles, net:		
Curriculum	$ 12,079	$ 12,182
Trade names	5,075	5,101
	17,154	17,283
Less accumulated amortization	(4,223)	(5,198)
	$ 12,931	$ 12,085

Amortization expense associated with intangibles was $1,138,000, $1,571,000 and $1,800,000 for the years ended June 30, 2000, 2001 and 2002, respectively, and includes amortization of goodwill of $252,000, $636,000 and $824,000, respectively. Additionally, the Company recognized non-compete agreement expense and deferred loan fee amortization totaling $107,000 for the year ended June 30, 2002.

NOTE 3 STUDENT NOTES RECEIVABLE

Student notes receivable represent loans which have maturity dates that generally range between 12 months to 120 months from the loan origination date. The interest charged on the notes generally ranges from 9 to 18 percent per annum.

The following reflects an analysis of student notes receivable at June 30, 2002:

	Net Student Notes Receivable	Allowance For Doubtful Accounts	Gross Student Notes Receivable
		(In thousands)	
Current	$ 726	$ 320	$ 1,046
Long-term	1,218	434	1,652
Unearned portion			1,352
Total			$ 4,050

Payments due under student notes receivable are as follows:

	Fiscal Years Ending June 30,
	(In thousands)
2003	$ 982
2004	958

2005		810
2006		568
2007		277
Thereafter		455
Total	$	4,050

Table of Contents

NOTE 4 BUSINESS ACQUISITIONS

During fiscal year ended June 30, 2000, the Company completed the acquisition of substantially all of the assets of five colleges in three separate transactions for a combined purchase price of $8.3 million before working capital adjustments and liabilities assumed. The amount paid in excess of the fair market value of the assets acquired, net of liabilities assumed was $7.9 million and was allocated to goodwill and curriculum and was being amortized over 40 and 15 years, respectively during fiscal 2002. The acquisitions were accounted for using the purchase method of accounting and their respective results of operations are included in the consolidated results of operations of the Company since their respective acquisition dates.

During fiscal year ended June 30, 2001, the Company completed the acquisition of nine colleges in three separate transactions for a combined purchase price of $22.0 million before working capital adjustments and liabilities assumed. The amount paid in excess of the fair market value of the assets acquired, net of liabilities assumed was $17.3 million and was allocated to goodwill and curriculum and was being amortized over 40 and 15 years, respectively during fiscal 2002. The acquisitions were accounted for using the purchase method of accounting and their respective results of operations are included in the consolidated results of operations of the Company since their respective acquisition dates.

During fiscal year ended June 30, 2002 the Company completed the acquisition of three colleges in a single transaction for a purchase price of $14.4 million before working capital adjustments and liabilities assumed. The amount paid in excess of the fair market value of the assets acquired, net of liabilities assumed was $15.0 million and was allocated to goodwill. The acquisition was accounted for using the purchase method of accounting and its respective results of operations are included in the consolidated results of operations of the Company since April 1, 2002, its acquisition date.

NOTE 5 LONG-TERM DEBT

Long-term debt consists of the following:

	As of June 30,	
	2001	**2002**
	(In thousands)	
Promissory note due April 2007, with interest at 10.95% per annum, secured by certain land and improvements.	$ 2,230	$ 1,575
Other	954	525
	3,184	2,100
Less current portion	(1,046)	(585)
	$ 2,138	$ 1,515

Principal payments due under the long-term debt arrangements discussed above are as follows :

	Fiscal Years Ending June 30, (In thousands)
2003	$ 585
2004	130
2005	127
2006	131
2007	1,127
Total	$ 2,100

In June 2002, the Company entered into a Credit Agreement for $100.0 million with a syndication of seven financial institutions administered by Bank of America, N.A. This Credit Agreement replaces the Company s $20.0 million credit facility with Union Bank of California. The Credit Agreement has been established to provide available funds for acquisitions and other general corporate purposes and to provide for letter of credit issuances of up to $5.0 million. Borrowings under the agreement bear interest at several pricing alternatives available to the Company, including LIBOR and adjusted reference or base rates. The base rate is defined as the higher of the Federal Funds rate plus 1/2 of 1% or the Bank of America prime rate, plus a margin of 0.25% to 0.75% depending on the Company s consolidated leverage ratio as defined in the agreement. Fees associated with outstanding letters of credit issued under the terms of the agreement range from 1.5% to 2.0% and are also dependent on the Company s consolidated leverage ratio. The agreement contains customary affirmative and negative covenants including financial covenants requiring the maintenance of consolidated net worth, fixed charge coverage ratios, leverage ratios, proforma adjusted EBITDA, Department of Education financial responsibility composite score ratio, and limitations on long term student notes receivables. As of June 30, 2002, the Company was in compliance of these covenants. As of June 30, 2002 there were no borrowings outstanding under the terms of this agreement. The Credit Agreement is secured by substantially all of the Company s real and personal property (including the stock of the Company s subsidiaries) and guaranteed by the Company s present and future significant operating subsidiaries.

