SkyePharma PLC

Annual Report 2005

Making Good Drugs Better

Contents

Our Mission

SkyePharma's mission is to become the world's leading speciality pharmaceutical company, powered through excellence in drug delivery.

We aim to use our multiple delivery technologies to create a product pipeline for out-licensing to marketing partners.

In addition we will strive to maintain our leadership position in drug delivery.

Corporate Highlights

Marketed products
Paxil CR™ back on US market
Triglide™ launched in USA

Pipeline progress
Pulmicort® filed
Foradil® Certihaler™ now approved in 24 markets
Flutiform™ starts Phase III clinical trials
DepoBupivacaine™ completes Phase II clinical trials

New corporate developments
Flutiform™ licensed to Kos Pharmaceuticals for USA; negotiations ongoing with other parties for remaining key territories
DepoBupivacaine™ licensed to Mundipharma and Maruho
Rights issue raised £35 million (net of expenses)
Strategic decision to divest injectables business unit

Financial Highlights

Financial highlights presented under IFRS	2005 £m	2005 $m	2004 £m	2004 $m
Revenue	**61.3**	**111.1**	75.2	136.3
Gross profit	**32.1**	**58.2**	47.0	85.2
Operating loss	**(37.5)**	**(68.0)**	(3.1)	(5.6)
Loss for the year	**(50.9)**	**(92.2)**	(18.6)	(33.7)
Basic and diluted earnings per share	**(8.1p)**	**(14.7c)**	(3.0p)	(5.4c)

US dollar equivalents are shown for convenience and have been calculated for both periods using the current period average rate of $1.8120 to the pound sterling.

Chairman's Statement

There is no disguising that 2005 was a difficult year for SkyePharma. Despite a number of significant achievements, outlined in the Review of Operations below, we did not complete a development agreement for Flutiform™, our major pipeline product. As explained in more detail in the feature on page 16, we believe that Flutiform™ has substantial commercial value. Faced with the prospect of a delay to the development of this important product, which might have impaired its commercial potential, we took the decision in September to raise £35 million (net of expenses) by means of a rights issue to keep Flutiform™ on its planned development timeline through Phase III. As such, our target launch date in the USA remains 2009. We are convinced that proceeding with the clinical development of Flutiform™ ourselves and funding this development through a rights issue were in shareholders' best interests.

Our decision was vindicated by the excellent terms we obtained in the agreement with Kos Pharmaceuticals for the US market that we announced in May 2006. Kos is a specialty pharmaceutical company that has an excellent track record of successful marketing against major competitors and Kos shares our view that Flutiform™ will become a major product. We remain in negotiation with potential strategic marketing partners for Flutiform™ for other key territories.

Prior to reaching the decision to ask shareholders for funding, we explored a number of financing alternatives to fund the development of Flutiform™ and also a variety of strategic options for the Company. These included discussions concerning a transaction that, had it been successful, would have created a combined company that could have marketed Flutiform™ itself in some markets. The discussions were called off by SkyePharma due to uncertainties over the other party's prospects. SkyePharma was unable to disclose this at the time due to reasons of confidentiality and the possibility that these discussions could resume at some time in the future.

In November, we also received an opportunistic takeover approach from Innovata PLC. As a result, the Board felt that it was in shareholders' interests to explore all options and consequently appointed Lehman Brothers to conduct a full strategic review of all the options open to the Company.

The conclusion of this review in early 2006 did not lead to an offer for the entire Company on terms that the Board felt able to recommend to shareholders. However, there were expressions of interest in individual parts of the business. The Board then took a strategic decision to divest the US-based injectables business in order to reduce the Company's projected cash outflow over the next few years and to raise funds to concentrate on the oral and inhalation businesses. The investment bank UBS has been retained recently to manage this sale and the process is ongoing. The injectables business includes DepoCyt® and DepoDur™, both marketed products, and the lead injectable pipeline product DepoBupivacaine™.

