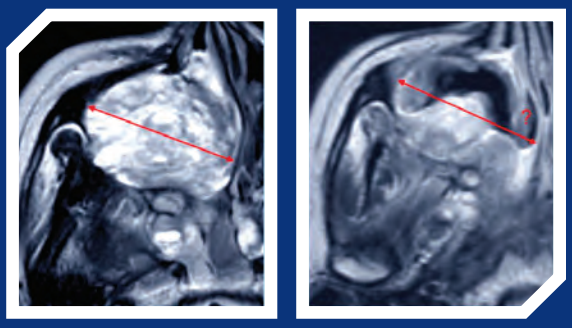
2011 ANNUAL REPORT

VIRTUALSCOPICS

Quantitative Imaging for Clinical Trials



VirtualScopics was built on innovation and it is that spirit that has driven us to change the way imaging is used in drug and device development. While imaging has long held a role in the drug development process, its benefits were, and still can be, limited by conventional qualitative analysis. VirtualScopics recognized such limitations and built the technology to overcome them.

Our highly automated **quantitative** analysis methodology is enabling pharmaceutical companies to utilize imaging in ways not previously possible. VirtualScopics provides reproducible medical image analysis driven by patented algorithms that enable precise quantification of biological structures and metabolic functions. Quantitative analysis not only allows research teams to determine **if** their drug is working, but **how** it is working.

VirtualScopics is a recognized scientific leader in the use of quantitative imaging solutions for clinical trials. From pre-clinical through Phase IV, we manage the entire range of clinical trials imaging services for drug and medical device development. We believe, our expert staff and patented systems enable our sponsors to make faster decisions with greater confidence resulting in more efficient, cost effective, and flexible clinical trials.

Dear Fellow Stockholders,

We entered 2011 with two key objectives for the company:

1. To **maximize** our participation in the clinical trial space through the efficient deployment of our current technology directly to clients and to develop, leverage, and expand our newly formed strategic alliance with PPD.

2. To **expand** our capabilities within the clinical trial space and to lay the foundation for our entry into personalized medicine and diagnostics.

I am very pleased to report we made great progress towards each of these areas in 2011.

2011 Financial Review

We achieved solid 2011 financial results growing revenues 7% compared to 2010, achieving $14.3 million. Our gross profit for the year was $6.3 million with a gross margin of 48% which is very good for a services based company. Underpinning the financial results, we made some very broad based personnel investments during 2011 with hiring in radiology, imaging science, global training, and software, closing the year with employment just shy of 100 employees.

Our core business continues to be a strong cash generator. Adjusted EBITDA closed the year at $1.4 million bringing our cash balance to $5.7 million at the end of 2011. This represented a 25% increase in cash on hand over the course of the year and further underscores our ability to generate cash in the business and efficiently manage our capital investments. The amount of cash on hand will play an important role as we consider strategic investments in new market areas going forward.

Our business development efforts continue to pay dividends as we brought on eight new clients during 2011. This includes four new clients through our PPD relationship. We now serve a customer base of 36 of the leading pharmaceutical and biotech companies in the world. Our active project total also reached a new high as it increased from 121 during 2010, to 133 in 2011.

2011 Strategic Initiatives – A Review

For 2011 we defined a set of 4 key strategic initiatives: 1) investments in our software and technology platforms, 2) a company-wide focus on operations and operational efficiencies, 3) the growth and expansion of the PPD strategic alliance, and 4) the further development of our personalized medicine application.

Software, Technology, and Operational Efficiency

In 2011, we increased our investment in software and technology by 29%. Our software and technology organization is responsible for the development and evolution of our operating platform and therapeutic applications – the backbone of our company. With the additional resources this group attained record productivity with the implementation of over 70 separate software releases in support of our operating infrastructure and client projects in new or existing disease areas, as well as facilitating the processing of new imaging modalities. Many of these enhancements enable operating efficiencies, while others give us a competitive advantage in the marketplace.

One great example of how new software tools can significantly increase operational efficiency can be seen through the implementation of a new semi-automated image segmentation and tracking algorithm. The implementation of this new tool reduced our analysis times in certain musculoskeletal projects by over 50%, not only reducing our costs but also enabling greater overall capacity.

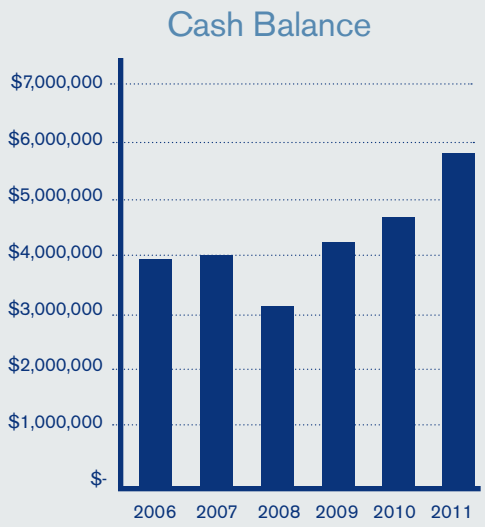
“Our core business continues to be a strong cash generator.”

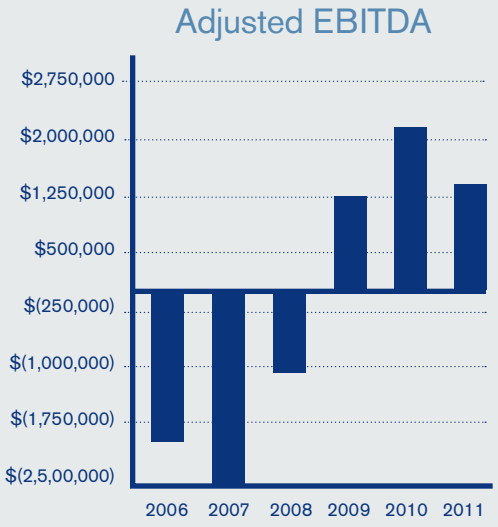
From a customer and competitive enhancement perspective we also rolled out a remote viewing application during 2011. These viewing stations allow clients to review subject images with full 3D fidelity direct from our database. This is an important offering for those clients that have imaging or radiological experts on staff, allowing them to review subject images and associated contours and measurements to facilitate greater understanding of the results we provide.

Also of significant note, we released a new commercial version of our client portal so individual sponsor study teams can review study status, individual site and patient status, along with key subject images, on a real-time basis. By providing clients greater access to study data we create more transparency to information and progress toward milestones while creating stronger communication between our teams. Ultimately this will allow us to provide greater efficiencies for our clients resulting in cost savings and the ability for them to make more timely and informed decisions.

With respect to pure operational efficiencies, we rearchitected our internal processes that deliver fast turnaround for certain drug trials where we need to confirm patient eligibility or in new medical device trials where there is an imaging assessment that must be completed prior to surgery. This is an area where we have seen very significant growth and these new processes not only reduce our cost but also make us more reliable and predictable at meeting these very tight timeframes.

A second operational efficiency example relates to our offerings for site recruitment and training. We typically offered two options for site training: on-site training by an experienced technologist or an on-line training hosted by a VirtualScopics trainer. While these options were effective we had difficulty arranging training times that met all needs. Thus we expanded our site training options to include a web-based training application whereby the sites can be trained on their schedule, 24/7. This is specifically tailored to large global studies that can have upwards of 500 imaging sites. This application makes it much quicker to recruit, train and qualify sites and is very convenient, scalable, and profitable for VirtualScopics.





PPD Expansion

2011 marked the first full calendar year of our strategic alliance with PPD. During the year we laid a strong foundation for a very successful long term partnership with the initiation of a number of new studies, as well as deepening the relationships between key personnel at both companies. Just as significant, clients were universally impressed with the level of integration and teamwork displayed by our teams so early in the alliance. Based upon these successes we jointly announced early in 2012 an expansion of the alliance to include cardiovascular, central nervous system, general medicine and medical device studies along with the existing oncology studies. With this expansion we are now the imaging provider for all of PPD underscoring the strategic importance of the partnership to both organizations.

While a strong foundation was laid in 2011, significant building is planned for 2012. We are planning to make additional investments into our IT systems to more directly allow study data to move from one company's systems to the other, further reducing cost and oversight by our data management teams. We also plan to more fully align and integrate our operational processes to eliminate overlap reducing cost and time. When coupled with the investments in IT, these processes will enable our teams to work as if they were in one, rather than two separate companies. With these continued investments, expansion into new therapeutic areas and a maturing of the overall relationship, our goal for 2012 is to double the number of opportunities we bid on jointly compared to 2011.

Personalized Medicine

During 2011 we took great strides in the continued development of our market entry into personalized medicine which will enable us to bring quantitative imaging to a much broader market. This market is currently served primarily by qualitative assessments which are subjective by design and thus can't provide the precision required to characterize response consistent with today's healthcare challenges.

Quantitative imaging utilizing repeatable and reliable software algorithms, we believe, offers a significant benefit to patients and physicians by enabling them to better and more quickly, monitor and predict the effectiveness of certain therapies on an individual patient basis. With the continued emphasis on controlling the increasing cost of healthcare, products and services that assist in patient stratification and rapid determination of efficacy or futility for expensive therapies are critical. We believe this approach is a unique step towards supporting the vision of personalized medicine.

For 2012 our goal is to align with key stakeholders in the delivery and reimbursement of healthcare services and industry leaders in the pharmaceutical industry and academia, along with the major imaging equipment manufacturers, to ensure we launch the right solution for the industry and our stockholders.

"I believe our company has never been stronger. We are growing, profitable, and have sufficient cash to fund our operations. For a young company this is vital."

Exciting Future

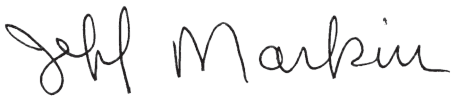
In closing I would like to add some additional perspective on the company and our future prospects. I believe our company has never been stronger. We are growing, profitable, and have sufficient cash to fund our operations. For a young company this is vital.

We also have tremendous growth opportunities in the clinical trial space with our current clients and those that will become our clients through our own efforts and those resulting from our strategic alliance with PPD, a large world class organization.

The market for personalized medicine is large and growing, and we have a proven technology, developed during more than 11 years in drug development, that we can now deploy to assist in impacting the rising cost of healthcare by aiding in the delivery of the right medications, to the right patients, at the right dose.

On top of that we have assembled a team of close to 100 people that are dedicated to the successful growth of the company and the impact we are and will make to society.

Thanks also for the confidence you have placed in the company and I look forward to continuing to update you on our progress.



Jeff Markin
President and Chief Executive Officer

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

Form 10-K

x ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 2011
OR
TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from ____ to____

Commission file number: 000-52018

VIRTUALSCOPICS, INC.

(Exact name of registrant as specified in its charter)

DELAWARE	**04- 3007151**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

500 Linden Oaks, Rochester, New York	**14625**
(Address of principal executive offices)	(Zip Code)

(585) 249-6231
(Registrant's Telephone Number, Including Area Code)

SECURITIES REGISTERED PURSUANT TO SECTION 12(b) OF THE EXCHANGE ACT:
Common Stock, $0.001 par value
NASDAQ Capital Market
SECURITIES REGISTERED PURSUANT TO SECTION 12(g) OF THE EXCHANGE ACT:
TITLE OF EACH CLASS:

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.
[ ] Yes **[**x **]** No
Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act.
[ ] Yes **[**x **]** No

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). * **[x]**

Indicate by check mark if disclosure of delinquent filers in response to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. **[x]**

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of “large accelerated filer,” “accelerated filer” and “smaller reporting” in Rule 12b-2 of the Exchange Act.

Larger accelerated filer **[ ]**	Accelerated filer **[ ]**
Non-accelerated filer **[ ]** (Do not check if a smaller reporting company)	Smaller reporting company **[**x **]**

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

The aggregate market value of the issuer’s voting and non-voting common equity held by non-affiliates of the issuer as of December 31, 2011 was approximately $17,940,236 (calculated by excluding all shares held by executive officers, directors and holders known to the registrant of five percent or more of the voting power of the registrant's common stock, without conceding that such persons are “affiliates” of the registrant for purposes of the federal securities laws). This amount does not include any value for the issuer’s series A preferred stock or series B preferred stock, for which there is no established United States public trading market, or any value for the common stock issuable upon conversion of shares of such preferred stock.

As of February 29, 2012, there were outstanding 29,370,687 shares of the issuer’s common stock, $.001 par value.

Documents Incorporated By Reference: Portions of the Company's Proxy Statement to be delivered to the Company’s stockholders in connection with the Company’s 2011 Annual Meeting of Stockholders, which the Company plans to file with the Securities and Exchange Commission pursuant to Regulation 14A promulgated under the Securities Exchange Act of 1934, on or prior to April 30, 2012, are incorporated by reference in Part III (Items 10, 11, 12, 13 and 14) of this Form 10-K.

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PART I

FORWARD-LOOKING STATEMENTS

Some of the statements under the captions of this report on Form 10-K titled “Risk Factors,” “Management's Discussion and Analysis of Financial Condition and Results of Operations” or “Business,” contained or incorporated by reference elsewhere in this report, and in our other reports filed with the Securities Exchange Commission (“SEC”) constitute “forward-looking statements” within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, which involve risks and uncertainties. These statements are made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. These forward-looking statements include statements that address activities, events or developments that we expect, believe or anticipate may occur in the future, including:

- adverse economic conditions;
- loss of market share due to competing products and services;
- unexpected costs, lower than expected sales and revenues, and operating defects;
- adverse results of any legal proceedings;
- the volatility of our operating results and financial condition;
- inability to attract or retain qualified senior management and scientific personnel;
- inability to raise sufficient additional capital to operate our business, if necessary, and;
- other specific risks that may be referred to in this report.

All statements, other than statements of historical facts, included in this report regarding our strategy, future operations, financial position, estimated revenue or losses, projected costs, prospects and plans and objectives of management are forward-looking statements. When used in this report, the words “may,” “believe,” “anticipate,” “intend,” “estimate,” “expect,” “project,” “plan,” “could,” “would” and similar expressions are intended to identify forward-looking statements, although not all forward-looking statements contain such identifying words. All forward-looking statements speak only as of the date of this report. We do not undertake any obligation to update any forward-looking statements or other information contained in this report. Existing stockholders and potential investors should not place undue reliance on these forward-looking statements. Although we believe that our plans, intentions and expectations reflected in or suggested by the forward-looking statements in this report are reasonable, we cannot assure our stockholders or potential investors that these plans, intentions or expectations will be achieved. We disclose important factors that could cause our actual results to differ materially from our expectations under “Risk Factors” and elsewhere in this report. These risk factors qualify all forward-looking statements attributable to us or persons acting on our behalf.

Information regarding market and industry statistics contained in this report is included based on information available to us that we believe is accurate. It is generally based on academic and other publications that are not produced for purposes of securities offerings or economic analysis. We have not reviewed or included data from all sources, and we cannot assure our stockholders or potential investors of the accuracy or completeness of the data included in this report. Forecasts and other forward-looking information obtained from these sources are subject to the same qualifications and the additional uncertainties accompanying any estimates of future market size, revenue and market acceptance of products and services. We have no obligation to update forward-looking information to reflect actual results or changes in assumptions or other factors that could affect those statements. See “Risk Factors” for a more detailed discussion of uncertainties and risks that may have an impact on future results.

ITEM 1: Business

We are a provider of quantitative imaging for clinical trials serving the pharmaceutical, biotechnology and medical device industries. We have created a suite of image analysis software tools and applications which are used in detecting and measuring specific anatomical structures and metabolic activity using medical images. Our proprietary software and algorithms provide measurement capabilities designed to improve clinical research and development. We focus on applying our imaging technology to improve the efficiency and effectiveness of the pharmaceutical and medical device research and development processes. We believe our technology can also be used in improving the treatment planning for patients with cancer and other debilitating diseases.

Business Overview

Our image-based measurement and visualization tools enable automated, accurate and reproducible measurement of minute changes that occur in anatomic structures in musculoskeletal, oncological, cardiological and neurological diseases. For pharmaceutical, biotechnology and medical device manufacturers, these tools can significantly alleviate or reduce clinical development bottlenecks by increasing the speed, accuracy and reliability of the demonstration of a new compound's efficacy. Further, these measurements can be used to assess the viability of continuing a drug development project and eliminate as soon as possible a drug that is likely to fail. Early failure is critical to the pharmaceutical industry to prevent the expenditure of R&D funds on a drug that will not perform as expected. We believe that this is especially important today with the large number of compounds that are awaiting evaluation.

We have also begun pursuing the expansion of the use of our quantitative imaging into new markets. Our first of these applications, which we believe has significant benefits to society, is our blood flow and vascular permeability software tool which could provide patients and oncologists information to assist in the determination whether an anti-angiogenic therapy is having the desired effect. We believe this application will better assist oncologists with treatment planning for patients undergoing anti-angiogenic cancer therapies. We have filed a 510k with the FDA and have received their initial comments. We are actively working towards answering their questions. In the meantime, we are in discussions with potential partners in the industry to assist with the validation, marketing and distribution of our first quantitative imaging application outside the drug development market we currently serve. We will continue to assess the best mechanism for channeling our application into the market as well as the process for obtaining reimbursement from payers; however, there can be no assurance that approval will be granted or we will experience significant demand for our application.

Benefits to Pharmaceutical, Biotech and Medical Device Companies

The benefits to pharmaceutical companies from using our image analysis tools can include shorter clinical development time, and earlier determination of the effectiveness or ineffectiveness of a new drug or compound. Our technology helps to curtail trials that are not likely to be beneficial and to avoid mistaken termination of compounds that are likely to prove efficacious, through:

- improved precision in the measurement of existing biomarkers resulting in shorter observation periods, with beneficial cost savings within a clinical trial;
- new biomarkers, which are better correlated with disease states, again reducing trial length and therefore costs; and
- reduced processing time for image data analysis through automation.

In addition, our technology reduces aggregate clinical development costs through:

- improved precision of existing biomarkers, thus requiring smaller patient populations and lower administrative costs; and

- new biomarkers that serve as better correlates, leading to better early screening and elimination of weak drug candidates in pre-clinical trials.