Average daily borrowings outstanding amounted to $0 in fiscal 2002, compared to $35,000 in fiscal 2001. As of June 30, 2002 we had $2.1 million of letters of credit issued and outstanding.

NOTE 6 PREFERRED STOCK AND COMMON STOCKHOLDERS EQUITY

Preferred Stock

The Company is authorized to issue 500,000 shares of preferred stock. As of June 30, 2002, there were no outstanding shares of preferred stock.

Common Stock

The Company s issued and outstanding common stock is entitled to one vote per share on all matters.

On November 15, 2001, the Company s stockholders approved an amendment and restatement of the Company s certificate of incorporation which (i) increased the number of shares of authorized

Table of Contents

common stock, par value $0.0001 per share, to a total of 80,000,000 shares, (ii) eliminated various provisions relating to the Company s previously authorized nonvoting common stock, none of which was outstanding at the time of such amendment and restatement, and (iii) eliminated various provisions relating to the previously issued classes and series of preferred stock, none of which were outstanding at the time of such amendment and restatement.

Stock Options

On April 28, 1998, the Board of Directors adopted the 1998 Performance Award Plan (the Plan). Under the Plan, 2,116,536 options, stock appreciation rights or other common stock based securities may be granted to directors, officers, employees and other eligible persons. During fiscal 2001, the Company s shareholders authorized an additional 4,400,000 options, stock appreciation rights or other common stock based securities available for grants to directors, officers, employee and other eligible persons under the 1998 Performance Award Plan. As of June 30, 2002, approximately 1,819,048 shares were available for future granting. Options granted under the Plan were issued at exercise prices ranging from $3.12 - $29.05 per share and have expiration dates not longer than 10 years. Options granted generally vest over a period of two to four years.

A summary of the status of the Company s stock option grants are presented below:

	Shares	Weighted Average Exercise Price
Outstanding at June 30, 1999	570,264	$ 6.71
Stock options granted during the year	958,560	4.21
Stock options exercised	(14,448)	3.12
Forfeitures	(26,660)	3.58
Outstanding at June 30, 2000	1,487,716	$ 3.90
Stock options granted during the year	1,858,000	14.02
Stock options exercised	(249,518)	3.96
Forfeitures	(11,176)	3.75
Outstanding at June 30, 2001	3,085,022	$ 9.99
Stock options granted during the year	1,404,000	13.33
Stock options exercised	(484,652)	8.55
Forfeitures	(55,500)	14.47
Outstanding at June 30, 2002	3,948,870	$ 11.29

Table of Contents

The following table summarizes information about stock options outstanding and exercisable at June 30, 2002:

	Options Outstanding			Options Exercisable	
Exercise Prices Range	Number Outstanding at 6/30/02	Weighted-Average Remaining Life	Weighted-Average Outstanding Price	Number Exercisable At 6/30/02	Weighted-Average Exercise Price
$3.12 $10.72	1,444,770	7.3	$ 6.03	560,490	$ 3.74
$12.59 $16.96	2,209,000	9.0	13.58	186,000	15.09
$17.29 $29.05	295,100	9.2	19.95	34,100	19.14
	3,948,870		$11.29	780,590	$ 7.12

There were 264,788 stock options exercisable at June 30, 2000 and 447,006 stock options exercisable at June 30, 2001.

Pursuant to SFAS No. 123, the weighted average fair value of stock options granted during fiscal 2000, 2001 and 2002 was $2.91, $9.26 and $10.27, respectively. As discussed in Note 1, the Company elected the disclosure alternative allowed under SFAS No. 123. Accordingly, the Company is required to disclose pro forma net income over the vesting period of the options.

The following is the pro forma effect for fiscal 2000, 2001 and 2002:

	Fiscal Years Ended June 30,		
	2000	2001	2002
	(In thousands, except per share data)		
Net income:			
As reported	$ 15,422	$ 25,731	$ 38,948
Pro forma	$ 14,589	$ 22,457	$ 33,928
Basic earnings per share:			
As reported	$ 0.37	$ 0.61	$ 0.91
Pro forma	$ 0.35	$ 0.53	$ 0.79
Diluted earnings per share:			
As reported	$ 0.37	$ 0.59	$ 0.87
Pro forma	$ 0.35	$ 0.52	$ 0.76

For pro forma disclosure, the fair value of compensatory stock options, stock appreciation rights and other common stock based securities was estimated using the Black-Scholes option pricing model using the following weighted average assumptions:

	2000	2001	2002
Risk-free rate	6.75%	5.44%	5.55%
Expected years until exercise	7 years	7 years	7 years
Expected stock volatility	64%	62%	83%
Expected dividends	$	$	$

NOTE 7 WEIGHTED AVERAGE NUMBER OF COMMON SHARES OUTSTANDING

On October 4, 2000, the Company completed a secondary stock offering which included 800,000 common shares sold by the Company.