In January 2006 certain shareholders requisitioned an Extraordinary General Meeting ("EGM") seeking to remove the Company's then Chairman and to appoint a nominated director to SkyePharma's Board with the ultimate aim of having him appointed as Executive Chairman. Although this motion was defeated at the EGM in early March, the Board has since made a number of changes and introduced a process whereby major investors are now involved in the selection of new Non-Executive Directors.

Board Changes

In January 2006, Ian Gowrie-Smith stepped down from his role as Non-Executive Chairman when I was appointed in his place. Ian subsequently resigned as a Director in February. As shareholders will be aware, Ian founded SkyePharma in 1996 and has seen it grow to become a substantial business. He remains a shareholder but will now be focusing his energies

> We believe that the strategic initiatives we have adopted will enable the Company to maximise the potential of Flutiform™ and other pipeline products, to become profitable in the near term and to deliver long-term value for shareholders.

on a number of early-stage non-pharmaceutical companies. I have been a Non-Executive Director of SkyePharma since 2000 and I have also had extensive experience at senior management levels of the international pharmaceutical industry.

Michael Ashton, who has now reached the age of 60, indicated to the Board last year that it was his intention to retire as Chief Executive in 2006. Michael will continue to serve as a Director until the 2006 Annual General Meeting in June but will not be seeking re-election.

I am sure that shareholders will join me in thanking both Ian and Michael for their contribution to the development of SkyePharma since its formation.

The Board has appointed Frank Condella as Chief Executive, who joined the Company on 1 March 2006, having previously run the European operations of the leading generic company IVAX. Before joining IVAX, Frank was Chief Executive of Faulding Pharmaceuticals and before that built up the speciality pharmaceuticals business of Roche. Frank joined the Board on 4 April 2006.

The Board has also appointed Dr Ken Cunningham in the new role of Chief Operating Officer. Ken was formerly Chief Executive of the private UK company Arakis and has a wealth of experience in pharmaceutical development, especially in the areas of oral and inhalation products. Ken joined the Board on 17 May 2006.

Two other Non-Executive Directors, Sir Michael Beavis and Dr Keith Mansford, will not be standing for re-election at the Annual General Meeting. The Board will miss their wise counsel and wishes them well in retirement. In their place, we will be appointing two new Non-Executive Directors.

The Future

The EGM process was costly and also diverted significant management time away from running the business. However, now that this is behind us we can focus on execution of the new strategy referred to above and outlined in more detail in the following pages. We are focused in the short term on the licensing of Flutiform™ in territories outside North America and the divestment of our injectables business. While there is obviously uncertainty as to the timing of these transactions, they will not only greatly reduce the Company's current and future cash requirements but also provide us with the funds to consider new opportunities related to oral and inhalation products. We are also devoting a significant amount of resource to ensure that Flutiform™ continues on its planned development timeline. We remain convinced that Flutiform™ will become a major product, as is evident from the number of companies that have expressed an interest in obtaining licensing rights. We believe that the strategic initiatives we have adopted will enable the Company to maximise the potential of Flutiform™ and other pipeline products, to become profitable in the near term and to deliver long-term value for shareholders.

Dr Jerry Karabelas
Non-Executive Chairman

Our Strategy

SkyePharma's mission is to become one of the world's leading speciality pharmaceutical companies, powered through excellence in drug delivery.

On 2 February 2006, the Company announced the outcome of its Strategic Review. The Board concluded that in the interests of achieving sustainable profitability in the shortest reasonable time, SkyePharma should concentrate on oral and inhalation products and divest its injectable business interests. The proposed divestment, which the Board expects to be subject to approval by shareholders, would not only release cash but also relieve the Company of a significant cash burn and future capital expenditure. The Board believes that the residual core business would be able to achieve profitability in the near term. Furthermore, with greater focused resources the Company would be in a better position to further develop its pipeline of oral and inhalation products. Ultimately, it is the Company's strategy to add a niche sales and marketing capability in one or more markets that would improve profit growth and give it greater control over revenue generation.