Benefits to Patients and Health Care Providers in Personalized Medicine

The specific opportunities that we are pursuing within personalized medicine are mostly related to the treatment monitoring of patients. Cancer is a leading cause of death throughout much of the developed world, and technologies for closely monitoring disease progression and response to treatment are currently lacking. We believe this presents us with a significant market opportunity.

In personalized medicine, our technology is designed to offer physicians and medical insurers better treatment planning of patients based on determination of patient response to compounds or other treatment options. For example, in oncology we have demonstrated the ability to determine whether patients are showing response to an anti-angiogenic drug after only 48 hours of treatment (Glenn Liu *et al.,* "Dynamic Contrast-Enhanced Magnetic Resonance Imaging as a Pharmacodynamic Measure of Response After Acute Dosing of AG-013736, an Oral Angiogenesis Inhibitor, in Patients With Advanced Solid Tumors: Results From a Phase I Study," *Journal of Clinical Oncology,* vol. 20, August 20, 2005).

We are the first company able to provide blood flow and volume measurements for cancer diagnosis and monitoring in a standardized and consistent way across multiple institutions (Jerry M. Collins, "Imaging and Other Biomarkers in Early Clinical Studies: One Step at a Time or Re-Engineering Drug Development?," *Journal of Clinical Oncology,* vol. 20, August 20, 2005). These quantitative measurements are vital for assessing patient response to next-generation anti-angiogenic cancer drugs.

Our Technology Solution

Oncology Applications

Automated Measurement of Tumor Structure in Oncology

Rapid determination of drug efficacy depends on precise measurement of tumor structure and function. Yet current practices - direct measurement from films and computer-aided tracing - can be time-consuming, inaccurate and highly variable. Manual approaches often lead to false conclusions when tumors take on abnormal shapes; where a two-dimensional analysis may indicate no change, a three dimensional analysis may show a significant change in tumor volume. The RECIST standard, still the primary imaging endpoint for assessing disease progression or response to treatment in many types of cancer, measures structural changes in tumors through a simple summation of longest diameters, limited to the axial imaging plane. Originally developed for x-ray imaging, it fails to take advantage of the far richer three dimensional information set available with today's imaging technologies.

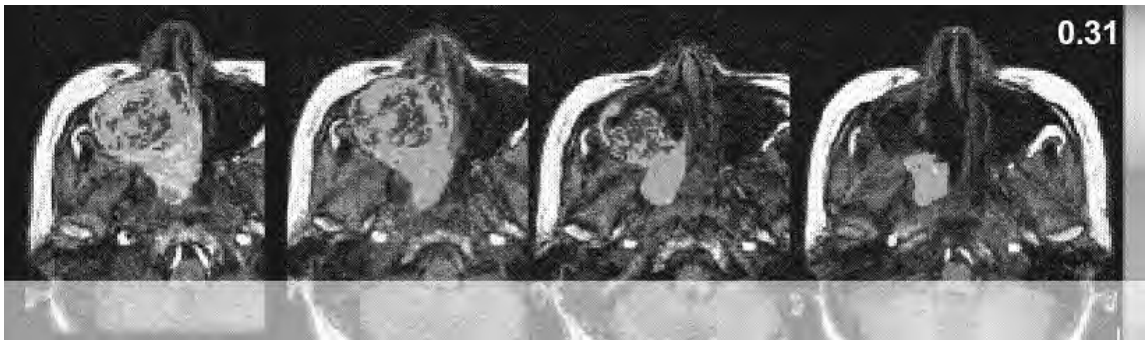
Our semi-automated, statistically-driven feature analysis provides greater precision, higher throughput and less dependence on a particular reader than manual tracing does. In retrospective analysis for a leading pharmaceutical company, our volumetric measurement showed that tumors found to be stable under RECIST were actually growing significantly. With our semi-automated analysis we believe we could have discovered the failure sooner and avoided the expense of funding the next phase of clinical research. Conversely, volumetric measurement can greatly accelerate clinical research by preventing mistaken kills and identifying efficacious compounds sooner.

Innovation in Image-Based Biomarkers

With a multidisciplinary team of medical professionals (including staff radiologists), scientists and software developers, we deliver unparalleled innovation in the analysis of specific biomarkers. Measurements may include specific FDA-acknowledged (RECIST and tumor volume) biomarkers as well as secondary or exploratory endpoints such as cavitation/necrosis, or shape. By extracting substantially more information from existing imaging modalities such as CT or MRI, we believe we offer a more definite and efficient basis for determining the course of clinical trials.

Measurement of Blood Flow and Metabolic Activity

A growing number of anti-cancer drugs both on the market (e.g., Iressa and Avastin) and under development are designed to reduce the blood supply available to tumors, thereby depriving them of the ability to grow and spread. During development, these compounds require the ability to accurately measure blood flow and vascular permeability in *vivo,* in order to determine dose-response relationships and compound efficacy. In the clinic, this same capability is necessary in order to determine whether a particular patient is responding to treatment. We have developed a method, using dynamic contrast enhanced magnetic resonance imaging (DCE-MRI), to accomplish this. This technique involves repeated imaging, generally every five to ten seconds, for a period of several minutes before and after the injection of a gadolinium-based, FDA-approved, contrast agent. Tracer concentration changes over time can then be measured both in normal and cancerous tissues, and based on this information parameters such as blood flow, blood volume and vascular permeability can be derived. These parameters have been shown to relate directly to the activity of anti-angiogenesis and anti-vascular cancer drugs, and to allow the prediction of response or failure after only a few days of treatment.



With dynamic contrast-enhanced series, changes in signal intensity can be related to tracer concentration in tissues. This information can be used to determine the blood flow to the tumor.

Musculoskeletal Applications

Our image analysis provides a degree of accuracy and reproducibility that cannot be duplicated by manual techniques. Standard endpoints, such as pain or functionality scoring are largely subjective and difficult to reproduce. Our quantitative imaging replaces subjective evaluation - knee pain ranked on a scale of 1 to 10 - with an objective quantification - volume of lost cartilage in cubic millimeters. Unlike manual assessment methods, our computer aided approach allows you to track the boundary location of each structure in a data set from one scan to another, even if the patient is not positioned in precisely the same way for each scan, or if there have been some anatomical changes between scans. For cartilage volumes and thickness measurements, the Coefficient of Variation (CV) typically falls between 2% and 4% - we can detect minute changes with statistical confidence, allowing our clients to reduce study populations or shorten study durations.

With our automated analysis, researchers can more confidently make the go/no go decision for a compound early in the evaluation process, allowing scarce resources to be allocated to the most promising candidates. In the evaluation of osteoarthritis, for example, MRI of the cartilage in the knee coupled with automated measurement of volume and composition shows disease changes in months; these changes would not be apparent for years using standard x-ray evaluation.

Reproducible medical image analysis is driven by computer image analysis algorithms that enable quantitative measurement of different structural parameters. Guided by the information present in the images, as well as embedded anatomical knowledge, the algorithms enable segmentation of different structures. From an MRI knee scan, for instance, it is possible to produce a three-dimensional reconstruction that graphically distinguishes cartilage from underlying bone, as well as from ligaments, fluid, degenerated menisci or inflamed synovium. This capability provides a valuable assessment tool for clinical research in osteoarthritis - a disease with multiple endpoints - because it allows sensitive and specific measurement of all the components of the knee joint and detects small changes in any of those components over time.

Medical Device and Biologics
New research continues to focus on the development of devices and/or biologics that will generate new and better cartilage for patients with osteoarthritis and knee injuries. Our technology uses a suite of tools to assist in the identification of cartilage lesions within the knee. These tools allow for the tracking of structural changes and the quality of new tissue being grown within those lesions. For example, we are currently working with leading biologic and medical device companies to determine the percent fill for lesions implanted with the device/biologic. This analysis serves as a useful tool in that it demonstrates the degree of success of the implant. It is presumed in the industry that the higher the percent fill the lower the degree of pain for the patient. We also provide quality of tissue assessments (i.e. T2 maps) to provide our customers with information on the composition of the repair tissue. It is also believed that the closer the repair tissue is to 'normal' tissue the longer the life span is of the repair tissue with the resulting benefit being the ultimate health and comfort of the patient.

Additionally, our motion tracking software capabilities allows us to more precisely measure changes in the structural and tissue quality measurements. It has been demonstrated that this technique can reduce the amount of variability inherent in these types of measurements, thereby, reducing the amount of patients necessary to demonstrate the effectiveness of the medical device and/or biologic.

Cardiovascular Applications
Cardiovascular disease is one of the leading causes of mortality within most developed countries. Early identification of the changes leading the disease can prompt early intervention which can result in longer and better quality of life as well as lower healthcare costs. Imaging provides a valuable tool for the assessment of early development of arterial plaques which can lead to arterial stenosis as well as stroke and myocardial infarction. The current primary imaging tool for screening cardiovascular patients is ultrasound but these carotid ultrasound scans produce a large amount of data which can be laborious and imprecise to analyze. We have developed a suite of patented semi-automated tools for the identification and measurement of carotid plaques which has proven to reduce analysis time to as little as 3 minutes per case compared to the current manual methods which can take over one hour. In addition, these tools have been tested against expert readers in the field and found to be highly precise and accurate and in many cases more sensitive to the appearance of small arterial plaques. This provides a valuable tool for screening of normal/healthy individuals as well as monitoring the use in patients enrolled in clinical trials.

More detailed information about plaque composition and progression can be obtained by using MRI. This modality has advantages over ultrasound in that it can precisely measure plaque volume as well as composition. This is important because it is widely recognized in the industry that certain plaques, in particular those with high lipid or necrotic cores, pose a much higher risk to the health of the patient, while those that are fibrous may pose a lower risk. Therefore, the ability to distinguish between benign and vulnerable plaques may enable treating physicians to better personalize the treatment for each patient. Additionally, certain drugs designed to reduce blood lipids may have greater effect on lipid rich plaques, making this a potentially beneficial screening tool for patients enrolled in clinical trials. Our patented semi-automated tools for the measurement of plaques in MRI and automated identification of lipids and calcification allows accurate and precise analysis of vulnerable plaques.

These proprietary ultrasound and MRI techniques for cardiovascular health are being used in large industry sponsored trials today.

Neurology Applications
Evaluating diseases such as multiple sclerosis (MS), epilepsy, and Alzheimer's requires the identification and measurement of neurological structures and lesions. However, current methods for obtaining data points rely on subjective and error prone manual techniques. Manual tracing, especially of abnormal neurological structures, requires considerable expertise and time. Tracing introduces significant variability even when all measurements are made by one individual, an effect that is compounded with multiple operators. Intra- and inter-operator variability poses a major obstacle for researchers attempting to take advantage of the power of MRI analysis in the study of neurological disease. VirtualScopics eliminates these problems with automated, statistically driven feature analysis. Our algorithms employ the two types of knowledge that expert radiologists use to measure structures within the brain: differentiation of various tissue types and knowledge of structure, size, location, and shape. Our software incorporates an *a priori*

model of neurological anatomy that enables the measurement of structures with indistinct boundaries such as the hippocampus. Knowledge of anatomical structures also improves reproducibility, allowing disease progression to be precisely monitored over time. To gain higher resolution and superior tissue separability, we reconstruct volumes by co-registering and fusing images from multiple imaging planes and pulse sequences. Moreover, its automatic reconstruction produces a smooth and continuous surface, much closer to actual shape than would result from manual segmentation.

Many neurological conditions can be detected and evaluated with quantitative measures of structures in MRI studies. While automated measurement tracks lesions in MS clinical trials, it also provides a critical tool in measuring hippocampal volume for diagnosing and monitoring both intractable temporal lobe epilepsy and Alzheimer's disease. Validation studies prove that our automated approach provides greater speed, precision and accuracy in clinical trials than current manual methods do. In MS clinical trials, where current techniques to measure progress in drug development are largely manual, we provide an FDA-approved metric for quickly determining drug efficacy of MS compounds. A VirtualScopics validation study compared manual tracing using two VirtualScopics software algorithms for automated measurement: geometrically constrained region growth (GEORG) and directed clustering. Our Core Lab utilizes both algorithms to achieve an optimal system for quantification of MS lesions in multi-spectral MRI studies. In the MS validation study, mean processing time was 60 minutes for manual tracing, 10 minutes for GEORG, and 3 minutes for directed clustering. Intra- and inter-operator coefficients of variation were 5.1% and 16.5% for manual tracing, 1.4% and 2.3% for region growth and 1.5% and 5.2% for directed clustering. The study also compared our automated measurement and manual tracing from an expert radiologist against a phantom data set, obtained from the McConnell Brain Imaging Center. In all data sets, automated algorithms performed significantly better than manual tracing. Our automated measurements also proved more repeatable than manual methods, an important feature in multi-center clinical trials.

Sales and Marketing

Our sales and business development strategy is centered around the publication and presentation of our technology and services at targeted industry conferences along with an active marketing effort aimed at pharmaceutical, medical device, and biotechnology companies. To date, we have made significant inroads by having contracts with 10 of the 15 leading pharmaceutical, biotechnology and medical device companies. During 2011, we performed services for 133 projects representing 36 customers. We continue to grow our business by leveraging relationships with our current customers and through referrals. As a result, our current customers have been instrumental in introducing us to other therapeutic groups within their organization. Our marketing efforts are instrumental in broadening the awareness of VirtualScopics throughout the industry and educating current customers on the breadth of our services.

Complementing our sales and marketing effort is our strategic alliance with PPD, Inc., signed in October 2010 and expanded to include multiple therapeutic areas in January 2012. The alliance affords us the opportunity to penetrate an expanded customer base through a combined solution to the market. We are working closely to develop the best in kind solution combining core Clinical resource Organization, or CRO, services with our imaging platform. The alliance also provides for our earlier engagement with potential customers because PPD tends to be engaged earlier in the supplier selection process of the drug development cycle.

In addition to these initiatives, we actively participate in medical conferences to showcase our technology, services and results, as well as joint publications with sponsors which often results in highly visible, research. We have built a strong base of clinical collaborators across varied disease platforms.

Industry Background and Market Trends

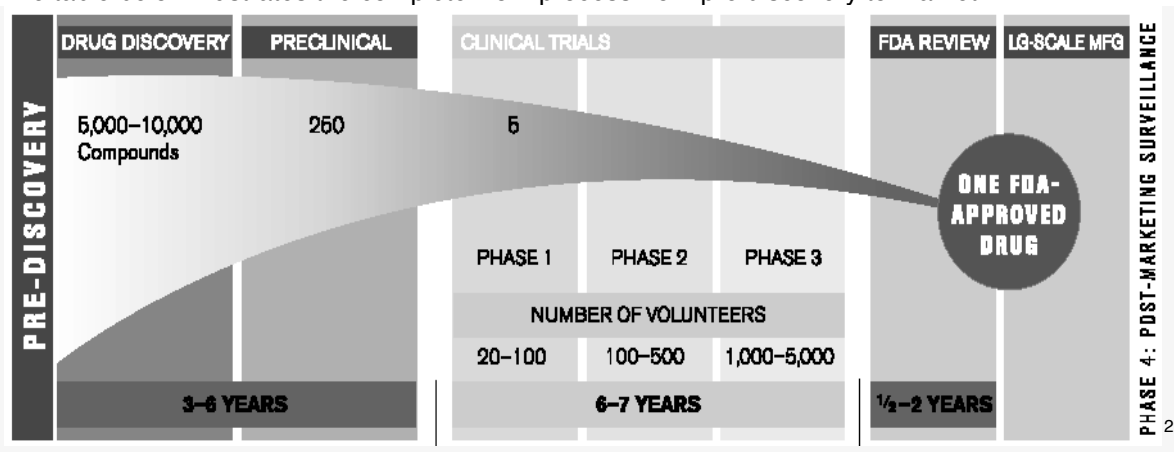
Market in Pharmaceutical and Medical Device Development

Industry Overview
The global Pharmaceutical market is expected to have grown by 5-7% in 2011 with the industry forecasted to generate around $880 billion in revenues with an expected expansion to $975 billion by

2013. Although impacted by the economic downturn in 2009, the industry is insulated to a greater extent than other industries where consumer spending is far more discretionary. Other factors such as patent expirations, the introduction of cheaper generics, a slowdown in innovative product launches, and hurdles imposed by payers on market access and acceptance have contributed to record low sales growth this year. While the pharmaceutical market is expected to rebound as the global economy recovers, an unprecedented level of potential patent expirations in 2011 and 2012 will curb sales growth. In spite of these pressures, the demand for medicines and treatments is expected to rise due to 1) an aging world population with an increased need for medical care, 2) unhealthy lifestyles leading to increased frequency of chronic diseases, 3) high economic growth in emerging markets leading to an increased demand for better quality healthcare and 4) scientific advances that create the foundation for innovative treatments for previously untreatable diseases.

The global compound annual growth rate (CAGR) for pharmaceutical market growth is forecasted to be 4-7 percent through 2013.[1]The U.S. Pharmaceutical market was expected to expand by 3-5 percent in 2011. Emerging markets on the other hand were expected to grow collectively at a 15-17 percent rate in 2011 to $170-180 billion. Meanwhile, the five major European markets of Germany, France, Italy, Spain and the UK, along with Canada, will only grow at a 1-3% pace. Approximately 50 - 60 new chemical or biological products are expected to be launched over the next two years with at least 10 of them being potential blockbuster drugs.

As the growth rate in the demand for prescription drugs decreases, it is getting harder for Pharmaceutical companies to maintain the same levels of R&D spending as in the past. Additionally, the cost and complexity of developing new drugs, in part due to the increased scrutiny over product safety and the pressure to demonstrate health outcomes earlier, has increased substantially relative to its eventual potential value. Due to the high attrition rates, with Phase 3 terminations alone doubling from 2007-2009 compared with 2004-2006, the total resources required to yield one successful product are rising. For every 5,000 -10,000 compounds that enter at the discovery stage, only one goes on to reach the market. The table below illustrates the complete R&D process from pre discovery to market.