Table of Contents

The table below indicates the weighted average number of common share calculations used in computing basic and diluted net income per common share utilizing the treasury stock method:

	Fiscal Years Ended June 30,		
	2000	2001	2002
	(In thousands)		
Basic common shares outstanding	41,386	42,064	42,692
Effects of dilutive securities:			
Stock options	312	1,398	2,002
Diluted common shares outstanding	41,698	43,462	44,694

NOTE 8 INCOME TAXES

The components of the income tax provision (benefit) are as follows:

	Fiscal Years Ended June 30,		
	2000	2001	2002
	(In thousands)		
Current provision:			
Federal	$ 8,843	$ 14,851	$ 19,171
State	2,095	3,222	4,200
	10,938	18,073	23,371
Deferred provision:			
Federal	(221)	(831)	1,955
State	123	(144)	629
	(98)	(975)	2,584
Total provision for income taxes	$ 10,840	$ 17,098	$ 25,955

Actual income tax provision (benefit) differs from the income tax provision (benefit) computed by applying the U.S. federal statutory tax rate of 35% for fiscal 2000, 2001, and 2002 to income (loss) before provision for income taxes as follows:

	Fiscal Years Ended June 30,		
	2000	2001	2002
	(In thousands)		
Provision at the statutory rate	$ 9,192	$ 14,990	$ 22,716
State income tax provision, net of federal benefit	1,441	2,000	3,139
Other	207	108	100
	$ 10,840	$ 17,098	$ 25,955

Table of Contents

The components of the Company s deferred tax asset and liability are as follows:

	As of June 30,	
	2001	2002
	(In thousands)	
Current deferred tax asset (liability):		
Accounts receivable allowance for doubtful accounts	$ 2,039	$ 3,465
Accrued vacation	692	1,089
State taxes	1,121	1,785
Other	237	(197)
Current deferred tax asset	4,089	6,142
Non-current deferred tax asset (liability):		
Notes receivable allowance for doubtful accounts	182	320
Depreciation	(381)	(4,224)
Amortization	(1,367)	(2,214)
Deferred gain on sale/leaseback	283	198
Non-current deferred tax liability	(1,283)	(5,920)
	$ 2,806	$ 222

NOTE 9 COMMITMENTS AND CONTINGENCIES

Leases

The Company leases most of its operating facilities and various equipment under non-cancelable operating leases expiring at various dates through 2012. The facilities leases require the Company to pay various operating expenses of the facilities in addition to base monthly lease payments.

Future minimum lease payments under operating leases are as follows:

	Fiscal Years Ending June 30,
	(In thousands)
2003	$ 21,913
2004	19,700
2005	18,122
2006	17,547
2007	15,079
Thereafter	27,080
	$ 119,441

Rent expense for the fiscal years ended June 30, 2000, 2001 and 2002 amounted to $12.4 million, $17.8 million and $23.3 million, respectively, and is reflected in educational services and general and administrative expense in the accompanying consolidated statements of operations.

Legal Matters

In the ordinary conduct of our business, we and our colleges are subject to occasional lawsuits, investigations and claims, including, but not limited to, claims involving students or graduates and routine employment matters. Although we cannot predict with certainty the ultimate resolution of lawsuits, investigations and claims asserted against us, we do not believe that any currently pending

legal proceedings to which we are a party will have a material adverse effect on our business, results of operations or financial condition.

One of the legal actions currently pending against us is *Aldape, et al. v. Corinthian Schools, Inc., et al.,* filed on July 11, 2002, in Los Angeles Superior Court in Los Angeles, California by nine former students of the Company s Bryman campus in Los Angeles, California (the Individual Plaintiffs) and the Trade School Review Association (TSRA), a California nonprofit association that claims to be acting as a private attorney general under California s Business and Professions Code. TSRA admits in the complaint that it has suffered no injury and that it seeks no monetary recovery for itself except for fees for its counsel and its costs. The suit alleges, among other things, statutory violations by us of the California Education Code and the California Business and Professions Code and intentional misrepresentation and/or concealment. The claims relate primarily to our marketing and recruitment practices and the quality of our services. The plaintiffs seek refunds and/or compensatory damages, injunctive relief, civil penalties, attorneys fees, restitution on behalf of the Individual Plaintiffs and all persons similarly situated, plus costs. The Individual Plaintiffs have also filed complaints with the Accrediting Commission of Career Schools and Colleges of Technology (ACCSCT) and the California Bureau for Private Postsecondary and Vocational Education (the BPPVE). The BPPVE and ACCSCT have both investigated the claims and neither has found any violation of accrediting standards or any violation of California law. Both entities have closed their files without taking any adverse action against the Company.