The injectables business, located in San Diego, consists of two marketed products: DepoCyt® for a complication of cancer and Depodur™ for the treatment of post-surgical pain. This business also has a pipeline of projects in various stages of development. These include controlled-release injectable formulations of a number of biological products and DepoBupivacaine™, a long-acting injectable formulation of the local anaesthetic bupivacaine for the control of post-operative pain. The Company remains convinced that DepoBupivacaine™ addresses an important area of unmet medical need and has major commercial potential. However, further development of this business would require significant cash resources and would also impact the Company's ability to become profitable in the near term.

The Company has retained UBS to act as its investment bank to manage the divestment process. This process is ongoing and several third parties, both trade and financial, have already shown significant interest in the injectables business.

Funds raised by the divestment of the injectables business will be available to enhance the core oral and inhalation business. We expect to be able to accelerate the development of certain pipeline products whose development has had to be delayed in recent years. Several of these products are at an early stage of development but would address important therapeutic areas such as gastrointestinal, diabetes and hypertension. Development activities will continue to be based in Muttenz, Switzerland and manufacturing in Muttenz and Lyon, France.

Our oral and inhalation pipeline includes SkyePharma's most important project Flutiform™, a combination asthma product. The Company is convinced that Flutiform™ has substantial value as it is poised to enter a large and rapidly growing market with currently limited competition. This is reflected in the excellent terms on which we have recently licensed Flutiform™ to Kos Pharmaceuticals for the US market (with an option on Canada). We are currently negotiating with several companies for the rights to market Flutiform™ in Japan and the countries of the European Union.

The core oral and inhalation business has seven products marketed by licensees, including Paxil CR®, Xatral® OD and Triglide®. These products will continue to generate revenues and cash for the Company. There are also a number of late-stage products that are close to the market.

The Company will focus its efforts on working with partners to maximise revenues from existing and future marketed products. We will also be able to devote more resources in this area to the development of additional products and to increase the size of our pipeline.

Review of Operations

Respiratory Products

Flutiform™ HFA-MDI

Flutiform™ HFA-MDI is a fixed-dose combination of the long-acting bronchodilator formoterol and the inhaled steroid fluticasone in a metered-dose aerosol inhaler (MDI) using a hydrofluoroalkane (HFA) propellant. The global market for combination therapies for asthma was worth more than $5 billion in 2005 and is expected to exceed $10 billion by 2010. Combination therapies are currently the fastest growing component of the asthma market and by 2010 are projected to account for over half of the total market. There is an additional substantial market for these combination products in the treatment of chronic obstructive pulmonary disease (COPD).

In 2005 the Company completed phase II trials and a review of development activities with the FDA and European regulatory agencies. Subsequent to these meetings, the Company initiated Phase III trials for Flutiform™ in February 2006. The product is on track for its target filing date with the US Food and Drug Administration ("FDA") in the second half of 2007 with US market entry expected in early 2009. SkyePharma expects Flutiform™ to be the third combination product to enter the US market, following GlaxoSmithKline's Advair and AstraZeneca's Symbicort. Despite the eventual likelihood of additional entrants, the Company believes that no competing product is likely to enter the US market before 2012. Therefore, there is an opportunity to establish Flutiform™ as the "best in class" combination therapy on the US market.

Further details of this important pipeline product will be found in the feature on page 16. SkyePharma remains in discussions with various potential marketing partners for territories outside North America.

Foradil® Certihaler™

Foradil® Certihaler™ is our version of Novartis' long-acting bronchodilator Foradil® (formoterol). Global sales of Foradil® were $332 million in 2005, of which the Certihaler™ version made up a very small proportion, the product having only been on the market for a short time. We developed not only the multi-dose dry-powder inhaler device but also the formulation technology that had been shown to ensure dose consistency. Foradil® Certihaler™ has now been approved in 24 countries in Europe, the Middle East and Latin America. The product was launched in Germany and Switzerland in September 2005 but a recall from these markets was initiated in January 2006 because of concerns that accidental mishandling of the device had resulted in inaccurate dosing in a small number of cases. SkyePharma is collaborating with Novartis and the relevant health authorities to investigate the reasons and the actions necessary before the product can be returned to the market. These are likely to include modification of the device. In the US, the FDA issued an "approvable" letter for Foradil® Certihaler™ in April 2006 but the FDA is requiring device modification as a prerequisite for approval. Novartis is currently working with the FDA on the most effective way to address its concerns.