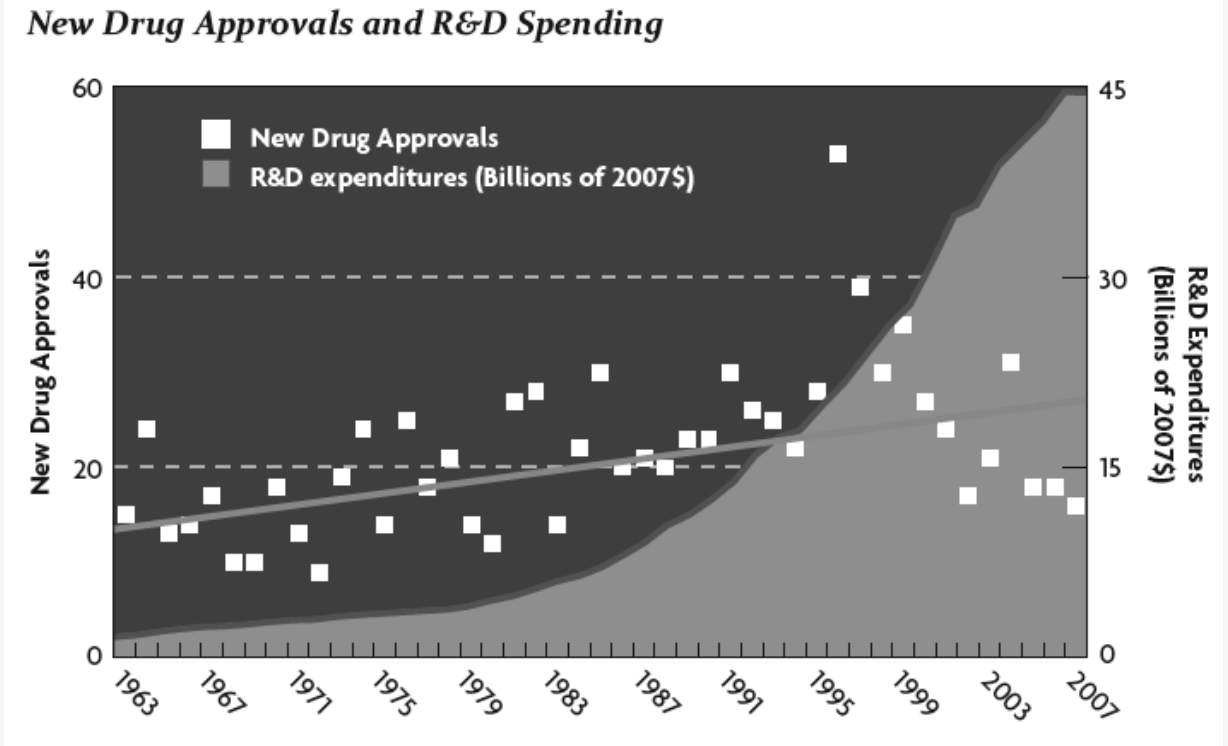
[2]

Drug Development Process

Typically, most functions of the drug and medical device R&D process are managed by Clinical Research Organizations (CROs). Rising costs and falling productivity, among other trends are driving pharmaceutical companies to outsource an increasing range of functions to CROs in search of time and cost savings. This produced strong double-digit growth in the CRO sector between 2003 and 2008. The total CRO market size is estimated to have reached $36.6bn in 2011 with a projected CAGR of 10% over the next five years. The market is highly fragmented and the number of CROs worldwide has reached over 1,100 despite continued consolidation. The leading CRO's by amount of market share are Quintiles (12.9%), Covance (8.8%) and PPD (5.6%)

[1] imshealth.com - IMS Health Lowers 2009 Global Pharmaceutical Market Forecast to 2.5 – 3.5 Percent Growth
[2] PHRMA Industry Report 2009

Although the FDA has significantly reduced the average approval time for new drugs (1.1 years in 2005-2007 period), clinical development time has been increasing over the years, resulting in total development time being fairly flat in recent years (average of 8.6 years since 2002). Growing complexities in protocol design leading to longer clinical development times has been the major contributor to the rising costs that sponsors are facing. The table below illustrates the increasing trend in R&D costs over the years, while the number of new drug approvals continues to stagnate.



The current trend in drug development is for pharmaceutical companies to shift towards a niche market. The 'one size fits all' approach is being replaced by a more targeted, innovative approach to develop treatments for small patient groups with complicated diseases such as cancer, rheumatoid arthritis and immune disorders. Such 'niche buster drugs' are expected to exploit new technologies such as biomarkers and theranostics and will support the continued development of personalized medicine.

With the U.S administration trying to implement health care reform, increased regulatory oversight and pressure on drug companies to reduce prices, there is a need for R&D to become more efficient and reduce costs to prevent an innovation slowdown in the industry. Many leading pharmaceutical companies have restructured their R&D processes by establishing centers of R&D excellence and disease focused centers. Commercial success rate for new drugs is low, with only 2 out of 10 drugs matching or exceeding average R&D costs.

Because of these factors, we believe our quantitative imaging analysis offer a solution to these issues within drug development by providing more precise and reliable information in the assessment of compounds being developed. We believe our increased precision and reproducibility enable our customers to make more confident decisions on the efficacy of their compounds.

Quantitative Image Analysis Services

We have conducted research to determine the current size of the market for image analysis services in clinical trials supporting the pharmaceutical, biotech and medical device industries. Based on our research and discussion within the imaging CRO and medical device and drug development industries,

we have found that the market is fragmented, with approximately $500 million in total annual revenues projected for 2011.

Prior to 2011, the industry underwent a growth phase as the use of imaging end-points is becoming more prevalent within the FDA. In 2011, we estimate that the market size was consistent with 2010 as companies experienced reductions in R&D spending. We currently estimate the annual growth rate for the market at 5% to 10% for the next five years. Our estimates are based on the amount of trials currently conducted within therapeutic areas that we work in. We also have performed a bottom-up calculation of the individual growth rates of the companies and academic centers within the industry. We believe that some of the largest players, which offer the broadest set of capabilities, are also growing. Specifically, BioClinica, Perceptive (division of Parexel), RadPharm and ICON.

Image Analysis Solutions in the Pharmaceutical and Medical Device Industries

It is well known that greater reproducibility of measurements can decrease the cost and time to market of compounds in development. The higher reproducibility of our automated analysis enables researchers to achieve statistically significant results with substantially smaller patient populations. Automated analysis greatly reduces the analyst variability and interaction time required to process clinical trial data. Published studies demonstrate that our automated analysis consistently yields a lower coefficient of variation than manual techniques. As measurement variation diminishes, so does the percentage change in a given structure necessary to determine whether a treatment is having the desired effect. In short, precise measurement allows companies to learn more from smaller populations earlier in the compound development process.

Drug discovery and development has been constrained by the lack of accurate image analysis tools and appropriate image-based biomarkers. In many musculoskeletal clinical studies, X-ray is the chosen modality for evaluating a compound's efficacy. X-ray imaging in drug discovery has significant limitations, which include:

- partial or complete inability to detect changes in a region of interest due to poor contrast or occlusion;
- the potential for inter/intra-observer variability - error in radiologist measurements can amount to upwards of 30% for small structures of interest;
- the need for a radiologist to perform manual tracings is not only subject to error, but is also time consuming; and
- reliance on a radiologist for biomarker measurements results in very limited throughput.

The constraints mentioned above can add months and years to the drug discovery process.

The use of MRI and CT to determine drug efficacy is increasing, owing to its superior information content relative to X-ray. MRI and CT are more sensitive to pathology, provide higher contrast for soft tissue and are three-dimensional. These attributes improve the detection of disease and the ability to monitor disease progression over time. While MRI and CT are preferred modalities, they too suffer from the need to have a radiologist review the images, detect disease, monitor progression and, when necessary, perform manual calculations.

Intellectual Property

We consider our proprietary and patented technology and the technology for which we have applied for patent protection to be of importance to our business plan. We hold ten patents issued by the United States Patent and Trademark Office. These patents begin to expire in November 2018 through 2027. We have also applied for a number of other patents, both domestically and in foreign jurisdictions. To protect our proprietary technology, we rely primarily on a combination of confidentiality procedures, copyright, trademark and patent laws. Our policy is to require employees and consultants to execute

confidentiality and invention assignment agreements upon the commencement of their relationship with us. These agreements provide that confidential information developed or made known during the course of a relationship with us must be kept confidential and not disclosed to third parties except in specific circumstances and for the assignment to us of intellectual property rights developed within the scope of the employment relationship.

Competition

Our main competitors are imaging clinical research organizations (iCROs) providing clinical trial services to pharmaceutical companies. As of the date of this report, we believe that none of the leading imaging CROs have technology capabilities that are comparable to our technology. Imaging CROs typically provide manual and non-differentiated interpretation of medical images for the pharmaceutical industry. As a result, we believe that currently there is an opportunity for us to establish a technology advantage and a set of differentiated services in the advanced image-based biomarker market.

The main CROs which participate in imaging trials are BioClinica, Core Lab Partners, Synarc, Perceptive and ICON. It is our understanding that these companies use predominately manual approaches that are unable to quantify minute structures in medical images. As a result, it may be difficult for them to offer differentiated services to achieve higher profit margins and at the same levels of reproducibility as ours. Additionally, some academic centers have worked on software that has applications for neurological diseases. However, we believe these organizations lack the required FDA compliance standards and ability to scale their operations to meet customer demand and we believe they offer inferior technology.

Our technology competition is largely comprised of a limited number of university research centers that are developing the next generation of image analysis tools. Aside from university centers, there are a few commercial entities that have a desire to provide these advanced imaging services; however, we believe they are constrained by a lack of technical capabilities.

Government Regulation

Healthcare in the United States is heavily regulated by the federal government, and by state and local governments. The federal laws and regulations affecting healthcare change constantly, thereby increasing the uncertainty and risk associated with any healthcare-related company.

The federal government regulates healthcare through various agencies, including the following:

- the Food and Drug Administration, or FDA, which administers the Food, Drug, and Cosmetic Act, or FD&C Act, as well as other relevant laws;
- Centers for Medicare & Medicaid Services, or CMS, which administers the Medicare and Medicaid programs;
- the Office of Inspector General, or OIG, which enforces various laws aimed at curtailing fraudulent or abusive practices, including by way of example, the Anti-Kickback Law, the Anti-Physician Referral Law, commonly referred to as Stark, the Anti-Inducement Law, the Civil Money Penalty Law, and the laws that authorize the OIG to exclude health care providers and others from participating in federal healthcare programs; and
- the Office of Civil Rights which administers the privacy aspects of the Health Insurance Portability and Accountability Act of 1996, or HIPAA.

All of the aforementioned are agencies within the Department of Health and Human Services, or HHS. Healthcare is also provided or regulated, as the case may be, by the Department of Defense through its TriCare program, the Public Health Service within HHS under the Public Health Service Act, the Department of Justice through the Federal False Claims Act and various criminal statutes, and state governments under the Medicaid program and their internal laws regulating all healthcare activities.

FDA

The FDA regulates medical devices. A "medical device," or device, is an article, including software and software associated with another medical device, which, among other things, is intended for use in the diagnosis of disease or other conditions, or in the cure, mitigation, treatment or prevention of disease, in man or other animals. Computer software that complements a CT or MRI scan, such as VirtualScopics, we believe is considered a medical device and is therefore subject to FDA regulation. To date, our sales have been to the pharmaceutical and medical device industries to support their clinical trials. We would need to obtain FDA clearance or approval, as discussed below, before using our technology and services for diagnostic or treatment planning in a clinical setting. We have begun our process for obtaining clearance for our first personalized medicine application (DCE-MRI), no assurance can be given that such clearance or approval would be granted or that it would be granted in a timely manner.

Devices are subject to varying levels of regulatory control, the most comprehensive of which requires that a clinical evaluation be conducted before a device receives approval for commercial distribution. In the United States, we generally are able to obtain permission to distribute a new device in two ways. The first applies to any new device that is substantially equivalent to a device first marketed prior to May 1976. In this case, to obtain FDA permission to distribute the device, we generally must submit a premarket notification application (a section 510(k) submission), and receive an FDA order finding substantial equivalence to a device (first marketed prior to May 1976) and permitting commercial distribution of that device for its intended use. A 510(k) submission must provide information supporting its claim of substantial equivalence to the predicate device.

If clinical data from human experience are required to support the 510(k) submission, these data must be gathered in compliance with investigational device exemption (IDE) regulations for investigations performed in the United States. The 510(k) process is normally used for software products of the type that we propose distributing. The FDA review process for premarket notifications submitted pursuant to section 510(k) takes on average about 90 days, but it can take substantially longer if the agency has concerns, and there is no guarantee that the agency will "clear" the device for marketing, in which case the device cannot be used for diagnosis and distributed in the United States. Nor is there any guarantee that the agency will deem the article subject to the 510(k) process, as opposed to the more time-consuming and resource intensive and problematic, premarket approval, or PMA, process described below.

The second, more comprehensive, approval process applies to a new device that is not substantially equivalent to a pre-1976 product. In this case, two steps of FDA approval generally are required before we can market the product in the United States. First, we must comply with IDE regulations in connection with any human clinical investigation of the device. Second, the FDA must review our PMA application, which contains, among other things, clinical information acquired under the IDE. The FDA will approve the PMA application if it finds there is reasonable assurance the device is safe and effective for its intended use.

Certain changes to existing devices that do not significantly affect safety or effectiveness can be made with *in vitro* testing under reduced regulatory procedures, generally without human clinical trials and by filing a PMA supplement to a prior PMA. Exported devices are subject to the regulatory requirements of each country to which the device is exported, as well as certain FDA export requirements.

After approval or clearance to market is given, the FDA and foreign regulatory agencies, upon the occurrence of certain events, have the power to withdraw the clearance or require changes to a device, its manufacturing process, or its labeling or additional proof that regulatory requirements have been met.

A device manufacturer is also required to register with the FDA. As a result, we may be subject to periodic inspection by the FDA for compliance with the FDA's Quality System Regulation requirements and other regulations. In the European Union, we are required to maintain certain International Organization for Standardization (ISO) certifications in order to sell product and to undergo periodic inspections by notified bodies to obtain and maintain these certifications. These regulations require us to manufacture products and maintain documents in a prescribed manner with respect to design, manufacturing, testing and

control activities. Further, we are required to comply with various FDA and other agency requirements for labeling and promotion. The Medical Device Reporting regulations require that we provide information to the FDA whenever there is evidence to reasonably suggest that a device may have caused or contributed to a death or serious injury or, if a malfunction were to occur, could cause or contribute to a death or serious injury. In addition, the FDA prohibits us from promoting a medical device for unapproved indications.

We currently meet the requirements of *Good Clinical Practices: Consolidated Guidance*, which governs the conduct of clinical trials, and our software complies with the FDA's Regulation 21 CFR Part 11 (Electronic Records; Signatures) and 21 CFR Part 820.30, which outline the requirements for design controls in medical devices. As mentioned throughout this section, as we develop our approach into personalized medicine, FDA approval would most likely be required for the use of our software in that market.

Privacy Provisions of HIPAA

HIPAA, among other things, protects the privacy and security of individually identifiable health information by limiting its use and disclosure. HIPAA directly regulates "covered entities" (healthcare providers, insurers and clearinghouses) and indirectly regulates "business associates" with respect to the privacy of patients' medical information. All entities that receive and process protected health information are required to adopt certain procedures to safeguard the security of that information. It is our policy to comply with HIPAA requirements.

Research and Development Costs

We incurred $1,450,608 and $1,130,744 in research and development costs for the years ended December 31, 2011 and 2010, respectively.

Customers

One customer accounted for 10% or more of our revenue during the year ended December 31, 2011, this same customer accounted for more than 10% of our revenue during the year ended December 31, 2010. The following table sets forth information as to revenue and percentage of revenue for these years for our three largest customers in 2011 and corresponding revenues for 2010:

	Years Ended December 31,			
Customer	2011		2010	
Novartis	$ 7,897,108	(55%)	$ 7,494,103	(56%)
Eisai	$ 588,529	(4%)	$ 261,473	(2%)
Eli Lilly	$ 515,674	(4%)	$ 259,855	(2%)

Employees

As of December 31, 2011, we had 96 employees and eight contract radiologists. Of our employees, 90 are full-time.

ITEM 1A: Risk Factors

You should carefully consider the following risk factors before making an investment decision. If any of the following risks actually occur, our business, financial condition, or results of operations could be materially adversely affected. In such cases, the trading price of our common stock could decline, and you may lose all or part of your investment.

If our products and services do not continue to attract interest from new and existing customers, we may not achieve future growth.

If we are unable to continue to attract interest in the industry for our services, we could fail to achieve future growth which would have a detrimental effect on our business. Our ability to generate revenues is highly dependent on building and maintaining relationships with leading pharmaceutical and biotechnology companies. No assurance can be given that a sufficient number of such companies will increase their demand for our services, thereby limiting the overall market for quantitative imaging services and not enable us to increase our revenue to the extent expected. In addition, the rate of the growth of MRI and CT image-based biomarkers is difficult to predict. Failure to attract and maintain a significant customer base would have a detrimental effect on our business, operating results and financial condition.

The majority of the contracts we have with customers are cancelable for any reason by giving 30 days advance notice.

Our customers typically engage us to perform services for them on a project-by-project basis and are required by us to enter into a written contractual agreement for the work, labor and services to be performed. Generally, our project contracts are terminable by the customer for any or no reason on 30 days' advance notice to us. If a number of our customers were to exercise cancellation rights, our business and operating results would be materially and adversely affected.

If we are unable to manage and sustain our growth, our operating results would be adversely affected.

We have seen a growing demand for our image analysis services over the past several years. We are also planning to seek growth through the expansion of the use of quantitative imaging into new markets. Although there can be no assurance that our past growth will continue, if it does continue we may be unable to scale our capacity efficiently to meet this demand. If we are unable to do so, we may fail to maintain our operating margins or achieve expected operating margins. This may have a material and adverse effect on our operating results.