The written enrollment agreement between us and each of the Individual Plaintiffs (as well as virtually every student enrolled in our campuses from May 1999 to the present) provides that all disputes between the parties will be resolved through binding arbitration instead of litigation. On August 19, 2002, we filed a motion in the Los Angeles Superior Court seeking to compel the plaintiffs to submit their claims to binding arbitration and to stay the Superior Court litigation. We believe the plaintiffs claims are entirely without merit and we intend to vigorously defend ourselves against them.

NOTE 10 EMPLOYEE BENEFIT PLANS

The Company has established an employee savings plan under Section 401(k) of the Internal Revenue Code. All employees with at least one year and 1,000 hours of employment are eligible to participate. Contributions to the plan by the Company are discretionary. The plan provides for vesting of Company contributions over a five-year period. Employees previously employed by each of the campuses acquired by the Company vest in the plan based on total years of service with the Company and with the predecessor company. Company contributions to the plan were $498,000, $1,042,000 and $1,203,000 for the fiscal years ended June 30, 2000, 2001 and 2002, respectively.

In August 2000, the Company adopted the Corinthian Colleges, Inc. Employee Stock Purchase Plan (ESPP). Under the terms of the ESPP, eligible employees of the Company are permitted to purchase shares of common stock at a price equal to 90% of the fair market value on the first or last day, whichever is lower, of each six month offering period. A total of 1,000,000 shares of common stock were initially reserved for sale under the ESPP. At June 30, 2002, employees had purchased approximately 22,792 shares and 977,208 shares were still available for purchase under the ESPP.

Table of Contents

NOTE 11 SUBSEQUENT EVENTS

Effective July 1, 2002, we acquired all of the outstanding stock of Wyo-Tech Acquisition Corporation. The cash purchase price was $84.4 million and is subject to certain post closing working capital adjustments. The cash purchase price was funded through cash on hand and approximately $43 million provided from the $100 million Credit Agreement. Wyo-Tech had approximately 1,500 students as of July 1, 2002 and operates two colleges in Laramie, Wyoming and Blairsville, Pennsylvania that offer both degree and diploma programs with concentrations of study in automotive repair, diesel technician and collision repair.

NOTE 12 GOVERNMENTAL REGULATION

The Company and each institution are subject to extensive regulation by federal and state governmental agencies and accrediting bodies. In particular, HEA, and the regulations promulgated thereunder by DOE subject the institutions to significant regulatory scrutiny on the basis of numerous standards that schools must satisfy in order to participate in the various federal student financial assistance programs under Title IV of the HEA.

To participate in the Title IV Programs, an institution must be authorized to offer its programs of instruction by the relevant agencies of the state in which it is located, accredited by an accrediting agency recognized by the DOE and certified as eligible by the DOE. The DOE will certify an institution to participate in the Title IV Programs only after the institution has demonstrated compliance with the HEA and the DOE s extensive regulations regarding institutional eligibility. An institution must also demonstrate its compliance to the DOE on an ongoing basis. As of June 30, 2002, management believes all of the Company s institutions meet these requirements.

Political and budgetary concerns significantly affect the Title IV Programs. Congress must reauthorize the HEA approximately every five years. The most recent reauthorization in October 1998 reauthorized the HEA for an additional five years (the 1998 HEA Reauthorization). Congress reauthorized all of the Title IV Programs in which the schools participate, generally in the same form and at funding levels no less than for the prior year. Changes made by the 1998 HEA Reauthorization include (i) expanding the adverse effects on schools with high student loan default rates, (ii) increasing from 85% to 90% the portion a proprietary school s cash basis revenues that may be derived each year from the Title IV Programs, (iii) revising the refund standards that require an institution to return a portion of the Title IV Program funds for students who withdraw from school and (iv) giving the DOE flexibility to continue an institution s Title IV participation without interruption in some circumstances following a change of ownership or control.

A significant component of Congress initiative to reduce abuse in the Title IV Programs has been the imposition of limitations on institutions whose former students default on the repayment of their federally guaranteed or funded student loans above specific rates (cohort default rate). An institution whose cohort default rates (CDR) equal or exceed 25% for three consecutive years will no longer be eligible to participate in the FFEL or FDL programs. An institution whose CDR under certain Title IV Programs for any federal fiscal year exceeds 40% may have its eligibility to participate in all of the Title IV Programs limited, suspended or terminated by the DOE.

All institutions participating in the Title IV Programs must satisfy specific standards of financial responsibility. The DOE evaluates institutions for compliance with these standards each year, based on the institution s annual audited financial statements and following a change of ownership of the institution.