The Certihaler™ and related formulation technology are also involved in a second collaboration with Novartis to jointly develop QAB149 (indacaterol), a novel inhaled long-acting beta-2-agonist that provides sustained 24-hour bronchodilation with rapid onset of action, which has completed Phase II development in both asthma and COPD. Novartis is currently revising the indacaterol development plan in Certihaler™ to accommodate the device modifications mentioned above.

Formoterol HFA-MDI

This is a formulation of the long-acting bronchodilator formoterol in an HFA-powered MDI. Because of the growing use of combination products for asthma and COPD, there is now a correspondingly diminishing market opportunity for single agent bronchodilators. While this product has completed Phase II development, pending the divestment of the injectables business, the Company will conclude its strategic review of this product.

Pulmicort® HFA-MDI

This new HFA-powered MDI containing AstraZeneca's inhaled corticosteroid Pulmicort® (budesonide) was filed for marketing authorisation in June 2005 on a country-by-country basis in Europe for the treatment of asthma in adults and children. In February 2006, the product received approval in Finland, its first European market. Other European approvals are expected this year. The currently available MDI formulation of Pulmicort® has been on the market since 1981 and uses chlorofluorocarbons (CFCs) as the propellant. In accordance with the Montreal Protocol, this version will now be replaced by the non-ozone depleting device using HFAs as propellant. SkyePharma developed this new HFA-MDI formulation, which employs its proprietary formulation technology, and also conducted the clinical development programme for AstraZeneca. SkyePharma will earn a double digit royalty on AstraZeneca's sales of this formulation of Pulmicort®.

Oral Products

Paxil CR™

Our improved formulation of GlaxoSmithKline's antidepressant Paxil® (paroxetine) remains a major source of royalty income. In March 2005 GlaxoSmithKline temporarily suspended production of Paxil CR™ and certain other products made at its Cidra plant in Puerto Rico. GlaxoSmithKline announced in April 2005 that it had entered into a consent decree with the FDA regarding manufacturing processes at the plant and recommenced supply of product to the market shortly thereafter. As previously reported, we concluded a new agreement with GlaxoSmithKline last year that not only provided us with a $10 million lump-sum payment and increased the royalty rate on this product from 3% to 4% but also maintained our royalty income even while the product was temporarily off the market.

Despite the product's return to the market, new documentary procedures introduced as part of the consent decree have hindered the Cidra plant's ability to meet demand and GlaxoSmithKline alerted customers to supply constraints in January 2006. Paxil CR™ currently holds about 3% of new prescriptions in this market, well below the 7% share held before the March 2005 withdrawal. World sales of Paxil CR™ were $231 million in 2005, of which US sales were $209 million, 70% below the 2004 level in constant exchange rate terms.

In late 2005 we and our partner GlaxoSmithKline received notification from Mylan Pharmaceuticals Inc. that it had filed an Abbreviated New Drug Application ("ANDA") with the FDA for a version of paroxetine hydrochloride extended release tablets. The ANDA contains a "Paragraph IV certification" that certain of the patents listed in the FDA's "Orange Book" by GlaxoSmithKline for Paxil CR™ (paroxetine hydrochloride Controlled Release tablets) are not infringed. These patents include SkyePharma's US patent 5,422,123. The certification does not challenge GlaxoSmithKline's basic active ingredient patent covering paroxetine hydrochloride hemihydrate, which protects the product until June 2007. GlaxoSmithKline has decided not to exercise its right to file suit for patent infringement within the 45-day period permitted by the Hatch-Waxman Act ("the Act") and therefore there will be no 30-month stay of approval for this product pursuant to the Act. SkyePharma has a number of issued patents covering technology incorporated in Paxil CR™ and our policy is to enforce our intellectual property wherever possible.