Our services may become obsolete if we do not effectively respond to rapid technological change on a timely basis.

Our services depend on the needs of our customers and their desire to utilize image-related services in drug and medical device development and clinical diagnosis and treatment. Since the image-based biomarker industry is characterized by evolving technologies, uncertain technology and limited availability of standards, we must respond to new research findings and technological changes affecting our customers. We may not be successful in developing and marketing, on a timely and cost-effective basis, new or modified products and services, which respond to technological changes, evolving customer requirements and competition. If we are unsuccessful in this regard, our business and operating results could be materially and adversely affected.

We have a history of operating losses and uncertain future profitability.

Prior to 2009, VirtualScopics incurred losses from operating activities since it began operations in 2001. As we continue to grow the business, we may face risks and difficulties in our business including uncertainties of further market penetration, competition, cost increases and delays in achieving business objectives. There can be no assurance that we will succeed in addressing any or all of these risks or that we will achieve future profitability and the failure to do so would have a material adverse effect on our business, financial condition and operating results.

Although we believe that our products and services do not and will not infringe upon the patents or violate the proprietary rights of others, it is possible such infringement or violation has occurred or may occur which could have a material adverse effect on our business.

Portions of our business are reliant upon patented and patentable systems and methods used in our image analysis and related intellectual property. In the event that products and services we sell are deemed to infringe upon the patents or proprietary rights of others, we could be required to modify our products and services or obtain a license for the manufacture and/or sale of such products and services. In such event, there can be no assurance that we would be able to do so in a timely manner, upon acceptable terms and conditions, or at all, and the failure to do any of the foregoing could have a material adverse effect upon our business. Moreover, there can be no assurance that we will have the financial or other resources necessary to enforce or defend a patent infringement or proprietary rights violation action. In addition, if our products and services or proposed products and services are deemed to infringe or likely to infringe upon the patents or proprietary rights of others, we could be subject to injunctive relief and, under certain circumstances, become liable for damages, which could also have a material adverse effect on our business.

We are subject to pharmaceutical, medical device and healthcare industry regulations, which could adversely affect the nature and extent of the products and services we offer.

Many aspects of the pharmaceutical, medical device and healthcare industry are subject to regulation at the federal level. From time to time, the regulatory entities that have jurisdiction over the industry adopt new or modified regulations or take other actions as a result of their own regulatory processes or as directed by other governmental bodies. This changing regulatory environment could adversely affect the nature and extent of the services we are able to offer.

To date, our sales have been within the clinical trial industry. To enter the patient treatment or personalized medicine market we would need to obtain FDA clearance or approval before marketing our services in this area. We have begun this process, but there can be no assurance that such clearance or approval would be granted or that it would be granted in a timely manner. To effectively market our products to physicians as a treatment aid, we would also need to obtain appropriate coverage and favorable reimbursement from third-party payers, such as Medicare and insurance companies, in order to more fully benefit from the market opportunity. There can be no assurance that appropriate coverage would be granted or that reimbursement levels or conditions of coverage would be adequate to ensure acceptance among physicians. Additionally, the efforts of governments and third-party payers to contain or reduce the cost of health care, such as a number of legislative and regulatory proposals currently being discussed, could affect our ability to implement our plans in this area.

We may in the future experience competition from academic sites, imaging CROs, and other competing technologies.

Competition in the development of imaging solutions may become more widespread as with emerging technologies such as proteomics and genomics which can serve as predictive tools of drug efficacy. Competitors range from university-based research and development projects which would develop advanced tools to development stage companies and major domestic and international companies which would commercialize the tools. Some of these entities have greater financial, technical, marketing, sales, distribution and other resources than ours. There can be no assurance that we can continue to develop our technologies or that present or future competitors will not develop technologies that render our image-based biomarker industry obsolete or less marketable or that we will be able to introduce new products and product enhancements that are competitive with other products marketed by industry participants.

We have experienced significant demand from one customer, thereby increasing our dependence on the customer until we can further diversify our customer base.

While we continue to serve a broad range of customers, we've experienced strong demand from one of our customers, and our dependence on that customer to sustain our continued growth has increased. In 2011 and 2010, this customer accounted for 55% and 56% of our revenue, respectively. We continue to see demand from other customers, however, not to the same significant pace. We continue to invest on our sales and marketing efforts to further diversify our customers and more broadly penetrate the market, in order to minimize reliance on any one customer. As with all of our contracts, this customer

may terminate its contractual relationship with us for any or no reason on 30 days' advance notice. A decision by the customer to cancel all of its studies with us could have an adverse impact on the growth of our business.

Consolidation within the pharmaceutical industry and changes within healthcare regulation may have an adverse impact on our business.

Over the past few years, there have been several mergers and acquisitions among pharmaceutical and biotechnology companies. Historically, these transactions have positively impacted our business due to a broader exposure within the merged entity, however, there can be no assurance that consolidation within the industry will continue to be beneficial to us. Additionally, with the recent political landscape and changes within the healthcare industry, there may be an adverse impact on our business if the cost of imaging significantly increases or no longer becomes standard of care for patients. Although, we don't believe imaging will decline in its level of use, if it does we may need to reduce prices or invest in research to advance the education and science of medical imaging.

The trading price of our stock may be adversely affected if we are not able to continue to grow the business.

We intend to continue to use our cash on hand to broaden our market penetration of our services within the industry and pursue the application of one of our technologies in the personalized medicine market. If our plans or assumptions with respect to our business change or prove to be inaccurate, we may be required to use part or all of our cash to fund general operating expenses and/or reduce costs within the organization. This will depend on a number of factors, including, but not limited to:

- the lack of significant cancellations of customer contracts
- the further market penetration of our products and services; and
- our ability to manage and sustain the growth of our business.

We currently do not plan to raise additional capital , however, if we need to raise additional capital, it may not be available on acceptable terms, or at all. Our failure to obtain required capital, or the acquisition of capital on less favorable terms, would have a material adverse effect on our business. If we issue additional equity securities in the future, you could experience dilution or a reduction in priority of your securities.

The market price of our common stock may fluctuate significantly.

The market price of our common stock may fluctuate significantly in response to factors, some of which are beyond our control, such as the announcement of new products or product enhancements by us or our competitors; developments concerning intellectual property rights and regulatory approvals; quarterly variations in our competitors' results of operations; changes in earnings estimates or recommendations by securities analysts; developments in our industry; product liability claims or other litigation; and general market conditions and other factors, including factors unrelated to our own operating performance.

Our common stock may be considered a "penny stock" and may be difficult to sell.

The SEC has adopted regulations which generally define "penny stock" to be an equity security that has a market or exercise price of less than $5.00 per share, subject to specific exemptions. The market price of our common stock is currently below $5.00 per share and therefore may be designated as a "penny stock" according to SEC rules. This designation requires any broker or dealer selling these securities to disclose certain information concerning the transaction, obtain a written agreement from the purchaser and determine that the purchaser is reasonably suitable to purchase the securities. These rules may restrict the ability of brokers or dealers to sell our common stock and may affect the ability of our stockholders to sell their shares.

Our strategic alliance with PPD is an important aspect of our growth, and the market may not value our strategic alliance with PPD as we anticipate.

In 2010, we formed an alliance with PPD to provide a joint solution to provide clients with an integrated and customized clinical development and medical imaging solution for oncology clinical trials. The alliance was expanded in January 2012 to include cardiovascular, central nervous system and medical device studies. If the market does not value this model as we anticipate, our ability to grow our business may be negatively impacted. Additionally, the agreement may be terminated by either party on 90 days notice. In the event PPD terminates the agreement, we may also experience a negative impact in our ability to experience the level of growth the company has historically achieved.

A significant number of the shares of our common stock are eligible for sale, and their sale could depress the market price of the our common stock.

Sales of a significant number of shares of our common stock in the public market or the possibility of such sales, could harm the market price of our common stock and impede our ability to raise capital through the issuance of equity securities. As of December 31, 2011, we had 29,370,687 shares of common stock outstanding. These shares are eligible for resale in the public market either immediately or subject to applicable limitations of Rule 144. In addition to these outstanding shares of common stock, we also have shares to be issued upon the conversion or exercise of outstanding options, warrants and convertible securities. The series B convertible preferred stock and the warrants to purchase common stock issued in our 2007 private placement are convertible into 1,400,253 shares of our common stock and registered for resale under a registration statement on Form S-3. The 1,818,485 shares of our common stock issuable upon conversion of our series A convertible preferred stock and warrants sold in our November 2005 private placement are eligible for resale under Rule 144. We have filed registration statements on Form S-8 to register the sale of up to 6,900,000 shares issued or to be issued pursuant to our Amended and Restated 2006 Long-Term Incentive Plan. Additionally, there are outstanding warrants issued prior to 2005 and options under our 2001 and 2005 long-term incentive plans that are convertible into 444,888 shares and 671,481 shares of our common stock, respectively, and will be available for resale following cash exercise after the applicable holding period under Rule 144, or immediately following a net exercise of those securities. Sales of our common stock in the public market may have a depressive effect on the market for the shares of our common stock.

Our principal stockholders have significant voting power and may take actions that may not be in the best interests of other stockholders.

Our officers, directors, principal stockholders (greater than 10%) and their affiliates control approximately 30% of our outstanding voting securities. If these stockholders act together, they will be able to exert significant control over our management and affairs requiring stockholder approval, including approval of significant corporate transactions. This concentration of ownership may have the effect of delaying or preventing a change in control and might adversely affect the market price of our common stock. This concentration of ownership may not be in the best interests of all our stockholders.

We do not anticipate paying dividends on our common stock in the foreseeable future, and the lack of dividends may have a negative effect on the stock price.

We currently intend to retain our future earnings to support operations and to finance expansion and meet dividend obligations on our series B convertible preferred stock. In addition, the terms of our series B preferred stock limit our ability to pay dividends to the holders of our common stock. Therefore, we do not anticipate paying any cash dividends on our common stock in the foreseeable future.

ITEM 2: Properties

In July, 2007 we began leasing approximately 19,500 square feet of office space at our corporate headquarters in Rochester, New York. The base annual rent under the lease is $360,000, and increases three percent (3%) a year. During the first twenty months of the lease, the rent was paid in two portions:

a cash portion of $156,000 annually, paid in equal monthly installments, increasing three percent (3%) annually; and, a stock portion of $204,000 annually, paid in equal monthly installments, increasing three percent (3%) annually. The stock portion was payable in shares of our common stock. In February 2009, the Landlord exercised their option to receive their remaining rental payments in all cash. The lease period ends in July 2012. Management is currently in negotiations on securing rental space and does not anticipate a significant increase in the cost to lease property. Management believes that the leased property is adequately covered by insurance.

ITEM 3: Legal Proceedings

None.

PART II

ITEM 5: Market For Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

Our shares of common stock are listed for trading on the NASDAQ Capital Market under the trading symbol "VSCP." The following table sets forth the high and low closing sales prices for our common stock as reported on the NASDAQ Capital Market for the period from January 1, 2010 through December 31, 2011. These prices do not include retail markup, markdown or commission and may not necessarily represent actual transactions. Investors should not rely on historical stock price performance as an indication of future price performance.

Fiscal Year Ended December 31, 2010

	HIGH	LOW
First Quarter	$ 1.25	$ 0.82
Second Quarter	1.35	1.13
Third Quarter	1.17	0.90
Fourth Quarter	2.50	0.89

Fiscal Year Ended December 31, 2011

	HIGH	LOW
First Quarter	$2.89	$1.58
Second Quarter	2.20	1.66
Third Quarter	1.89	1.00
Fourth Quarter	1.16	0.82

As of February 29, 2012, we had approximately 29,370,687 registered holders of record of shares of our common stock.

Dividend Policy

We have never declared a cash dividend on our common stock. We intend to retain any earnings to fund future growth and the operation of our business and, therefore, we do not anticipate paying any cash dividends on our common stock in the foreseeable future. In addition, the terms of our series B preferred stock limit our ability to pay dividends to the holders of our common stock. Thereafter, dividends may be paid on our common stock only if and when declared by our board of directors and paid on an as-converted basis to the holders of our series A and series B convertible preferred stock.

Equity Compensation Plan Information

The following table summarizes information, as of December 31, 2011, relating to our equity compensation plans:

	Number of Securities to be Issued Upon Exercise of Outstanding Options	Weighted-Average Exercise Price of Outstanding Options	Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans (Excluding Securities Reflected in Column (a)
Plan Category	(a)	(b)	(c)

Equity compensation plans approved by security holders	5,943,281[(1)]	$ 1.23	1,419,679
Equity compensation plans not approved by security holders	350,000[(2)]	$ 2.50	-
Total	6,293,281	$ 1.30	1,419,679

(1) This amount includes shares under the plans of VirtualScopics, LLC, in addition to 444,888 shares of our common stock to holders of warrants granted by VirtualScopics, LLC, in exchange for consideration in the form of goods and services. Also we agreed to issue 5,430,863 shares of common stock collectively, under our 2001, 2005 and 2006 Long Term Incentive Plans. Also included are 67,530 shares of common stock underlying warrants we issued to the placement agent in connection with our September 2007 private placement, which was approved by stockholders in November 2007.

(2) In November 2005, our Board of Directors granted to our Chairman and former CEO, Robert Klimasewski, an option to purchase 350,000 shares of our common stock at $2.50 per share.

Recent Sales of Unregistered Securities

We made no sales of unregistered securities during the quarter ended December 31, 2011.

Issuer Repurchases of Equity Securities

None.

ITEM 7: Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion should be read in conjunction with VirtualScopics' consolidated balance sheet, and related consolidated statements of operations, changes in stockholders' equity and cash flows for the years ended December 31, 2011 and 2010, included elsewhere in this report. This discussion contains forward-looking statements, the accuracy of which involves risks and uncertainties. Our actual results could differ materially from those anticipated in the forward-looking statements for many reasons including, but not limited to, those discussed in "Risk Factors" and elsewhere in this report. We disclaim any obligation to update information contained in any forward-looking statements.

Overview

VirtualScopics, Inc. is a leading provider of imaging solutions to accelerate drug and medical device development. We have developed a robust software platform for analysis and modeling of both structural and functional medical images. In combination with our industry-leading experience and expertise in advanced imaging biomarker measurement, this platform provides a uniquely clear window into the biological activity of drugs and devices in clinical trial patients, allowing our customers to make better decisions faster.

Revenue over the past ten years has been derived primarily from image processing services in connection with pharmaceutical drug trials. For these services, we have been concentrating in the areas of oncology and osteoarthritis. We have also derived a small portion of revenue from consulting services, and pharmaceutical drug trials in the neurology and cardiovascular areas. We expect that the concentration of our revenue will continue in these services and in those areas in 2012 Revenues are

recognized as the MRI and CT images that we process are quantified and delivered to our customers and/or the services are performed. Beginning in 2010, we began to pursue the personalized medicine market, however, we do not anticipate significant revenues from this market opportunity in 2012 as we are just beginning the process of executing on our regulatory, validation and commercialization strategy.

As of December 31, 2011, the amount remaining to be earned from active projects and awards was approximately $32 million. Once we enter into a new contract for participation in a drug trial, there are several factors that can effect whether we will realize the full benefits under the contract, and the time over which we will realize that revenue. Customers may not continue our services due to performance reasons with their compounds in development. Furthermore, the contracts may contemplate performance over multiple years. Therefore, revenue may not be realized in the fiscal year in which the contract is signed or the award is made. Recognition of revenue under the contract may also be affected by the timing of patient recruitment and image site identification and training. Additionally, the majority of contracts we have with customers are cancelable for any reason by giving 30 days advance notice.

Results of Operations

Results of Operations for Year Ended December 31, 2011 Compared to Year Ended December 31, 2010

Revenues

We had revenues of $14,282,000 for the year ended December 31, 2011 compared to $13,393,000 for the year ended December 31, 2010, representing a 7% increase. The increase in revenues is predominately related to our work on Phase III projects during the year, in addition to the overall increased demand for our services in the industry. During 2011, we performed work for 36 customers, representing 133 different projects, in connection with their pharmaceutical drug trials primarily in the fields of oncology and musculoskeletal diseases (osteoarthritis and rheumatoid arthritis) along with various other projects. This compares to 31 customers representing 121 projects in 2010.

As of December 31, 2011, we had active projects with 10 of the leading 15 pharmaceutical and biotechnology companies in the world. In 2011, 51% of our revenues were generated from Phase III studies compared to 38% in 2010. Additionally, for the year ended December 31, 2011, oncology, musculoskeletal and other projects represented 77%, 18%, and 5%, respectively, of our revenues. This compares to 80%, 16%, and 4%, respectively, for 2010.

Gross Profit

We had a gross profit of $6,274,000 for the year ended December 31, 2011 compared to $6,824,000 for the comparable period in 2010. Our gross margin fluctuations are largely a result of the level of revenues and the mix of services performed during a given period. Of the revenues recognized during 2011, 33% were derived from image analysis work, which tends to have lower margins, compared to 23% derived from image analysis work in 2010. Start up activities associated with getting a project underway, including site initiation, qualification and training, yield a higher margin than image analyses. In 2010, a higher percent of our business came from site initiation activities as we began work on several Phase III studies. Therefore, depending on the project mix, we may experience fluctuations in our reported margins.

Research and Development

Research and development costs increased in 2011 by $320,000, or 28%, to $1,451,000, when compared to 2010. The increase was due to hiring within our software development group at the end of 2010 and early 2011. Our research and development efforts center around refining our processes through the use of our software platform in order to gain efficiencies which we believe will better allow us to standardize our processes as we scale our business. Additionally, we continue to invest in the commercialization of new imaging techniques across various imaging modalities and therapeutic areas. Also included in R&D are the costs incurred to complete our 510(k) Medical Device Submission with the

FDA for our blood perfusion application. As of December 31, 2011, there were 12 employees in our research and development group, which includes the algorithm and software development groups, compared to 9 employees as of December 31, 2010.