Under regulations which took effect July 1, 1998, the DOE calculates the institution s composite score for financial responsibility based on its (i) equity ratio, which measures the institution s capital resources, ability to borrow and financial viability; (ii) primary reserve ratio, which measures the institution s ability to support current operations from expendable resources; and (iii) net income ratio, which measures the institution s ability to operate at a profit. An institution that does not meet the DOE s minimum composite score may demonstrate its financial responsibility by posting a letter of credit in favor of the DOE in an amount equal to at least 50% of the Title IV Program funds received by the institution during its prior fiscal year and possibly accepting other conditions on its participation in the Title IV Programs. At June 30, 2002, all of the Company s schools and the Company on a consolidated basis satisfied each of the DOE s standards of financial responsibility.

Because the Company operates in a highly regulated industry, it, like other industry participants, may be subject from time to time to investigations, claims of non-compliance, or lawsuits by governmental agencies or third parties which allege statutory violations, regulatory infractions or common law causes of action. In October 1998, the Inspector General s Office (IG) of the DOE began an examination of the Company s compliance with the 90/10 rule and to review in general the Company s administration of Title IV funds. This examination was part of a broader review conducted by the IG of proprietary institutions compliance with these requirements. The Company provided all information and documentation requested by the IG. During fiscal 2000, the Company received the final audit report from the DOE. There were no actions taken against the Company as a result of the examination. However, there can be no assurance that other regulatory agencies or third parties will not undertake investigations or make claims against the Company, or that such claims, if made, will not have a material effect on the Company s business, results of operations or financial condition.

Table of Contents

NOTE 13 QUARTERLY FINANCIAL SUMMARY (UNAUDITED)

	Fiscal Quarters				
	First	Second	Third	Fourth	Fiscal Year
	(In thousands, except per share amounts)				
Fiscal 2002					
Net revenues	$ 73,696	$ 81,565	$ 88,334	$ 94,551	$ 338,146
Income from operations	10,463	14,660	18,263	19,317	62,703
Net income	6,474	9,330	11,105	12,039	38,948
Income per share					
Basic	$ 0.15	$ 0.22	$ 0.26	$ 0.28	$ 0.91
Diluted	$ 0.14	$ 0.21	$ 0.25	$ 0.27	$ 0.87
Fiscal 2001					
Net revenues	$ 51,793	$ 60,768	$ 65,197	$ 66,405	$ 244,163
Income from operations	6,901	10,566	11,558	11,726	40,751
Net income	4,412	6,578	7,164	7,577	25,731
Income per share					
Basic	$ 0.11	$ 0.15	$ 0.17	$ 0.18	$ 0.61
Diluted	$ 0.11	$ 0.15	$ 0.16	$ 0.17	$ 0.59
Fiscal 2000					
Net revenues	$ 38,644	$ 42,183	$ 43,874	$ 46,033	$ 170,734
Income from operations	3,729	6,216	7,544	6,917	24,406
Net income	2,379	3,852	4,659	4,532	15,422
Income per share					
Basic	$ 0.06	$ 0.09	$ 0.11	$ 0.11	$ 0.37
Diluted	$ 0.06	$ 0.09	$ 0.11	$ 0.11	$ 0.37

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

We terminated our engagement of Arthur Andersen as independent auditors on February 18, 2002. The decision to terminate the engagement of Arthur Andersen was recommended by our Audit Committee and approved by the Board of Directors. Arthur Andersen s report on our financial statements for each of the years ended June 30, 2000 and June 30, 2001, did not contain an adverse opinion or a disclaimer of opinion and was not qualified or modified as to uncertainty, audit scope or accounting principles. During the years ended June 30, 2000, and June 30, 2001, and the interim period between June 30, 2001 and February 18, 2002, there were no disagreements between us and Arthur Andersen on any matter of accounting principles or practices, financial statement disclosure or auditing scope or procedure, which disagreements, if not resolved to the satisfaction of Arthur Andersen, would have caused it to make reference to the subject matter of the disagreements in connection with its report.

During the years ended June 30, 2000, and June 30, 2001, and the interim period between June 30, 2001 and February 18, 2002, there were no reportable events (as defined in Item 304(a)(1)(v) of Regulation S-K promulgated by the Securities and Exchange Commission). During the years ended June 30, 2000, and June 30, 2001, and the interim period between June 30, 2001, and February 18, 2002, we did not consult with Ernst & Young LLP regarding (i) the application of accounting principles to a specified transaction, either completed or proposed, (ii) the type of audit opinion that might be rendered

Table of Contents

on our financial statements or (iii) any matter that was either the subject of a disagreement (as described above) or a reportable event.

We provided Arthur Andersen with a copy of the above disclosures and requested that it furnish us with a letter addressed to the Securities and Exchange Commission stating whether or not it agrees with the above statements. That letter was attached to a Form 8-K we filed on February 21, 2002 to disclose our change in auditors.