Requip Once-a-day

In December 2005, SkyePharma's collaborator GlaxoSmithKline submitted Requip Once-a-day, a once-daily dosage formulation of Requip® (ropinirole), for approval by US and European regulatory authorities for the treatment of Parkinson's disease. The FDA has raised some administrative issues that were identified in the preliminary initial review and which led GlaxoSmithKline to withdraw the US filing. SkyePharma has been informed that it is the intention of GlaxoSmithKline to resubmit as soon as possible. It is not expected that the European regulatory review process will be affected by these issues. This new once-daily oral formulation of Requip® incorporates SkyePharma's Geomatrix™ oral controlled-release delivery technology. SkyePharma will receive royalties on the product sales.

Triglide™

Following FDA approval in May 2005, First Horizon Pharmaceutical Corporation launched Triglide™ (fenofibrate) on the US market in July. First Horizon, which licensed Triglide™ in 2004, has a 400-strong representative force focused on cardiovascular

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physicians and high-prescribing primary care practitioners and has a proven ability to capture market share in the cardiovascular therapeutic area. We and First Horizon see a substantial opportunity for Triglide™, a once-daily oral treatment for lipid disorders such as elevated cholesterol and triglycerides. Fenofibrate not only lowers levels of total triglycerides and LDL cholesterol ("bad cholesterol") in the bloodstream but also has the valuable property of raising abnormally low levels of HDL cholesterol ("good cholesterol"), increasingly recognised as a major cardiovascular risk factor. In Triglide™, the problem of variable uptake arising from the low solubility of fenofibrate has been overcome by our proprietary IDD-P™ solubilisation technology. Triglide™ has comparable absorption under both fed and fasting conditions and therefore allows patients to take the drug at any time, improving compliance and simplicity for both patients and prescribers. First Horizon's 2005 sales of Triglide™ in the 5 months since launch were just under $5 million but we and First Horizon expect a significant increase in the current year.

SkyePharma has now received $20 million in milestone payments from First Horizon ($15 million of which was due on FDA approval, obtained in May 2005) and could receive up to $30 million more in sales-based milestone payments. In addition we receive 25% of First Horizon's net sales, out of which we pay for manufacturing and supply. In 2005 we also agreed to contribute towards the marketing costs incurred by First Horizon to establish the product in its first two years after launch, the aim being to enhance market penetration and thereby optimise revenues. Originally we agreed to contribute up to $5 million towards First Horizon's marketing costs through 2007 and to provide samples. In January 2006 this arrangement was modified in order to emphasise its intent as a marketing contribution. SkyePharma will now make a contribution of up to $11.3 million towards First Horizon's marketing costs (of which $3.1 million was paid in 2005) and First Horizon will pay SkyePharma for the supply of product samples. There is no change in the net cost to SkyePharma.

Xatral® OD

Xatral® OD (Uroxatral® in the USA) is our once-daily version of Sanofi-Aventis's Xatral® (alfuzosin), a treatment for the urinary symptoms of benign prostatic hypertrophy. Xatral® OD has been on the market outside the USA since April 2000 and the older multidose versions of Xatral® have now largely been withdrawn. Uroxatral®, launched in the US in November 2003, currently holds over 11% of the combined prescriptions written for it and for its principal competitor Flomax (tamsulosin, jointly marketed in the US by Boehringer Ingelheim and Astellas). Xatral® OD has now been approved in more than 50 countries, including 24 in Europe, for a second indication, acute urinary retention. However Sanofi-Aventis is no longer pursuing US approval for this indication. In 2005, global sales of all forms of Xatral® reported by Sanofi-Aventis were €328 million ($410 million), up by 18% in constant exchange rate terms. Included in this total were US sales of Uroxatral® of €53 million ($66 million), up by 121% in constant exchange rate terms. We estimate that Xatral® OD now accounts for more than 90% of the sales of Xatral® reported by Sanofi-Aventis.