In 2012, we anticipate making additional investments within our software platform in order to generate more operating efficiencies and enhanced reporting tools as well as costs associated with our 510k filing with the FDA for our personalized medicine software application and the related costs of designing and running a validation study for the further demonstration of the correlation of the application to patient outcomes.

Sales and Marketing

Sales and marketing costs decreased in 2011 by $65,000, or 6%, to $1,119,000, when compared to 2010. The decrease was a result of a reduction in trade show and related travel costs during 2011. We anticipate additional investments in our sales and marketing efforts in 2012 as we execute on our revenue growth initiatives. We also plan to continue to actively promote our strategic alliance with PPD to expand and deepen new and existing customer relationships through the integrated joint solution we provide to the industry. The PPD alliance was expanded in January 2012 to include cardiovascular, central nervous system and medical device studies. We plan to actively drive awareness of the benefits of the alliance throughout 2012 as a key channel for us into the market. As of the date of this report, there are 6 individuals in our sales and marketing department.

General and Administrative

General and administrative expenses for the year ended December 31, 2011 were $3,178,000, representing an increase of $53,000 or 2%, when compared to 2010. The slight increase was driven by higher IT expenses during 2011 related to the support of our IT infrastructure which included increased network and system costs. General and administrative expenses include both personnel and non-personnel costs. Departments included within general and administrative function are finance, information technology, quality, human resources and the CEO position. Non-payroll related costs included within general and administration include stock option expense, audit and legal fees, regulatory and compliance fees, Nasdaq listing fees, board fees, non-capitalizable hardware and software costs and licenses and non-sales related travel costs.

We anticipate higher general and administrative costs in 2012 as we incur costs associated with our strategy to obtain a Current Procedural Terminology (CPT) code and with the formation a Scientific Advisory Board.

Depreciation and Amortization

Depreciation and amortization charges decreased for the year ended December 31, 2011 by $33,000 or 6%, to $479,000, when compared to 2010. The slight reduction is due to the complete amortization of our right to use an MRI unit at the University of Rochester (a related party). Offsetting this reduction was higher depreciation charges related to recent capital purchases, including the purchase and installation cost of an ERP system. The amortization and depreciation costs are based on the timing and life of patents and property and equipment. We continue to invest in our patent portfolio, however, do not anticipate significant expenditures to support our current business and future strategies. Our IT systems are the basis of our operating platform, therefore, we will continue to invest in our IT infrastructure to support our growth and ensure we have a robust and reliable operating system.

Other income(expense), net

Interest income for the year ended December 31, 2011 was $18,000, representing interest derived on the Company's operating and savings accounts, compared to interest income of $10,000 in 2010. The increase in interest income was due to higher average account balances. Other expense for the years ended December 31, 2011 and 2010 was $32,000 and $25,000, respectively which relates to state and franchise taxes paid during the year. Additionally, we recognized a marked to market gain of $669,000

related to the decrease in fair value of certain warrants that were issued in connection with our 2007 series B offering (see Financial Statement Note 5) for the year ended December 31, 2011. For the year ended December 31, 2010, we recognized an unrealized loss of $1,470,000 due to the increase in fair value of those warrants. The aggregate increase of $2,139,000 when compared to 2010 is attributable to the lower average price of our common stock during 2011 as compared to 2010, a shorter remaining contractual life remaining on the warrants, and a significant number of warrants being exercised. Due to the price reset, or ratchet, provision within the warrant agreements, accounting standards require us to mark to market the change in fair value of the warrants during the reporting period. If our stock price appreciates during the reporting period, we report a loss, if our stock price declines, we will report a gain.

Net Income (Loss)

Our net income for the year ended December 31, 2011 was $703,000 compared to a net loss of $629,000 for the year ended December 31, 2010. The increase in our net income over the prior period was related to the lower non-cash marked to market adjustment for the change in the fair value of certain outstanding warrants offset by higher research and development costs and lower gross profit.

Liquidity and Capital Resources

Our working capital as of December 31, 2011 and 2010 was approximately $6,353,000 and $2,864,000, respectively. The significant increase in working capital was primarily a result of the decrease in fair value of the derivative liabilities as a result of the lower average price of our common stock during 2011 compared to 2010 and exercises of the warrants classified as derivative liabilities. We also experienced increased cash balances resulting from the amount of cash provided by operating activities due to timing differences in the payment of accounts payable and receipt of accounts receivables, in addition to advanced payments received for new projects during the year. Net cash provided by operating activities in 2011 was $1,443,000 compared to $679,000 in 2010.

We invested $419,000 in the purchase of equipment and the acquisition of patents in 2011, compared to $216,000 for the investment in these items in 2010. The increase represents investments in our IT and IS infrastructure in 2011 and the costs associated with the acquisition of a new IT storage system to support the level of demand we are experiencing for our services. We anticipate that our IT related costs will increase in 2012 as we support our growth which requires additional investments to be made in our operating system and infrastructure. During 2011 we incurred $7,000 in patent costs associated with filing costs for intellectual property, as compared to $12,000 in 2010. The reduction is due to the timing of office actions within our existing patent filings.

Net cash provided in financing activities in 2011 was $137,000 compared to net cash used in financing activities of $215,000 in 2010. This increase was due to lower required dividend payments on our series B preferred shares due to the conversion of the securities by the holders to common stock. Additionally, the Company received proceeds from the exercise of warrants and stock options during 2011.

We currently expect that existing cash will be sufficient to fund our existing operations for the next 12 months and foreseeable future. If in the future our plans or assumptions change or prove to be inaccurate, we may be required to seek additional capital through public or private debt or equity financings. If we need to raise additional funds, we may not be able to do so on terms favorable to us, or at all. If we cannot raise sufficient funds on acceptable terms, we may have to curtail our level of expenditures and our rate of expansion.

Off Balance Sheet Arrangements

We have no off-balance sheet arrangements, other than operating leases (as described in “Contractual Obligations” below) that have or are reasonably likely to have a current or future effect that is material to investors on our financial condition, revenues or expenses, results of operations, liquidity, capital resources or capital expenditures.

Contractual Obligations

The following table summarizes our contractual obligations at December 31, 2011 which we expect to have an effect on our liquidity and cash flow in future periods. (See Item 2: Description of Property for a full description of our lease obligations.)

	Payments Due by Period		
	Total	Less than 1 Year	1-2 Years
Operating Leases	$ 176,993	$ 175,687	$ 1,306

ITEM 8: Financial Statements and Supplementary Data

The financial statements required hereby are located on pages F-1 through F-21 of this report.

ITEM 9: Changes In and Disagreements with Accountants on Accounting and Financial Disclosure

Not applicable.

ITEM 9A: Controls and Procedures

Evaluation of Disclosure Controls and Procedures

We maintain a set of disclosure controls and procedures, as defined in Section 13a-15(e) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), that are designed to ensure that information required to be disclosed by us in the reports filed by us under the Securities Exchange Act of 1934, as amended (the "Exchange Act") is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. We carried out an evaluation, under the supervision and with the participation of our Chief Executive Officer and our Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Rule 13a-15(b) of the Exchange Act. Based on that evaluation, our Chief Executive Officer and our Chief Financial Officer concluded that our disclosure controls and procedures were effective as of the end of the period covered by this report.

Notwithstanding the foregoing, there can be no assurance that the Company's disclosure controls and procedures will detect or uncover all failures of persons within the Company to disclose material information otherwise required to be set forth in the Company's periodic reports. There are inherent limitations to the effectiveness of any system of disclosure controls and procedures, including the possibility of human error and the circumvention or overriding of the controls and procedures. Accordingly, even effective disclosure controls and procedures can only provide reasonable, not absolute, assurance of achieving their control objectives.

Management's Report on Internal Control Over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rule 13a-15(f). Internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. Internal control over financial reporting includes those policies and

procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of our assets; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of the financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures are being made only with proper authorizations; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of our assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Our management, under the supervision of and with the participation of the Chief Executive Officer and the Chief Financial Officer, assessed the effectiveness of our internal control over financial reporting as of December 31, 2011 based on criteria for effective control over financial reporting described in Internal Control — Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission, or COSO. Based on this assessment, our management concluded that our internal control over financial reporting was effective as of December 31, 2011.

This annual report does not include an attestation report of the Company's independent registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by the Company's registered public accounting firm pursuant to Section 404(c) of the Sarbanes-Oxley Act of 2002, which permits the Company to provide only management's report in this annual report.

Changes in Internal Controls over Financial Reporting

An evaluation was performed under the supervision of the Company's management, including the Chief Executive Officer and Chief Financial Officer, as required under Exchange Act Rules 13a-15(d) and 15d-15(d), of whether any change in the Company's internal control over financial reporting occurred during the fiscal quarter ended December 31, 2011. Based on that evaluation, the Company's management, including the Chief Executive Officer and Chief Financial Officer, concluded that no change in the Company's internal controls over financial reporting occurred during the fiscal quarter ended December 31, 2011 that has materially affected or is reasonably likely to materially affect, the Company's internal control over financial reporting.

ITEM 9B: Other Information

None.

PART III

ITEM 10: Directors, Executive Officers, Promoters and Control Persons; Compliance with Section 16(a) of the Exchange Act

The information required by this Item regarding our directors and executive officers is incorporated in this report by reference to our Proxy Statement for our 2012 Annual Meeting of Stockholders where such information appears under the heading “Directors and Executive Officers” in our Proxy Statement for our 2012 Annual Meeting of Stockholders.

Section 16(a) Beneficial Ownership Reporting Compliance

The discussion under the heading “Security Ownership of Certain Beneficial Owners and Management” in our definitive proxy statement for the 2012 Annual Meeting of Stockholders is incorporated herein by reference to such proxy statement.

Code of Ethics

The Company has adopted a Code of Ethics that is applicable to our principal executive officer and principal financial officer and can be viewed on our website *www.virtualscopics.com*.

ITEM 11. Executive Compensation

The information required by this Item is incorporated in this report by reference to our definitive Proxy Statement referred to in Item 10 above where such information appears under the heading “Executive Compensation and Other Matters.”

ITEM 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

The information required by this Item regarding security ownership of certain beneficial owners and management is incorporated in this report by reference to our definitive Proxy Statement referred to in Item 10 above where such information appears under the heading “Security Ownership of Certain Beneficial Owners and Management” and “Equity Compensation Plans.”

ITEM 13. Certain Relationships and Related Transactions

The information required by this Item is incorporated in this report by reference to our definitive Proxy Statement referred to in Item 10 above where such information appears under the heading “Certain Relationships and Related Transactions.”

ITEM 14. Principal Accountant Fees and Services

The information required by this Item is incorporated in this report by reference to our definitive Proxy Statement referred to in Item 10 above where such information appears under the heading “Principal Accounting Fees and Services.”

ITEM 15: Exhibits

The list of exhibits required by this Item is incorporated in this Item by reference to the exhibit index attached after the signature page to this report.

SIGNATURES

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

March 21, 2012 **VirtualScopics, Inc.** (Registrant)
/s/ Molly Henderson
Chief Business and Financial Officer, Sr. Vice President

POWER OF ATTORNEY

KNOW ALL BY THESE PRESENTS, that each person whose signature appears below constitutes and appoints Jeffrey Markin and Molly Henderson, or either of them, as his or her true and lawful attorneys-in-fact and agents, with full power of substitution and resubstitution, for him and in his name, place and stead, in any and all capacities, to sign any and all amendments to this Annual Report on Form 10-K and any documents related to this report and filed pursuant to the Securities and Exchange Act of 1934, and to file the same, with all exhibits thereto, and other documents in connection therewith, with the Securities and Exchange Commission, granting unto said attorneys-in-fact and agents, full power and authority to do and perform each and every act and thing requisite and necessary to be done in connection therewith as fully to all intents and purposes as he might or could do in person, hereby ratifying and confirming all that said attorneys-in-fact and agents, or their substitute or substitutes may lawfully do or cause to be done by virtue hereof.

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.

DATE	SIGNATURE	TITLE
March 21, 2012	/s/ Jeffrey Markin (Jeffrey Markin)	President and Chief Executive Officer (Principal Executive Officer)
March 21, 2012	/s/ Molly Henderson (Molly Henderson)	Chief Business and Financial Officer and Sr. Vice President (Principal Financial and Accounting Officer)
March 21, 2012	/s/ Robert Klimasewski (Robert Klimasewski)	Chairman of the Board of Directors
March 21, 2012	/s/ Norman Mintz (Norman Mintz)	Director
March 21, 2012	/s/ Charles Phelps (Charles Phelps)	Director
March 21, 2012	/s/ Sidney Knafel (Sidney Knafel)	Director
March 21, 2012	/s/ Dan Kerpelman (Dan Kerpelman)	Director
March 21, 2012	/s/ Terence Walts (Terence Walts)	Director
March 21, 2012	/s/ Mostafa Analoui (Mostafa Analoui)	Director

Exhibit Index

2.1 Securities Purchase Agreement dated September 12, 2007 by and among the VirtualScopics, Inc. and the Buyers listed on the Schedule of Buyers attached thereto (Incorporated herein by reference to Exhibit 10.1 of the VirtualScopics, Inc. Report on Form 8-K filed with the Securities and Exchange Commission on September 17, 2007 (File No. 000-52018)). (Schedules and exhibits have been omitted pursuant to Regulation S-B Item 601(b)(2) and will be made available to the Commission upon request).

3.1 Certificate of Incorporation of VirtualScopics, Inc. dated April 21, 1988 (Incorporated herein by reference to Exhibit 3.1 of the VirtualScopics, Inc.'s Registration Statement on Form SB-2 filed with the Securities and Exchange Commission on November 4, 2004 (File No. 333-120253)).

3.2 Certificate of Amendment of Certificate of Incorporation of VirtualScopics, Inc. dated February 2, 1989 (Incorporated herein by reference to Exhibit 3.1a of the VirtualScopics, Inc.'s Registration Statement on Form SB-2 filed with the Securities and Exchange Commission on November 4, 2004 (File No. 333-120253)).

3.3 Certificate for Renewal and Revival of Certificate of Incorporation of VirtualScopics, Inc. dated February 23, 2004 (Incorporated herein by reference to Exhibit 3.1b of the VirtualScopics, Inc.'s Registration Statement on Form SB-2 filed with the Securities and Exchange Commission on November 4, 2004 (File No. 333-120253)).

3.4 Certificate of Amendment of Certificate of Incorporation of VirtualScopics, Inc. dated August 20, 2004 (Incorporated herein by reference to Exhibit 3.1c of the VirtualScopics, Inc.'s Registration Statement on Form SB-2 filed with the Securities and Exchange Commission on November 4, 2004 (File No. 333-120253)).

3.5 Certificate of Amendment of Certificate of Incorporation of VirtualScopics, Inc. dated October 7, 2005 (Incorporated by reference to Exhibit 3.5 the VirtualScopics, Inc.'s Annual Report on Form 10-KSB filed with the Securities and Exchange Commission on March 30, 2006 (File No. 333-120253)).

3.6 Certificate of Amendment to Certificate of Incorporation of VirtualScopics, Inc. dated November 4, 2005 (Incorporated herein by reference to Exhibit 3.1 of the VirtualScopics, Inc. Report on Form 8-K filed with the Securities and Exchange Commission on November 10, 2005 (File No. 333-120253)).

3.7 Certificate of Designations, Powers, Preferences and Other Rights and Qualifications of Series A Convertible Preferred Stock of VirtualScopics, Inc. dated November 4, 2005 (Incorporated herein by reference to Exhibit 3.2 of the VirtualScopics, Inc. Report on Form 8-K filed with the Securities and Exchange Commission on November 10, 2005 (File No. 333-120253)).

3.8 Certificate of Designation of Rights and Preferences of the Series B Preferred Stock of VirtualScopics, Inc. dated September 12, 2007 (Incorporated herein by reference to Exhibit 3.1 of the VirtualScopics, Inc. Report on Form 8-K filed with the Securities and Exchange Commission on September 17, 2007 (File No. 000-52018)).

3.9 Certificate of Amendment to Certificate of Designation of Rights and Preferences of the Series B Preferred Stock of VirtualScopics, Inc. dated November 27, 2007 (Incorporated herein by reference to Exhibit 3.1 of the VirtualScopics, Inc. Report on Form 8-K filed with the Securities and Exchange Commission on November 29, 2007 (File No. 000-52018)).

3.10 Amended and Restated Bylaws of VirtualScopics, Inc. dated August 28, 2007 (Incorporated herein by reference to Exhibit 3.9 to the VirtualScopics, Inc.'s Registration Statement of Form S-3 filed with the Securities Exchange Commission on October 11, 2007 (File No. 333-146635)).

4.1 Registration Rights Agreement Dated September 12, 2007 between the VirtualScopics, Inc. and the Buyers listed on the Schedule of Buyers thereto (Incorporated herein by reference to Exhibit 10.3 of the VirtualScopics, Inc. Report on Form 8-K filed with the Securities and Exchange Commission on September 17, 2007 (File No. 000-52018)).

4.2 Form of Warrant to Purchase Common Stock of VirtualScopics (Incorporated herein by reference to Exhibit 10.2 of the VirtualScopics, Inc. Report on Form 8-K filed with the Securities and Exchange Commission on September 17, 2007 (File No. 000-52018)).