After reasonable efforts, we have been unable to obtain Arthur Andersen s consent to the incorporation by reference of their report for our fiscal years ended June 30, 2000 and June 30, 2001 into our previously filed registration statements under the Securities Act of 1933, and we have not filed that consent with this Annual Report on Form 10-K in reliance upon Rule 437a under the Securities Act. Because we have not been able to obtain Arthur Andersen s consent, you may not be able to recover against Arthur Andersen under Section 11 of the Securities Act for any untrue statements of a material fact contained in our financial statements audited by Arthur Andersen or any omission to state a material fact required to be stated therein.

PART III

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

Certain information in response to this item is incorporated herein by reference to the Company s definitive Proxy Statement for the Annual Meeting of Shareholders, which will be filed with the Securities and Exchange Commission not later than 120 days after June 30, 2002. Information regarding executive officers of the Company is set forth under the caption Executive Officers of the Registrant in Item 1 hereof.

ITEM 11. EXECUTIVE COMPENSATION

Information in response to this Item is incorporated herein by reference from the Company s definitive Proxy Statement for the Annual Meeting of Shareholders, which will be filed with the Securities and Exchange Commission not later than 120 days after June 30, 2002.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

Information in response to this Item is incorporated herein by reference from the Company s definitive Proxy Statement for the Annual Meeting of Shareholders, which will be filed with the Securities and Exchange Commission not later than 120 days after June 30, 2002.

Table of Contents

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

Information in response to this Item is incorporated herein by reference from the Company s definitive Proxy Statement for the Annual Meeting of Shareholders, which will be filed with the Securities and Exchange Commission not later than 120 days after June 30, 2002.

Table of Contents

PART IV

ITEM 14. EXHIBITS, FINANCIAL STATEMENT SCHEDULES, AND REPORTS ON FORM 8-K

(a) *The following documents are filed as part of this Report:*

1. Financial Statements
2. Financial Statement Schedules

The required financial statements and financial statement schedules of the Company and its subsidiaries are included in Part II, Item 8, of this Form 10-K and on Schedule II Valuation and Qualifying Accounts. All other schedules have been omitted since the required information is not present or not present in amounts sufficient to require the submission of such schedules, or because the information required is included in the consolidated financial statements or the notes thereto.

3. Exhibits:

The exhibits listed in the accompanying Index to Exhibits are filed as part of this annual report.

(b) *Reports on Form 8-K:*

On April 12, 2002, the Company filed a report on Form 8-K disclosing that it had entered into a Stock Purchase and Sale Agreement, dated April 10, 2002, by and among Wyo-Tech Acquisition Corp., Allied Capital Corporation, David Grenat and the Company, pursuant to which the Company contracted to purchase all of the outstanding capital stock of Wyo-Tech Acquisition Corp.

On July 2, 2002, the Company filed a report on Form 8-K disclosing that the Company had completed the acquisition of all the outstanding capital stock of Wyo-Tech Acquisition Corp.

On September 16, 2002, the Company is concurrently filing a report on Form 8-K/A as required by Items 2 and 7 of such form regarding the pro forma financial information of the Company and its acquisition of Wyo-Tech Acquisition Corp.

Table of Contents

CORINTHIAN COLLEGES, INC.

INDEX TO EXHIBITS

Exhibit Number	Description of Exhibit	Incorporation Reference
2.1+	Stock Purchase and Sale Agreement, dated as of April 10, 2002, among Corinthian Colleges, Inc., Wyo-Tech Acquisition Corp., Allied Capital Corporation and David Grenat, excluding exhibits, appendices and schedules thereto.	(a)
3.3+	Amended and Restated Certificate of Incorporation	(b)
3.4+	Bylaws of the Company incorporated by reference to Exhibit 3.3 of the Company s Registration Statement on Form S-1 (Registration No. 33-59505) as filed with the Securities and Exchange Commission on July 21, 1998	
10.52+	1998 Performance Award Plan of the Company	(c)
10.58+	Asset Purchase Agreement, dated as of September 10, 2000, by and amoung Corinthian Schools, Inc., Computer Training Academy, Inc. and Sam Shirazi, Bahman Imani, Marilyn Emel, Mahammed Tahmasebi and Peter Tsuda	(d)
10.59+	Stock Purchase Agreement, dated as of December 29, 2000, by and among Corinthian Schools, Inc., Grand Rapids Educational Center, Inc., Malone Management Company, and Robert J. Malone and Mary C. Malone	(e)
10.62+	Form of Employment Agreement by and between the Company and each of David Moore, Paul St. Pierre and Dennis Devereux.	(f)
10.63+	Form of Employment Agreement by and between the Company and each of Dennis Beal, Beth Wilson, Mary Barry, Nolan Miura and Stan Mortensen.	(f)
10.64+	Stock Purchase Agreement, dated as of February 28, 2002, by and among Corinthian Colleges, Inc., Rhodes Colleges, Inc., National School of Technology, Inc., Martin Knobel, Rosa M. Iverson, Dan Frazier and Arthur Ortiz.	(g)
10.65+	Credit Agreement, dated as of June 26, 2002, among Corinthian Colleges, Inc., each Lender from time to time party thereto, JP Morgan Chase Bank, as Documentation Agent, Union Bank of California, N.A., as Syndication Agent, and Bank of America, N.A. as Administrative Agent, Swing Line Lender and L/C Issuer.	(h)
21.1	List of Subsidiaries	
23.1	Consent of Independent Auditors, Ernst and Young LLP	
23.2	Note regarding Consent of Arthur Andersen LLP, dated August 15, 2001	
24.1	Power of Attorney (see signature page)	
99.1	Certification Pursuant to 18 U.S.C Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.	
99.2	Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.	