Zyflo® CR

SkyePharma's partner Critical Therapeutics, Inc. announced in January 2006 that it had initiated two studies designed to support a New Drug Application for a twice-daily version of Zyflo® (zileuton), an oral leukotriene synthesis inhibitor for the treatment of asthma. The current version of Zyflo® has to be taken four times a day and the CR version is expected to improve convenience for patients and therefore compliance. The controlled release formulation employed in the CR version was developed by SkyePharma. Critical Therapeutics expects to file the CR version with the FDA in the third quarter of 2006.

Other Products

Solaraze®

Solaraze® is our topical gel treatment for actinic keratosis and our proprietary hyaluronic acid formulation ensures that a high concentration of the active ingredient is maintained in the upper layers of the skin. Solaraze® is now marketed in the US by the Doak Dermatologics unit of Bradley Pharmaceuticals. Bradley has recently reported that sales in the first nine months of 2005 were just under $10 million and SkyePharma estimates that full year sales were approximately $15 million. Sales in 2004 were only $6 million, reflecting the fact that product rights were not acquired by Bradley until August 2004. Solaraze® is marketed in Europe and certain other territories by Shire Pharmaceuticals. In 2005 Shire's total non-US sales of Solaraze were $12.5 million, up by 32%.

Injectable Products (to be divested)

Biologicals portfolio

There has been encouraging progress with the Company's portfolio of versions of protein drugs with enhanced delivery profiles, based on its two complementary sustained-release injectable technologies DepoFoam™ and Biosphere™. The objective of the work has been to develop different protein formulations to provide a range of durations from 7 up to 28 days of activity. The DepoFoam™ system has the benefit of neither altering the native protein during the formulation process nor the way in which it acts upon release into the body. SkyePharma has now successfully formulated seven different protein drugs, including major commercial products such as G-CSF, EPO, HGH, IFN-α and IFN-β. In the second half of 2005 the Company entered into three new feasibility study agreements with third parties for enhanced biologics. It is anticipated that several of these products will enter Phase I clinical trials in 2007.

DepoBupivacaine™

We are pleased to report that we have now completed the Phase II trial programme for DepoBupivacaine™, a long-acting local anaesthetic for use in the treatment of post-operative pain. DepoBupivacaine™ is SkyePharma's novel sustained-release injectable formulation of the local anaesthetic bupivacaine, currently widely used as a local or regional anaesthetic during surgery, either in a hospital in-patient setting or in ambulatory (or "day") surgery in which the patient is discharged from the hospital or clinic shortly after surgery to recover at home. DepoBupivacaine™ employs SkyePharma's proprietary DepoFoam™ technology and was shown in Phase I and Phase II studies to provide local relief of pain for more than 48 hours after a single injection instead of 8-12 hours for conventional immediate-release bupivacaine. Superior control of pain after discharge is expected to reduce the need for other analgesics and to improve patient recovery and rehabilitation. The Phase III trial programme is expected to commence in the first half of 2006.

We have extended our relationship with Mundipharma, our European marketing partner for DepoCyt®, by granting rights outside North America and Japan for DepoBupivacaine™. Under the terms of the agreement we could receive up to $80 million in milestone payments and a 35% share of sales (30% in markets outside Europe). The milestone payments include a contribution of up to $20 million towards the cost of the Phase III trial once Mundipharma agrees to the design of the trial.

DepoBupivacaine™ has also been licensed to the Japanese pharmaceutical company Maruho for the Japanese market. Maruho will pay SkyePharma up to $18 million in milestone payments and conduct at its own cost the clinical development of DepoBupivacaine™ required for regulatory approval in Japan. Additionally, SkyePharma will receive a share of Maruho's sales in Japan, out of which SkyePharma will bear the cost of manufacture.