10.1 VirtualScopics, Inc. 2005 Long Term Incentive Plan (Incorporated herein by reference to Exhibit 10.1 of the VirtualScopics, Inc. Report on Form 8-K filed with the Securities and Exchange Commission on November 10, 2005 (File No. 333-120253)).*

10.2 Option Agreements with Robert Klimasewski dated November 5, 2005 (Incorporated herein by reference to Exhibit 10.18 to the VirtualScopics, Inc. Registration Statement on Form SB-2 filed with the Securities and Exchange Commission on May 2, 2006 (File No. 333-133747)).*

10.3 Form of April 28, 2006 Indemnification Agreement by and among VirtualScopics, Inc. and the directors and officers of the VirtualScopics, Inc. (Incorporated herein by reference to Exhibit 10.19 to the VirtualScopics, Inc. Registration Statement on Form SB-2 filed with the Securities and Exchange Commission on May 2, 2006 (File No. 333-133747)).*

10.4 VirtualScopics, Inc. Amended and Restated 2006 Long Term Incentive Plan (incorporated herein by reference to Appendix B to the Registrant's Definitive Proxy Statement on Schedule 14A, filed with the Commission on April 10, 2009 (File No. 000-52018))

10.5 Independent Director Compensation Plan (Incorporated herein by reference to Exhibit 10.22 of the VirtualScopics, Inc. Annual Report on Form 10-KSB filed with the Securities and Exchange Commission on April 2, 2007 (File No. 000-52018))*

10.6 Indemnification Agreement by and among VirtualScopics, Inc. and Norman Mintz, dated as of August 1, 2007. (Reference is made to the VirtualScopics, Inc. Form of Indemnification Agreement by and among VirtualScopics, Inc., and the directors and officers of the VirtualScopics, Inc. filed as Exhibit 10.19 to the VirtualScopics, Inc. Registration Statement on Form SB-2 filed with the Securities and Exchange Commission on May 2, 2006 (File No. 333-133747)).*

10.7 Non-Employee Director Compensation Plan (Incorporated herein by reference to Exhibit 10.1 to the VirtualScopics, Inc. Report on Form 10-Q filed with the Securities and Exchange Commission on August 12, 2008 (File No. 000-52018)).*

10.8 2009 Bonus Plan (Incorporated herein by reference to Exhibit 10.3 of the VirtualScopics, Inc. Quarterly Report on Form 10-Q filed with the Securities and Exchange Commission on May 15, 2009 (File No. 000-52018)).*

10.9 Employment Agreement dated February 24, 2009, by and between Jeffrey Markin and VirtualScopics, Inc.* (Incorporated herein by reference to Exhibit 10.17 to the VirtualScopics, Inc., Annual Report on Form 10-K filed with the Securities and Exchange Commission on March 19, 2009 (File No. 000-52018)).

10.10 Employment Agreement dated February 24, 2009, by and between Molly Henderson and VirtualScopics, Inc.* (Incorporated herein by reference to Exhibit 10.18 to the VirtualScopics, Inc., 2008 Annual Report on Form 10-K filed with the Securities and Exchange Commission on March 19, 2009 (File No. 000-52018)).

10.11	Strategic Alliance Agreement between VirtualScopics, Inc. and PPD Development, LP, dated October 20, 2010 (Incorporated herein by reference to Exhibit 10.1 to the VirtualScopics, Inc. Report on Form 10-Q filed with the Securities and Exchange Commission on November 12, 2010 (File No. 000-52018)).
10.12	Amendment to the Strategic Alliance Agreement between VirtualScopics, Inc. and PPD Development, LP, dated January 24, 2012 (Incorporated herein by reference to Exhibit 10.1 to the VirtualScopics, Inc. Report on Form 8-K filed with the Securities and Exchange Commission on January 26, 2012 (File No. 000-52018)).
21	Subsidiaries of VirtualScopics, Inc.
23.1	Consent of Marcum LLP
24	Power of Attorney (included on the signature page to this report)
31.1	Certification of Chief Executive Officer as required by Rule 13a-14 Or 15d-14 of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 Of The Sarbanes-Oxley Act of 2002
31.2	Certification of Chief Financial Officer as required by Rule 13a-14 Or 15d-14 of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 Of The Sarbanes-Oxley Act of 2002
32.1	Certification pursuant to 18 U.S.C. Section 1350 by the Chief Executive Officer, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification pursuant to 18 U.S.C. Section 1350 by the Chief Financial Officer, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101.CAL	XBRL Taxonomy Extension Calculation Linkbase.
101.DEF	XBRL Taxonomy Extension Definition Linkbase.
101.INS	XBRL Instance Document.
101.LAB	XBRL Taxonomy Extension Label Linkbase.
101.PRE	XBRL Taxonomy Extension Presentation Linkbase.
101.SCH	XBRL Taxonomy Extension Schema Linkbase.
*	Management contract or compensatory plan or arrangement.

Exhibit 21

Subsidiaries of VirtualScopics, Inc.

Name	Jurisdiction of Organization
VirtualScopics, LLC	New York

Exhibit 23.1

INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM'S CONSENT

We consent to the incorporation by reference in this Registration Statement of VirtualScopics, Inc. on Form S-8 filed on November 29, 2007 (File Number 333-147718), October 1, 2009 (File Number 333-162253), and on Form S-3 filed on October 11, 2007 (File Number 333-146635) of our report dated March 21, 2012, with respect to our audits of the consolidated financial statements of VirtualScopics, Inc. and Subsidiary as of December 31, 2011 and 2010 and for the years then ended, which report is included in this Annual Report on Form 10-K of VirtualScopics, Inc. for the year ended December 31, 2011.

/s/ Marcum LLP
Marcum LLP
New York, NY
March 21, 2012

Exhibit 31.1

Certification of Chief Executive Officer
as required by Rule 13a-14 Or 15d-14 of the Securities Exchange Act of 1934,
as adopted pursuant to Section 302 of The Sarbanes-Oxley Act of 2002

I, Jeffrey Markin, certify that:

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

2. Based on my knowledge, this 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 report;

3. Based on my knowledge, the financial statements, and other financial information included in this 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 report;

4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

(a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

(b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

(c) Evaluated the effectiveness of the registrant’s disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

(d) Disclosed in this report any change in the registrant’s internal control over financial reporting that occurred during the registrant’s most recent fiscal quarter (the registrant’s fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant’s internal control over financial reporting; and

5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

(a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 21, 2012
/s/ Jeffrey Markin
Jeffrey Markin
President and Chief Executive Officer

Exhibit 31.2

Certification of Chief Financial Officer
as required by Rule 13a-14 Or 15d-14 of the Securities Exchange Act of 1934,
as adopted pursuant to Section 302 of The Sarbanes-Oxley Act of 2002

I, Molly Henderson, certify that:

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

2. Based on my knowledge, this 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 report;

3. Based on my knowledge, the financial statements, and other financial information included in this 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 report;

4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

   (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

   (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

   (c) Evaluated the effectiveness of the registrant’s disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

   (d) Disclosed in this report any change in the registrant’s internal control over financial reporting that occurred during the registrant’s most recent fiscal quarter (the registrant’s fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant’s internal control over financial reporting; and

5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

   (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

   (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 21, 2012

/s/ Molly Henderson
Molly Henderson
Chief Business and Financial Officer, Sr. Vice President

Exhibit 32.1

Certification pursuant to 18 U.S.C. Section 1350 by the Chief Executive Officer,
as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

In connection with the Annual Report of VirtualScopics, Inc. (the "Company") on Form 10-K for the year ended December 31, 2011 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I Jeffrey Markin, as Chief Executive Officer of the Company, hereby certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 to the best of my knowledge, that:

(1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and result of operations of the Company.

/s/ Jeffrey Markin
Jeffrey Markin
President and Chief Executive Officer
March 21, 2012

This Certification accompanies this Report pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 and shall not be deemed filed by the Company for purposes of Section 18 of the Securities Exchange Act of 1934, as amended.

Exhibit 32.2

Certification pursuant to 18 U.S.C. Section 1350 by the Chief Financial Officer,
as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

In connection with the Annual Report of VirtualScopics, Inc. (the "Company") on Form 10-K for the year ended December 31, 2011 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I Molly Henderson, as Chief Financial Officer of the Company, hereby certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 to the best of my knowledge, that:

(1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and result of operations of the Company.

Date: March 21, 2012

/s/ Molly Henderson
Molly Henderson
Chief Business and Financial Officer, Sr. Vice President

This Certification accompanies this Report pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 and shall not be deemed filed by the Company for purposes of Section 18 of the Securities Exchange Act of 1934, as amended.

VirtualScopics, Inc. and Subsidiary
Index to Consolidated Financial Statements

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Audit Committee of the
Board of Directors and Stockholders of
VirtualScopics, Inc.

We have audited the accompanying consolidated balance sheets of VirtualScopics, Inc. and Subsidiary (the "Company") as of December 31, 2011 and 2010, and the related consolidated statements of operations, changes in stockholders' equity and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements, 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 consolidated financial position of VirtualScopics, Inc. and Subsidiary as of December 31, 2011 and 2010, and the results of its operations and cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

/s/ Marcum LLP
Marcum LLP
New York, NY
March 21, 2012

VirtualScopics, Inc. and Subsidiary
Consolidated Balance Sheets

Assets

	December 31, 2011	December 31, 2010
Current assets		
Cash	$ 5,737,009	$ 4,576,060
Accounts receivable, net of allowance for doubtful accounts of $15,000 and $30,000, respectively	2,435,496	2,727,525
Prepaid expenses and other current assets	361,376	305,079
Total current assets	8,533,881	7,608,664
Patents, net	1,582,938	1,711,501
Property and equipment, net	514,230	404,426
Other assets	27,140	-
Total assets	$ 10,658,189	$ 9,724,591

Liabilities and Stockholders' Equity

Current liabilities		
Accounts payable and accrued expenses	$ 843,275	$ 1,099,838
Accrued payroll	759,470	821,107
Unearned revenue	421,486	214,508
Derivative liabilities	156,596	2,609,708
Total current liabilities	2,180,827	4,745,161
Commitments and Contingencies (See Note 10)		
Stockholders' Equity		
Convertible preferred stock, $0.001 par value; 15,000,000 shares authorized;		
Series A; 8,400 shares authorized; issued and outstanding, 2,190 and 3,188 at December 31, 2011 and 2010, respectively, liquidation preference $1,000 per share	2	3
Series B; 6,000 shares authorized; issued and outstanding, 600 and 800 at December 31, 2011 and 2010, respectively, liquidation preference $1,000 per share	1	1
Common stock, $0.001 par value; 85,000,000 shares authorized;		
issued and outstanding, 29,370,687 and 27,414,620 shares at December 31, 2011 and 2010, respectively	29,371	27,415
Additional paid-in capital	17,882,936	15,090,254
Accumulated deficit	(9,434,948)	(10,138,243)
Total stockholders' equity	8,477,362	4,979,430
Total liabilities and stockholders' equity	$ 10,658,189	$ 9,724,591

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

VirtualScopics, Inc. and Subsidiary
Consolidated Statements of Operations

	For the Years Ended December 31,	
	2011	2010
Revenues	$ 13,115,459	$ 12,333,003
Reimbursement revenues	1,166,144	1,060,117
Total revenues	14,281,603	13,393,120
Cost of services	6,841,321	5,508,911
Cost of reimbursement revenues	1,166,144	1,060,117
Total cost of services	8,007,465	6,569,028
Gross profit	6,274,138	6,824,092
Operating expenses		
Research and development	1,450,608	1,130,744
Sales and marketing	1,119,100	1,184,454
General and administrative	3,177,934	3,124,669
Depreciation and amortization	478,908	511,982
Total operating expenses	6,226,550	5,951,849
Operating income	47,588	872,243
Other income (expense)		
Interest income	18,103	9,788
Other expense	(31,798)	(25,318)
Unrealized gain (loss) on change in fair value of the derivative liabilities	669,402	(1,469,755)
Total other income (expense)	655,707	(1,485,285)
Net income (loss) before income taxes	703,295	(613,042)
Provision for income taxes	-	(16,000)
Net Income (Loss)	703,295	(629,042)
Series B preferred stock cash dividend	48,989	173,016
Net income (loss) attributable to common stockholders	$ 654,306	$ (802,058)
Basic and diluted earnings (loss) per common share	$ 0.02	$ (0.03)
Weighted average number of common shares outstanding		
Basic	28,950,864	26,153,573
Diluted	33,413,824	26,153,573

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

VirtualScopics, Inc. and Subsidiary
Consolidated Statements of Changes in Stockholders' Equity
For the Years Ended December 31, 2011 and 2010

	Series A Preferred Stock		Series B Preferred Stock		Common Stock		Additional	Accumulated	
	Shares	Amount	Shares	Amount	Shares	Amount	Paid-In Capital	Deficit	Total
Balances at December 31, 2009	3,438	$ 3	2,910	$ 3	25,233,255	$ 25,233	$ 14,354,929	$ (9,509,201)	$ 4,870,967
Conversion of Series A Preferred to Common Stock	(250)	-			207,590	208	(208)		-
Conversion of Series B Preferred to Common Stock			(2,110)	(2)	1,752,057	1,752	(1,750)		-
Cashless exercise of warrants					21,163	21	(21)		-
Exercise of employee stock options					25,000	25	25,225		25,250
Cashless exercise of employee stock options					61,501	62	(62)		-
Withholdings taxes paid on cashless exercise of employee stock options							(66,798)		(66,798)
Amortization of stock option costs							819,766		819,766
Restricted stock units issuance					114,054	114	132,189		132,303
Series B preferred stock cash dividends based on 8% annual rate							(173,016)		(173,016)
Net loss								(629,042)	(629,042)
Balances at December 31, 2010	3,188	$ 3	800	$ 1	27,414,620	$ 27,415	$ 15,090,254	$ (10,138,243)	$ 4,979,430
Conversion of Series A Preferred to Common Stock	(998)	(1)			828,709	829	(828)		-
Conversion of Series B Preferred to Common Stock			(200)	-	166,072	166	(166)		-
Cashless exercise of warrants					531,506	532	(532)		-
Exercise of warrants					87,188	87	104,914		105,001
Reclassification of derivative liabilities upon exercise of warrants							1,783,710		1,783,710
Exercise of employee stock options					76,986	77	92,306		92,383
Cashless exercise of employee stock options					239,805	240	(240)		-
Withholdings taxes paid on cashless exercise of employee stock options							(11,722)		(11,722)
Amortization of stock option costs							844,004		844,004
Restricted stock units issuance					25,801	25	30,225		30,250
Series B preferred stock cash dividends based on 8% annual rate							(48,989)		(48,989)
Net income								703,295	703,295
Balances at December 31, 2011	2,190	$ 2	600	$ 1	29,370,687	$ 29,371	$ 17,882,936	$ (9,434,948)	$ 8,477,362

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

VirtualScopics, Inc. and Subsidiary
Consolidated Statements of Cash Flows

	For the Years Ended December 31,	
	2011	2010
Cash flows from operating activities		
Net income (loss)	$ 703,295	$ (629,042)
Adjustments to reconcile net income (loss)		
to net cash provided by operating activities		
Depreciation and amortization	478,908	511,982
Gain on the disposal of property and equipment	(8,369)	-
Provision for doubtful accounts	(15,000)	9,214
Stock-based compensation	880,622	863,522
Derivative liabilities	(669,402)	1,469,755
Changes in operating assets and liabilities		
Accounts receivable	307,029	(1,255,358)
Prepaid expenses and other assets	(116,695)	(8,103)
Unearned revenue	206,978	(796,990)
Accounts payable and accrued expenses	(262,931)	529,955
Accrued payroll	(61,637)	(16,070)
Total adjustments	739,503	1,307,907
Net cash provided by operating activities	1,442,798	678,865
Cash flows from investing activities		
Purchase of equipment	(411,861)	(203,170)
Acquisition of patents	(6,661)	(12,481)
Net cash used in investing activities	(418,522)	(215,651)
Cash flows from financing activities		
Proceeds from the exercise of stock options for common stock	92,383	25,250
Withholding taxes paid on the cashless exercise of employee stock options	(11,722)	(66,798)
Proceeds from the exercise of warrants for common stock	105,001	-
Cash dividends on series B preferred stock	(48,989)	(173,016)
Net cash provided by (used in) financing activities	136,673	(214,564)
Net increase in cash	1,160,949	248,650
Cash		
Beginning of year	4,576,060	4,327,410
End of year	$ 5,737,009	$ 4,576,060
Supplemental disclosure of cash flow information		
Cash paid during the year for:		
Taxes	$ 66,457	$ 18,335
Non-cash financing activity:		
Issuance of restricted awards in settlement of accrued liability for board fees	$ 30,250	$ 132,303
Cashless exercise of stock options	$ 240	$ 62
Cashless exercise of warrants	$ 532	$ 21
Reclassification of derivative liabilities upon exercise of warrants to additional paid in capital	$ 1,783,710	$ -

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

NOTE 1 - Organization and Basis of Presentation

Nature of Business

The Company's headquarters are located in Rochester, New York. The Company has created a suite of image analysis software tools and applications which are used in detecting and analyzing specific structures in medical images. The Company's developed software provides measurement and visualization capabilities designed to improve clinical research and development.

NOTE 2 - Summary of Significant Accounting Policies

Principles of Consolidation

The accompanying consolidated financial statements include the accounts of VirtualScopics, Inc. and its wholly-owned subsidiary, VirtualScopics, LLC. All significant intercompany balances and transactions have been eliminated in consolidation.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the year. Actual results could differ from those estimates. Estimates included in these consolidated financial statements relate to assessing the collectability of accounts receivable, the valuation of securities underlying share-based compensation and derivative financial instruments, realization of deferred tax assets, tax contingencies and any related valuation allowance, and the useful lives and potential impairment of the Company's property and equipment and intangible assets. Estimates and assumptions are reviewed periodically and the effects of revisions are reflected in the period that they are determined to be necessary.

Reclassifications

Certain prior period amounts have been reclassified to conform to the current year presentation. These reclassifications had no impact on previously reported results of operations or stockholders' equity.

Cash and Cash Equivalents

The Company considers all highly liquid investments when purchased with a maturity of three months or less to be cash equivalents. At December 31, 2011 and 2010, the Company had no cash equivalents.

Concentration of Credit Risk

Financial instruments that potentially subject the Company to significant concentrations of credit risk consist of cash. At times, our cash may be uninsured or in deposit accounts that exceed the Federal Deposit Insurance Corporation ("FDIC") insurance limits.

Accounts Receivable

Accounts receivable are stated at estimated net realizable value. Accounts receivable are comprised of balances due from customers net of estimated allowances for uncollectible accounts, if any. In determining collectability, historical trends are evaluated and specific customer issues are reviewed to arrive at appropriate allowances, if any.