+ Previously filed with the Securities and Exchange Commission as set forth in the following table:

(a) Incorporated by reference to Exhibit 2.1 of the Report on Form 8-K filed with the SEC on April 12, 2002.

Table of Contents

(b) Incorporated by reference to the Company s Definitive Proxy Statement for the Annual Meeting of Stockholders held on November 15, 2001, as filed with the Securities and Exchange Commission on October 15, 2001.

(c) Incorporated by reference to the like-numbered exhibit of the Company s Registration Statement on Form S-1 (Registration No. 333-59505), as filed with the Securities and Exchange Commission on July 21, 1998.

(d) Incorporated by reference to the like-numbered exhibit of the Company s Annual Report on Form 10-K, for the fiscal year ended June 30, 2000, as filed with the Securities and Exchange Commission on September 18, 2000.

(e) Incorporated by reference to Exhibit 10.1 of the Company s Quarterly Report on Form 10-Q, for the quarter ended December 31, 2000, as filed with the Securities and Exchange Commission on February 14, 2001.

(f) Incorporated by reference to the like-numbered exhibits of the Report on the Form 10-Q for the quarter ended December 31, 2001, as filed with the SEC on February 14, 2002.

(g) Incorporated by reference to the like-numbered exhibits of the Report on the Form 10-Q for the quarter ended March 31, 2001, as filed with the SEC on May 15, 2002.

(h) Incorporated by reference to Exhibit 10.1 of the Report on Form 8-K filed with the SEC on July 2, 2002.

Table of Contents

SIGNATURES AND POWER OF ATTORNEY

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

CORINTHIAN COLLEGES, INC.

By:	/s/ David G. Moore	By:	/s/ Dennis N. Beal
	David G. Moore **Chairman of the Board, President and Chief Executive Officer** **(Principle Executive Officer)** **September 16, 2002**		**Dennis N. Beal** **Executive Vice President and Chief Financial Officer** **(Principle Financial and Accounting Officer)** **September 16, 2002**

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated. Each person whose signature appears below hereby authorizes and appoints David G. Moore and Dennis N. Beal, or either of them, as attorneys-in-fact and agents to execute and file with the applicable regulatory authorities any amendment to this report on his or her behalf individually and in each capacity stated below.

Signature	Title	Date
/s/ David G. Moore **David G. Moore**	Chairman of the Board, President, Chief Executive Officer and Director (Principal Executive Officer)	September 16, 2002
/s/ Paul St. Pierre **Paul St. Pierre**	Executive Vice President and Director	September 16, 2002
/s/ Loyal Wilson **Loyal Wilson**	Director	September 16, 2002
/s/ Jack D. Massimino **Jack D. Massimino**	Director	September 16, 2002
/s/ Linda Arey Skladany **Linda Arey Skladany**	Director	September 16, 2002
/s/ Michael P. Berry **Michael P. Berry**	Director	September 16, 2002

82

Table of Contents

CERTIFICATION OF CHIEF EXECUTIVE OFFICER

I, David G. Moore, certify that:

1. I have reviewed this annual report on Form 10-K of Corinthian Colleges, Inc.;

2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this annual report; and

3. Based on my knowledge, the financial statements, and other financial information included in this annual report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this annual report.

Date: September 16, 2002

/s/ DAVID G. MOORE

David G. Moore
Chairman of the Board, President, and
Chief Executive Officer
(Principle Executive Officer)

83

Table of Contents

CERTIFICATION OF CHIEF FINANCIAL OFFICER

I, Dennis N. Beal, certify that:

1. I have reviewed this annual report on Form 10-K of Corinthian Colleges, Inc.;

2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this annual report; and

3. Based on my knowledge, the financial statements, and other financial information included in this annual report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this annual report.

Date: September 16, 2002

/s/ DENNIS N. BEAL

Dennis N. Beal
Executive Vice President and
Chief Financial Officer
(Principle Financial and Accounting Officer)

84

Table of Contents

CORINTHIAN COLLEGES, INC.