Patents

Costs incurred to acquire and file for patents, including legal costs, are capitalized as long-lived assets and amortized on a straight-line basis over the lower of the estimated useful life or legal life of the patent, which is 20 years.

Property and Equipment

Property and equipment are carried at cost less accumulated depreciation. When retired or otherwise disposed of, the related cost and accumulated depreciation are removed from the respective accounts and any resulting gain or loss is recognized and included in the consolidated statement of operations.

Expenditures for maintenance and repairs, which do not generally extend the useful life of the assets, are charged to expense as incurred. Gains or losses on disposal of property and equipment are reflected in general and administrative expense in the consolidated statement of operations in the period of disposal.

Depreciation is computed using the straight-line method over the following useful lives:

	Years
Office/computer equipment	3-5
Furniture and fixtures	5-7
Software	3

Leasehold improvements, which are included in property and equipment, are recorded at cost less accumulated depreciation. Depreciation on leasehold improvements is computed using the straight-line method over the shorter of their estimated useful lives or the lease term, whichever is shorter.

Impairment of Long-Lived Assets

The Company reviews long-lived assets, including intangible assets other than goodwill, for impairment whenever events or changes in circumstances indicate that the carrying value of the asset may not be recoverable. In connection with this review, the Company also reevaluates the periods of depreciation and amortization for these assets. The Company assesses recoverability by determining whether the net book value of the related asset will be recovered through the projected undiscounted future cash flows of the asset. If the Company determines that the carrying value of the asset may not be recoverable, it measures any impairment based on the projected future discounted cash flows as compared to the asset's carrying value. Through December 31, 2011, the Company has not recorded any impairment charges on its long-lived assets.

Derivative Financial Instruments

The Company does not use derivative instruments to hedge exposures to cash flow, market or foreign currency risks. The Company evaluates all of its financial instruments to determine if such instruments are derivatives or contain features that qualify as embedded derivatives. For derivative financial instruments that are accounted for as liabilities, the derivative instrument is initially recorded at its fair value and is then re-valued at each reporting date, with changes in the fair value reported in the consolidated statements of operations. For stock-based derivative financial instruments, the Company uses the Black-Scholes option valuation model to value the derivative instruments at inception and on subsequent valuation dates. The warrants issued with the Company's series B preferred stock, and to the placement agent in the series B financing, do not have fixed settlement provisions because their exercise prices may be lowered if the Company issues securities at lower prices in the future. The Company was required to include the reset provisions in order to protect the warrant holders from the potential dilution associated with future financings. Accordingly, the warrants are recognized as a derivative instrument. Although the Company determined the warrants include an implied downside protection feature, it performed a Monte-Carlo simulation and concluded that the value of the feature is de minimus and the use of the Black-Scholes valuation model is considered to be a reasonable method to value the warrants. The classification of derivative instruments, including whether such instruments should be recorded as liabilities or as equity, is evaluated at the end of each reporting period. Derivative instrument liabilities are classified in the balance sheet as current or non-current based on whether or not net-cash settlement of the derivative instrument could be required within 12 months of the balance sheet date (Note 5).

Revenue Recognition

The Company recognizes revenue when it is realized or realizable and earned. The Company considers revenue realized or realizable and earned when an agreement exists, services are performed, prices are fixed or determinable, and collectability is reasonably assured. Revenues are reduced for estimated discounts and other allowances, if any.

The Company provides advanced medical image analysis on a per analysis basis, and recognizes revenue when the image analysis is completed. Revenue related to project, data, and site management services is recognized as the services are rendered and in accordance with the terms of the contract. Consulting revenue is recognized once the services are rendered and typically charged as an hourly rate.

Occasionally, the Company provides software development services to its customers, which may require significant development, modification, and customization. Software development revenue is billed on a fixed price basis and recognized upon delivery of the software and acceptance by the customer on a completed contract basis. The Company does not sell software in its ordinary course of business, software licenses, upgrades or enhancements, or post-contract customer services.

Reimbursements received by the Company from its customers for out-of-pocket expenses incurred are reported as revenue in the financial statements.

Income Taxes

Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases, and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in operations in the period that includes the enactment date. A valuation allowance is provided when it is more likely than not that some portion or all of a deferred tax asset will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income and the reversal of deferred tax liabilities during the period in which related temporary differences become deductible. The benefit of tax positions taken or expected to be taken in the Company's income tax returns are recognized in the consolidated financial statements if such positions are more likely than not of being sustained.

Research and Development

Research and development expense relates to the development of new applications and processes including significant improvements to existing applications. These costs are expensed as incurred. Research and development costs for the years ended December 31, 2011 and 2010 were $1,450,608 and $1,130,744, respectively.

Fair Value of Financial Instruments

Fair value of financial instruments is defined as an exit price, which is the price that would be received upon sale of an asset or paid upon transfer of a liability in an orderly transaction between market participants at the measurement date. The degree of judgment utilized in measuring the fair value of assets and liabilities generally correlates to the level of pricing observability. Financial assets and liabilities with readily available, actively quoted prices or for which fair value can be measured from actively quoted prices in active markets generally have more pricing observability and require less judgment in measuring fair value. Conversely, financial assets and liabilities that are rarely traded or not quoted have less price observability and are generally measured at fair value using valuation models that require more judgment. These valuation techniques involve some level of management estimation and judgment, the degree of which is dependent on the price transparency of the asset, liability or market and the nature of the asset or liability. The Company has categorized its financial assets and liabilities measured at fair value into a three-level hierarchy. See Note 5 – Derivative Liabilities for a further discussion regarding the Company's measurement of financial assets and liabilities at fair value.

Stock Based Compensation

The Company accounts for share-based awards exchanged for employee services at the estimated grant date fair value of the award. Stock options issued under the Company's long-term incentive plans are granted with an exercise price equal to no less than the market price of the Company's stock at the date of

grant and expire up to ten years from the date of grant. These options generally vest over a three- or four-year period.

The fair value of stock options granted was determined on the grant date using assumptions for risk free interest rate, the expected term, expected volatility, and expected dividend yield. The risk free interest rate is based on U.S. Treasury zero-coupon yield curve over the expected term of the option. The expected term assumption is determined using the weighted average midpoint between vest and expiration for all individuals within the grant. Since the Company has limited historical volatility information, it bases its expected volatility on the historical volatility of similar entities whose share prices are publicly available averaged with the Company's historical volatility excluding the first ten months due to the discreet and non-recurring nature of the trading. In making its determination as to similarity, the Company considered the industry, stage of life cycle, size, and financial leverage of such other entities. The Company's model includes a zero dividend yield assumption, as the Company has not historically paid nor does it anticipate paying dividends on its common stock. The Company's model does not include a discount for post-vesting restrictions, as the Company has not issued awards with such restrictions. The periodic expense is then determined based on the valuation of the options, and at that time an estimated forfeiture rate is used to reduce the expense recorded. The Company's estimate of pre-vesting forfeitures is primarily based on the Company's historical experience and is adjusted to reflect actual forfeitures as the options vest.

The following assumptions were used to estimate the fair value of options granted for the years ended December 31, 2011 and 2010 using the Black-Scholes option-pricing model:

	December 31,	
	2011	2010
Risk free interest rate	2.44%	2.76%
Expected term (years)	6.18	6.19
Expected volatility	55.22%	57.69%
Expected dividend yield	-	-

Earnings (Loss) Per Share

Basic earnings and loss per share are computed by dividing the net income or loss applicable to common shares by the weighted average number of common shares outstanding during the period. Diluted earnings per share is computed using the weighted average number of common shares and, if dilutive, potential common shares outstanding during the period. Potential common shares consist of the incremental common shares issuable upon the exercise of stock options (using the treasury stock method) and the conversion of the Company's convertible preferred stock and warrants (using the if-converted method). Diluted loss per share excludes the shares issuable upon the conversion of preferred stock, the exercise of stock options and warrants from the calculation of net loss per share as their effect would be antidilutive.

The following table reconciles the numerator and denominator for the calculation

	For the Years Ended December 31,	
	2011	2010
Basic earnings (loss) per share		
Numerator:		
Net income (loss)	$ 703,295	$ (629,042)
Preferred stock cash dividends	(48,989)	(173,016)
Net income (loss) available to common stockholders	$ 654,306	$ (802,058)
Denominator:		
Weighted average basic shares outstanding	28,950,864	26,153,573

Earnings (loss) per basic share:		
Net income (loss)	$ 0.02	$ (0.02)
Preferred stock cash dividends	(0.00)	(0.01)
Net income (loss) available to common stockholders	$ 0.02	$ (0.03)
Dilutive earnings (loss) per share		
Numerator:		
Net income (loss)	$ 703,295	(629,042)
Preferred stock cash dividends	-	(173,016)
Net income (loss) available to common stockholders	$ 703,295	$ (802,058)
Denominator:		
Weighted average basic shares outstanding	28,950,864	26,153,573
Weighted average effect of dilutive securities:		
Employee stock options	1,583,594	-
Convertible preferred stock	2,316,700	-
Warrants	562,667	-
Weighted average diluted shares outstanding	33,413,825	26,153,573
Earnings (loss) per diluted share:		
Net income (loss)	$ 0.02	$ (0.02)
Preferred stock cash dividends	0.00	(0.01)
Net income (loss) available to common stockholders	$ 0.02	$ (0.03)
Securities excluded from the weighted average dilutive common shares outstanding because their inclusion would have been antidilutive:		
Employee stock options	1,306,154	6,021,033
Convertible preferred stock	-	3,311,477
Warrants	87,813	2,555,096

NOTE 3 - Property and Equipment

Property and equipment consisted of the following as of December 31:

	2011	2010
Office/computer equipment	$ 922,531	$ 954,614
Furniture and fixtures	265,347	216,454
Software	388,634	299,403
Leasehold improvements	114,669	107,388
	1,691,181	1,577,859
Less: accumulated depreciation	(1,176,951)	(1,173,433)
	$ 514,230	$ 404,426

Depreciation expense amounted to $310,426 and $254,913 for the years ended December 31, 2011 and 2010, respectively. The Company exchanged, disposed of, and wrote-off certain property and equipment resulting in a net gain of $8,369.

NOTE 4 - Patents

On May 24, 2002, the Company purchased from the University of Rochester, a related party, certain patents developed by the Company's founders and previously licensed by the Company under an Exclusive Right Agreement. The Company paid $1,500,000 and issued warrants to acquire 357,075 shares of common stock to the University of Rochester for the full right and title to the patents. The warrants were recorded at fair value which totaled $157,000. Since May 24, 2002, the Company has invested an additional $1,032,690 in connection with improving and expanding its patent portfolio. These costs consist predominately of legal and filing fees and historically been capitalized as long-lived assets. For the years ended December 31, 2011 and 2010, the Company capitalized $6,661 and $12,481, respectively, of legal expenses and filing fees associated with its patents.

Accumulated amortization on the patents amounted to $1,106,751 and $971,527 as of December 31, 2011 and 2010, respectively. Amortization expense for the years ended December 31, 2011 and 2010 amounted to $135,224 and $133,540, respectively. The estimated amortization expense on the patents for the next five years and thereafter is as follows:

For the Years Ending December 31,	Amount
2012	$ 135,222
2013	135,222
2014	135,222
2015	135,222
2016	135,222
Thereafter	906,828
Total	$1,582,938

NOTE 5 - Derivative Liabilities

The warrants issued with the Company's series B preferred stock, and to the placement agent in the series B financing, do not have fixed settlement provisions because their exercise prices may be lowered if the Company issues securities at lower prices in the future. The Company was required to include the reset provisions in order to protect the warrant holders from the potential dilution associated with future financings. The fair value of these liabilities are re-measured at the end of every reporting period with the change in value reported in the statement of operations.

The derivative liabilities were valued using the Black-Scholes option valuation model and the following assumptions on the following dates:

	December 31, 2011	**December 31, 2010**
Series B warrants:		
Risk-free interest rate	0.33%	1.39%
Expected volatility	47.71%	57.60%

Expected life (in years)	2.69	3.69
Expected dividend yield	-	-
Number of warrants	902,038	2,110,208
Fair value	$ 156,596	$ 2,609,708

The risk-free interest rate was based on rates established by the Federal Reserve. The Company's expected volatility was based on the historical volatility of similar entities whose share prices are publicly available averaged with the historical volatility of the Company's trading history excluding the first ten months of trading due to the discreet and non-recurring nature of the trading. The expected life of the warrants was determined by the expiration date of the warrants. The expected dividend yield was based upon the fact that the Company has not historically paid dividends on its common stock, and does not expect to pay dividends on its common stock in the future.

The fair value of these warrant liabilities was $156,596 and $2,609,708 at December 31, 2011 and 2010, respectively. The change in fair value during 2011 is $2,453,112, of which $669,402 is reported in our consolidated statement of operations as an unrealized gain on the change in fair value of the derivative liabilities and $1,783,710 is a reclassification of the fair value of the derivative liabilities to equity upon the exercise of the warrants. The change in fair value during 2010 was $1,469,755 of which was reported in our consolidated statement of operations as an unrealized loss on the change in fair value of the derivative liabilities. The fair value of the derivative liabilities are re-measured at the end of every reporting period and upon the exercise of the warrant. The change in fair value is reported in the consolidated statement of operations as an unrealized gain or loss on the change in fair value of the derivative liability.

Fair Value Measurement

Valuation Hierarchy
ASC 820, "Fair Value Measurements and Disclosures," establishes a valuation hierarchy for disclosure of the inputs to valuation used to measure fair value. This hierarchy prioritizes the inputs into three broad levels as follows. Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities. Level 2 inputs are quoted prices for similar assets and liabilities in active markets or inputs that are observable for the asset or liability, either directly or indirectly through market corroboration, for substantially the full term of the financial instrument. Level 3 inputs are unobservable inputs based on the Company's own assumptions used to measure assets and liabilities at fair value. A financial asset or liability's classification within the hierarchy is determined based on the lowest level input that is significant to the fair value measurement.

The following table provides the liabilities carried at fair value measured on a recurring basis as of December 31, 2011 and 2010:

		Fair Value Measurements at December 31, 2011		
	Total Carrying Value at December 31, 2011	**Quoted prices in active markets (Level 1)**	**Significant other observable inputs (Level 2)**	**Significant unobservable inputs (Level 3)**
Derivative liabilities	$ 156,596	$ -	$ -	$ 156,596

	Total Carrying Value at December 31, 2010	Fair Value Measurements at December 31, 2010 Quoted prices in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Derivative liabilities	$ 2,609,708	$ -	$ -	$ 2,609,708

The carrying amounts of cash, accounts receivable, accounts payable, and accrued liabilities approximate their fair value due to their short maturities. The derivative liabilities are measured at fair value using quoted market prices and estimated volatility factors, and are classified within Level 3 of the valuation hierarchy. There were no changes in the valuation techniques during the year ended December 31, 2011.

The following table sets forth a summary of the changes in the fair value of our Level 3 financial liabilities that are measured at fair value on a recurring basis:

	Years Ended December 31, 2011	2010
Beginning balance	$ 2,609,708	$ 1,139,953
Net unrealized (gain) loss on derivative financial instruments	(669,402)	1,469,755
Reclassification to stockholder's equity	(1,783,710)	-
Ending balance	$ 156,596	$ 2,609,708

NOTE 6 – Stockholders' Equity

Common Stock
The Company has authorized 85,000,000 shares of common stock, par value $0.001. As of December 31, 2011, the Company had reserved 2,327,937 shares of common stock for issuance under its 2001 and 2005 long-term incentive plans, another 350,000 shares of common stock issued to a previous CEO outside of one of its long-term incentive plans, and 6,900,000 shares for its 2006 Long-term Incentive Plan.

Preferred Stock
The Company has authorized 15,000,000 shares of preferred stock, par value $0.001 per share, of which 8,400 are designated as Series A Convertible Preferred Stock ("Series A Preferred") and 6,000 are designated as Series B Convertible Preferred Stock ("Series B Preferred") as specified in the Certificate of Designation (the "Certificate").

During November and December 2005, the Company completed a private placement totaling 7,000 units at a purchase price of $1,000 per unit. Each unit consisted of one share of Series A Preferred, convertible into 400 shares of common stock, and a detachable warrant to purchase 200 shares of common stock at an exercise price of $4.00 per share. Gross proceeds from the private placement amounted to $7,000,000 and net proceeds amounted to approximately $6,000,000. As a result of the private placement, in September 2007 (see below), Series A Preferred became convertible into 830.36 shares of the Company's common stock. All Series A warrants have expired.

On September 17, 2007, the Company completed a private placement of 4,350 shares of Series B convertible preferred stock, par value $0.001 per share, and warrants to purchase the Company's common stock, par value $0.001 per share, for an aggregate purchase price of $4,350,000. Each share of the Series B convertible preferred stock is initially convertible, at the holder's election, into approximately 830.36 shares

of common stock and has a liquidation preference that is pari passu with the Company's Series A convertible preferred stock and senior to the Company's common stock. Cumulative dividends on the Series B convertible preferred stock accrue on the initial stated value of $1,000 per share at an annual rate of 8%, payable monthly in cash and/or shares of the Company's common stock, at the option of the Company. As of December 31, 2011, there were no accrued but unpaid dividends to Series B convertible preferred stockholders. During the years ended December 31, 2011 and 2010, cash dividends paid aggregated to $48,989 and $173,016, respectively.

The warrants have a seven-year term and are initially exercisable into 2,167,232 shares of common stock. The warrants are exercisable, at the holder's election, for shares of the Company's common stock in either a cash or cashless exercise. Fifty percent of the warrants have an initial exercise price equal to $1.2043 per share and the other fifty percent have an initial exercise price of $1.3849 per share. The Company also issued warrants to the financial advisor in the transaction, Canaccord Adams, Inc., to purchase 67,530 shares of common stock, which was recorded at fair value of approximately $57,000 and was recognized as additional paid in capital. The value of the warrants was computed using the Black-Scholes option-pricing model with the following assumptions: risk free rate of 2.62%, contractual term of seven years, expected volatility of 67.5%, 0% expected dividend yield, stock price of $1.01 per share, and exercise prices of $1.2043 and $1.3849 per share.