SCHEDULE II--VALUATION AND QUALIFYING ACCOUNTS

	Balance at Beginning of Year	Charged to Costs and Expenses	Deductions	Balance at End of Year
		(In thousands)		
Allowance for doubtful accounts				
Accounts receivable:				
Year ended June 30, 2000	$ 3,258	$ 7,874	$ (6,769)	$ 4,363
Year ended June 30, 2001	4,363	13,822	(10,994)	7,191
Year ended June 30, 2002	7,191	16,869	(16,763)	7,297
Student notes receivable:				
Year ended June 30, 2000	1,898	886	(1,603)	1,181
Year ended June 30, 2001	1,181	143	(899)	425
Year ended June 30, 2002	$ 425	$ 1,659	$ (1,330)	$ 754

85

Table of Contents

CORINTHIAN COLLEGES, INC.

INDEX TO EXHIBITS

Exhibit Number	Description of Exhibit	Incorporation Reference
2.1+	Stock Purchase and Sale Agreement, dated as of April 10, 2002, among Corinthian Colleges, Inc., Wyo-Tech Acquisition Corp., Allied Capital Corporation and David Grenat, excluding exhibits, appendices and schedules thereto.	(a)
3.3+	Amended and Restated Certificate of Incorporation	(b)
3.4+	Bylaws of the Company incorporated by reference to Exhibit 3.3 of the Company s Registration Statement on Form S-1 (Registration No. 33-59505) as filed with the Securities and Exchange Commission on July 21, 1998	
10.52+	1998 Performance Award Plan of the Company	(c)
10.58+	Asset Purchase Agreement, dated as of September 10, 2000, by and amoung Corinthian Schools, Inc., Computer Training Academy, Inc. and Sam Shirazi, Bahman Imani, Marilyn Emel, Mahammed Tahmasebi and Peter Tsuda	(d)
10.59+	Stock Purchase Agreement, dated as of December 29, 2000, by and among Corinthian Schools, Inc., Grand Rapids Educational Center, Inc., Malone Management Company, and Robert J. Malone and Mary C. Malone	(e)
10.62+	Form of Employment Agreement by and between the Company and each of David Moore, Paul St. Pierre and Dennis Devereux.	(f)
10.63+	Form of Employment Agreement by and between the Company and each of Dennis Beal, Beth Wilson, Mary Barry, Nolan Miura and Stan Mortensen.	(f)
10.64+	Stock Purchase Agreement, dated as of February 28, 2002, by and among Corinthian Colleges, Inc., Rhodes Colleges, Inc., National School of Technology, Inc., Martin Knobel, Rosa M. Iverson, Dan Frazier and Arthur Ortiz.	(g)
10.65+	Credit Agreement, dated as of June 26, 2002, among Corinthian Colleges, Inc., each Lender from time to time party thereto, JP Morgan Chase Bank, as Documentation Agent, Union Bank of California, N.A., as Syndication Agent, and Bank of America, N.A. as Administrative Agent, Swing Line Lender and L/C Issuer.	(h)
21.1	List of Subsidiaries	
23.1	Consent of Independent Auditors, Ernst and Young LLP	
23.2	Note regarding Consent of Arthur Andersen LLP, dated August 15, 2001	
24.1	Power of Attorney (see signature page)	
99.1	Certification Pursuant to 18 U.S.C Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.	
99.2	Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.	

+ Previously filed with the Securities and Exchange Commission as set forth in the following table:

(a) Incorporated by reference to Exhibit 2.1 of the Report on Form 8-K filed with the SEC on April 12, 2002.

Table of Contents

(b) Incorporated by reference to the Company s Definitive Proxy Statement for the Annual Meeting of Stockholders held on November 15, 2001, as filed with the Securities and Exchange Commission on October 15, 2001.

(c) Incorporated by reference to the like-numbered exhibit of the Company s Registration Statement on Form S-1 (Registration No. 333-59505), as filed with the Securities and Exchange Commission on July 21, 1998.

(d) Incorporated by reference to the like-numbered exhibit of the Company s Annual Report on Form 10-K, for the fiscal year ended June 30, 2000, as filed with the Securities and Exchange Commission on September 18, 2000.

(e) Incorporated by reference to Exhibit 10.1 of the Company s Quarterly Report on Form 10-Q, for the quarter ended December 31, 2000, as filed with the Securities and Exchange Commission on February 14, 2001.

(f) Incorporated by reference to the like-numbered exhibits of the Report on the Form 10-Q for the quarter ended December 31, 2001, as filed with the SEC on February 14, 2002.

(g) Incorporated by reference to the like-numbered exhibits of the Report on the Form 10-Q for the quarter ended March 31, 2001, as filed with the SEC on May 15, 2002.

(h) Incorporated by reference to Exhibit 10.1 of the Report on Form 8-K filed with the SEC on July 2, 2002.