During 2011, the Company issued 87,188 shares of common stock upon the exercise of warrants at an exercise price of $1.2043 per share, issued in 2007 in connection with the Series B Preferred Stock private placement. The Company received an aggregate of $105,001 upon the exercise of these warrants. The Company also issued 531,506 shares of common stock upon the cashless exercise of 1,120,982 warrants by the warrant holders, as permitted under the terms of the Series B Preferred Stock. Under a cashless exercise, the holder uses a portion of the shares that would otherwise be issuable upon exercise, rather than cash, as consideration for the exercise. The amount of net shares issuable in connection with a cashless exercise will vary based on the exercise price of the option or warrant compared to the current market price of the Company's common stock on the date of exercise.

The conversion feature of the Company's warrants do not have fixed settlement provisions because their exercise prices may be lowered if the Company issues securities at lower prices in the future. The Company included the reset provisions in order to protect the warrant holders from the potential dilution associated with future financings. Accordingly the warrants have been classified as derivative liabilities as discussed above.

During the year ended December 31, 2011, 998 shares of the Company's series A convertible preferred stock were converted into 828,709 shares of the Company's common stock and 200 shares of series B convertible preferred stock were converted into 166,072 shares of the Company's common stock upon the conversion by existing holders thereof. The Company did not receive any cash or other consideration in connection with the conversions.

NOTE 7 – Share-Based Compensation

Stock Options

As of the end of 2011, the Company's 2001 Long-Term Incentive Plan, 2005 Long-Term Incentive Plan and 2006 Long-Term Incentive Plan had a total of 5,780,863 in stock option grants and 25,801 in restricted stock issued to directors, officers and employees of the Company for a total of 5,806,664. In May 2007, the stockholders of the Company approved the adoption of the Company's 2006 Stock Plan (the "Plan"), which amended the Company's 2005 and 2001 Stock Plan. The Plan provides for the grant of incentive stock options, within the meaning of Section 422 of the Internal Revenue Code, to employees and for the grant of non-statutory stock options, restricted stock, and stock appreciation rights to employees, directors, and consultants. The Compensation Committee of the Company's board of directors administers the Plan and has the authority to make awards under the Plan and establish vesting and other terms, but cannot grant stock options at less than the fair value of the Company's common stock on the date of grant or re-price

stock options previously granted. The employee stock options granted under the Plan generally vest ratably over three to four years of service and expire seven to ten years from the date of grant (or ninety days after the termination of employment). As of December 31, 2011, 1,419,679 stock options remained eligible for grant under the 2006 Long-Term Incentive Plan. The 2001 and 2005 Long-Term Incentive Plans have been closed for additional grants.

During the years ended December 31, 2011 and 2010, the Company granted options to purchase 752,853 and 1,574,328 shares of common stock, respectively, to employees at exercise prices of $1.10, $1.14, $1.73, and $1.99, which approximated the fair value on the respective grant dates under the 2006 VirtualScopics, Inc., Long Term Incentive Plan. These options generally vest ratably during the first four years following their issuance and have a ten-year life. There were 470,377 options exercised in a cashless manner during 2011 including the exercise of 119,475 non-employee stock options, resulting in the issuance of 239,805 shares of the Company's common stock. Additionally, there were 76,986 options exercised resulting in cash proceeds of $92,383 during 2011. This compares to a total of 250,000 options exercised during 2010, resulting in the issuance of 86,501 shares of the Company's common stock and cash proceeds of $25,250.

A summary of the employee stock option activity for the year ended December 31, 2011 and 2010 are as follows:

	Number of Shares	Weighted Average Exercise Price	Weighted-Average Remaining Contractual Term	Aggregate Intrinsic Value
Options outstanding at January 1, 2010	4,765,802	$ 1.28	6.10	$ 326,412
Granted	1,574,328	1.07		
Exercised	(250,000)	(0.77)		
Cancelled	(143,282)	(1.66)		
Options outstanding at December 31, 2010	5,946,848	1.24	6.30	5,640,172
Granted	752,853	1.91		
Exercised	(541,888)	(0.98)		
Cancelled	(220,087)	(1.74)		
Expired	(169,036)	(1.33)		
Options outstanding at December 31, 2011	5,768,690	1.33	6.32	55,000
Options exercisable at December 31, 2011	3,422,081	1.38	5.09	40,050

Additional information with respect to the outstanding employee stock options as of December 31, 2011 is as follows:

	Options Outstanding			Options Exercisable	
Exercise Prices	Number Outstanding at December 31, 2011	Weighted Average Remaining Life (Years)	Weighted Average Exercise Price	Number Exercisable at December 31, 2011	Weighted Average Exercise Price
$ 0.43 – 0.92	780,625	7.02	0.83	433,750	0.81

$ 0.93 – 0.98	834,337	8.07	0.94	208,584	0.94
$ 0.99 - 1.19	1,388,574	6.70	1.05	830,894	1.03
$ 1.20 – 1.34	1,335,193	5.46	1.22	1,073,045	1.21
$ 1.35 – 4.15	1,429,961	5.35	2.18	875,808	2.31
	5,768,690	6.32	1.33	3,422,081	1.38

The weighted-average grant-date fair value of options granted during the year ended December 31, 2011 and 2010 was $783,279 and $951,092, respectively.

For the years ended December 31, 2011 and 2010, the Company's consolidated statements of operations reflect $844,004 and $819,766, respectively, of stock-based compensation expense for stock options granted under its long-term incentive plans, which is allocated as follows:

	For Years Ended December 31, 2011	2010
Cost of service revenues	$ 47,214	$ 31,144
Research and development	126,144	102,653
Sales and marketing	19,535	19,094
General and administrative	651,111	666,875
Total stock-based compensation	$ 844,004	$ 819,766

A summary of the status of the non-vested shares as of December 31, 2011 and changes during the year ended December 31, 2011, is presented below:

Non-vested Shares	Shares	Weighted-Average Grant-Date Fair Value Per Share
Non-vested at January 1, 2010	2,375,453	$ 1.51
Granted	1,574,328	0.60
Vested	(938,330)	(0.54)
Cancelled Grants	(45,957)	(0.79)
Non-vested at December 31, 2010	2,965,494	$ 0.71
Granted	752,853	1.04
Vested	(1,184,039)	(0.77)
Cancelled Grants	(187,699)	(0.99)
Non-vested at December 31, 2011	2,346,609	$ 0.77

As of December 31, 2011, there was $923,969 of total unrecognized compensation cost related to non-vested share-based compensation arrangements. This cost is expected to be recognized over a weighted-average period of 2.47 years. The total fair value of shares vested during the year ended December 31, 2011 amounted to $916,247.

Prior to 2008, the Company issued options under the 2006 Long-Term Incentive Plan to non-employee consultants for radiological services performed. These options to non-employees generally vest immediately, have exercise prices ranging from $1.12 to $6.85 and a term of seven or six years from the

date of grant. The value of the options was based on the fair value of the services performed and were included in the Company's statements of operations. During 2011, a total of 56,537 of the non-employee options expired and 5,475 of the non-employee options were exercised in a cashless manner.

The total amount of stock options outstanding as of December 31, 2011 is:

Stock options granted to employees	5,768,690
Stock options granted to consultants	12,173
Total outstanding	5,780,863

During 2011, a total of 752,853 stock options were granted, of that amount 292,953 were granted to executive officers of the Company.

Restricted Stock Awards

A restricted stock award entitles the recipient to receive shares of unrestricted common stock upon vesting of the award. The fair value of each restricted stock award is determined upon granting of the shares and the related compensation expense is recognized ratably over the vesting period and charged to the statements of operations as non-cash compensation expense. Restricted stock awards granted but unvested shares are forfeited upon termination of employment, unless otherwise agreed. The fair value of restricted stock issued under the Plan is determined based on the closing price of the Company's common stock on the grant date. Under the provisions of the 2006 Long Term Incentive Plan, the Company may grant restricted stock to its employees, Board members and consultants. During 2006, the Board of Directors Compensation Committee approved an equity based compensation structure for non-employee Board members. As of December 31, 2011 and 2010, respectively, there were 292,526 and 265,806 shares of common stock that have been issued or are reserved for issuance as restricted stock units under the Plan. As of December 31, 2011, the Company has a liability of $66,681 (equating to 48,971 restricted stock units) related to awards that will be given to certain Board members, on pre-determined dates, in lieu of cash for their services as Board members during 2011 that is included in accounts payable and accrued expenses in the consolidated balance sheet. As the shares are issued, the liability is reduced. In 2011 and 2010, 25,801 and 114,054, respectively, restricted stock awards were issued to members of the Board for their services on the Board under the 2006 Long Term Incentive Plan. The restricted stock awards are fully vested and non-forfeitable and are therefore included in the outstanding common stock of the Company as of December 31, 2011. The weighted average grant date fair value of restricted stock issued by the Company during 2011 and 2010 were $30,250 and $132,303 respectively.

The Company incurred $36,618 and $43,756 in compensation expense in 2011 and 2010 related to the restricted stock awards for services by Board members for those respective periods.

NOTE 8 - Benefit Plan

The Company has a defined contribution plan which covers all of its full-time employees. The employees' annual contributions are limited to the maximum allowed under the Internal Revenue Code. During 2009, the Company began a matching contribution to participants 401k plans equal to 50% of the participants' contributions up to a maximum 3% of annual wages. The Company paid a total of $120,551 and $105,678 in 2011 and 2010 to participants representing the employer contribution amount.

NOTE 9 - Income Taxes

The Company has identified its federal tax return and its state tax return in New York as "major" tax jurisdictions, as defined. Based on the Company's evaluation, it has been concluded that there are no significant uncertain tax positions requiring recognition in the Company's consolidated financial statements. The Company's evaluation was performed for the tax years ended 2008 through 2011, the only periods subject to examination. The Company believes that its income tax positions and deductions will be

sustained on audit and does not anticipate any adjustments that will result in a material change to its financial position. The Company does not expect its unrecognized tax benefit to change during the next 12 months. As of December 31, 2011, all of the Company's deferred tax assets were fully reserved by a valuation allowance equal to 100% of the net deferred tax assets. During 2012, the Company will assess the likelihood of recognizing a portion of its deferred tax assets and will make an assessment of whether it should reduce the valuation allowance.

The Company has significant net operating loss and business credit carryovers which are subject to a valuation allowance due to the uncertain nature of the realization of the losses. Section 382 of the Internal Revenue Code imposes certain limitations on the utilization of net operating loss carryovers and other tax attributes after a change in control. If the Company has a change in ownership, such change could significantly limit the possible utilization of such carryovers.

The Company will recognize interest and penalties accrued related to unrecognized tax benefits as components of its income tax provision. The Company does not have any interest and penalties accrued related to unrecognized tax benefits.

The Company accounts for income taxes in accordance with ASC 740, Income Taxes. Under ASC 740, deferred income taxes and liabilities are recognized based on temporary differences between the financial statement and tax basis of assets and liabilities using the enacted tax rates in effect in the years in which the differences are expected to reverse. ASC 740 requires recognition of net deferred tax assets to the extent it is more likely than not that such net assets will be realized. To the extent that the Company believes that its net deferred tax assets will not be realized, a valuation allowance must be recorded against those assets.

The income tax provision consists of the following:

	2011	2010
Current		
Federal	$ -	$ 16,000
State	-	-
	-	16,000
Deferred		
Federal	172,438	421,733
State	23,766	73,393
Less: Valuation Allowance	(196,204)	(495,126)
	-	-
Total income tax provision	$ -	$ 16,000

During the year end December 31, 2011, the Company generated approximately $309,000 of net operating loss carryforward. This loss included a tax deduction for stock based compensation. This deduction will result in a windfall tax benefit, which will be recorded as an increase to APIC, when realized. Since, the Company is precluded from recognizing this tax benefit until realized, the Company cannot recognize an increase in its deferred tax asset for net operating losses in 2011. The deferred tax asset related to its net operating loss was decreased by $140,000, which represents the tax benefit which would have been utilized under the "with and without" method to recognize windfall tax benefits. The total valuation allowance has been reduced by $196,000 of which reduction of approximately 56,000 relates to other deferred tax assets.

The Company has net operating loss carryforwards ("NOLs") of approximately $7,929,000 as of December 31, 2011 that will be available to offset future taxable income. Approximately $520,000 of the NOL carryforward, if realized, will result in a benefit to be recorded in APIC. The NOLs are due to expire in 2026

through 2031. The Company has concluded that a full valuation allowance was appropriate for the NOLs as they are more likely than not to be utilized prior to their expiration.

The total net deferred tax asset and liabilities as of December 31, 2011 and 2010 consists of the following:

	2011	2010
Net operating loss carryforwards	$ 2,805,504	$ 2,945,983
Intangible assets	908,609	1,024,124
Accrued expenses	110,920	124,001
Credit carryforwards	151,830	110,783
Stock-based compensation	1,016,167	909,241
Total deferred tax asset	4,993,030	5,114,132
Deferred tax liability:		
Property and equipment	(156,488)	(81,385)
Subtotal	4,836,542	5,032,747
Less: valuation allowance	(4,836,542)	(5,032,747)
Total net deferred tax asset	$ -	$ -

The difference between the federal statutory and effective income tax rates for the years ended December 31, 2011 and 2010 is as follows:

	2011	2010
Federal statutory tax rate	34.00%	(34.00%)
State and local income taxes, net of federal benefit	4.09%	(4.69%)
Stock-based compensation	27.58%	43.51%
Loss from derivative financial instrument	(32.36%)	90.40%
Research and development credit	(5.94%)	(15.07%)
Other	.53%	1.10%
	27.90%	81.25%
Less: valuation allowance	(27.90%)	(78.71%)
Provision for income taxes	0%	2.54%

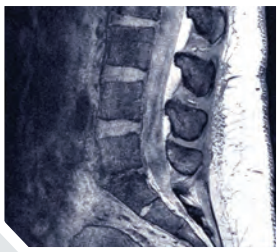
NOTE 10 - Commitments and Contingencies

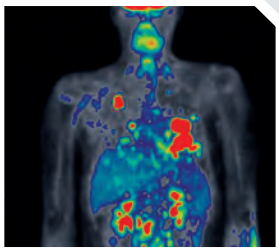
Operating Leases

In July, 2007 the Company began leasing approximately 19,500 square feet of office space at our corporate headquarters in Rochester, New York. The base annual rent under the lease is $360,000, and increases three percent (3%) a year. During the first twenty months of the lease, the rent was paid in two portions: a cash portion of $156,000 annually, paid in equal monthly installments, increasing three percent (3%) annually; and, a stock portion of $204,000 annually, paid in equal monthly installments, increasing three percent (3%) annually. The stock portion was payable in shares of our common stock. In February 2009, the Landlord exercised their option to receive their remaining rental payments in all cash. Management believes that the leased property is adequately covered by insurance.

In April 2010, the Company entered into a lease agreement for certain equipment. The lease is for 36 months and will expire in March 2013.

Total rent expense for the years ended December 31, 2011 and 2010 was $325,520 and $325,148, respectively.





Adaptable Solutions Across Disease Areas

VirtualScopics incorporates a multidisciplinary approach to image analysis. Our strength in biomarker development stems from a diverse team of imaging experts. Staff radiologists and technicians understand the relevance of image-based biomarkers to disease progression, and how to integrate biomarkers into clinical trials. Our software experts develop automated image quantification software that fuses a series of images into a 3-D representation, and allows anatomical structures to be segmented and measured. Scientific experts who understand the hundreds of options in imaging technologies (i.e., MRI, CT, PET) and pulse sequences provide valuable insight on clinical design.

VirtualScopics has built an extensive patent portfolio of image-based biomarker solutions across a broad range of therapeutic areas and imaging modalities. We have the ability to measure clinically and biologically validated imaging biomarkers to assess risks regarding safety, toxicity and drug interactions across a vast array of diseases, many of which are listed below.

Hematology / Oncology
- Solid Tumors
- Standard assessments such as RECIST
- Evaluation of blood flow, proliferation, metabolic activity
- Structural and volumetric assessments
- Lymphoma
- Cachexia

Central Nervous System
- Alzheimer's Disease
- Multiple Sclerosis
- Glioblastoma
- Tuberous Sclerosis
- SEGA

Medical Devices
- Fusion
- Degenerative Disc Disease
- Cartilage Repair
- Hernia Repair
- Stents
- Biologics

Infectious Disease
- HIV
- Myositosis
- Hepatitis
- Pneumonia
- Tuberculosis

Cardiovascular
- Plaque Volume, Calcification
- Cerebral MRA
- Myocardial T2*
- Ejection Fraction

General Medicine
- Osteoarthritis
- Rheumatoid Arthritis
- Ankylosing Spondylitis
- Muscle Wasting / Obesity
- Diabetes, Hepatic Steatosis (Fatty Liver Disease)
- Crohn's Disease
- Respiratory Diseases (COPD, Asthma)
- Myelofibrosis

Board of Directors

Robert G. Klimasewski
Chairman, VirtualScopics, Inc.

Mostafa Analoui, Ph.D.
Senior Advisor, Head of Healthcare and Life Sciences Division, Livingston Group

Daniel I. Kerpelman
President and Chief Executive Officer, Bio-Optronics

Sidney R. Knafel
Managing Partner, SRK Management Company

L. Jeffrey Markin
President and Chief Executive Officer, VirtualScopics, Inc.

Norman N. Mintz, Ph.D.
Managing Partner, Loeb Partners Corporation

Charles E. Phelps, Ph.D.
Former Provost, University of Rochester

Terence A. Walts
President and CEO, Transfusion and Transplantation Technologies

Executive Officers

L. Jeffrey Markin
President and Chief Executive Officer

Molly Henderson
Chief Business and Financial Officer, Senior Vice President

Independent Registered Public Accounting Firm

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212.509.4000

Stock Listings

VirtualScopics' common stock trades on the NASDAQ Global Stock Market under the symbol "VSCP".

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