Endo Pharmaceuticals, our North American partner for DepoDur™, which had a right of first negotiation for commercial rights to DepoBupivacaine™ for North America, has now relinquished this right, thereby providing a buyer of the injectables business with unencumbered US rights to this product. Subject to the terms of this sale, we may seek to retain an economic interest in the sales of DepoBupivacaine™, which we believe has major commercial potential.

DepoCyt®

DepoCyt® is an oncology drug for the treatment of lymphomatous meningitis. It consists of cytarabine in our proprietary DepoFoam™ formulation to avoid the need for frequent intrathecal (spinal) injections. Sales of DepoCyt® in the USA in 2005 by our partner Enzon

were $8 million, up 26% on the prior year. Our European partner Mundipharma, which launched the product as DepoCyte™ in February 2004, had sales of $6 million (against $1.5 million in 2004) and is forecasting a further substantial increase in 2006. We have completed the Phase IV trial required by the FDA when granting approval for this product and will be submitting the results to the FDA shortly. We have also filed in Europe for the additional indication of the most common form of neoplastic meningitis, associated with solid tumours. A response is expected in mid-2006.

DepoDur™

In December 2004 our US marketing partner Endo Pharmaceuticals launched DepoDur™, our sustained-release injectable version of the analgesic morphine for the treatment of post-operative pain. Sales in 2005 were $4 million, which was a disappointment both to us and to Endo. The product is still in the launch phase but has now been accepted on more than 400 hospital formularies, the first gateway to routine hospital use. Given the length of time typically needed to establish hospital products, we are confident that this initial sales level does not reflect the full potential of the product.

In the UK, we have recently been granted approval for DepoDur™ by the UK regulatory agency, the CSM. This will be used as the basis for seeking approval throughout the European Union under the EU's Mutual Recognition procedure. Zeneus Pharmaceuticals, SkyePharma's European licensee for DepoDur™, announced on 6 December 2005 that it had reached agreement to be acquired by the US company Cephalon Inc. SkyePharma has regained the European rights for DepoDur™ and is now seeking a new sales and distribution partner for the EU and other territories outside North America.

Propofol IDD-D™

Propofol IDD-D™ is our novel formulation of propofol, a widely-used injectable anaesthetic and sedative. Our formulation was designed not to support microbial growth, a recognised problem with current versions, and to provide uninterrupted sedation for 24 hours. Although this product completed Phase II trials in 2004, the Phase III trial has not yet commenced and in April 2006 we agreed with our North American partner Endo to terminate the joint development of Propofol IDD-D™.

The Future

In the immediate future, we will be concentrating on two tasks: the divestment of our injectables business and securing an additional marketing and co-development partner (or partners) for Flutiform™. Once these tasks have been completed, we will be able to focus our management and financial resources on the "new SkyePharma", consisting of our core inhalation and oral product business. We will drive for sustainable profitability. At the same time, however, we will invest in our inhalation and oral product pipeline to make sure that we bring forward the growth drivers of tomorrow. We have a longer term goal of forward integration into marketing and sales of our own products in selected specialty therapeutic areas. I believe that this new focus will create exciting opportunities for SkyePharma and increase investor confidence in our future.

"In the immediate future, we will be concentrating on two tasks: the divestment of our injectables business and securing a marketing and co-development partner (or partners) for Flutiform™. Once these tasks have been completed, we will be able to focus our management and financial resources on the "new SkyePharma", consisting of our core inhalation and oral product business."

Frank Condella
Chief Executive

Product Pipeline

	Client/licensee	Drug	Therapeutic category
Oral	GlaxoSmithKline	Paxil CR®	CNS
	Sanofi-Aventis	Xatral® OD/Uroxatral®	Genito-Urinary
	Roche	Madopar DR®	Parkinson's Disease
	Therabel	Coruno®	Angina
	Mundipharma	Cordicant-Uno®	Hypertension
	Ratiopharm	Diclofenac	Arthritis
	GlaxoSmithKline	Requip once-a-day	Parkinson's Disease
	Nitec	Undisclosed	Inflammatory Conditions
	Critical Therapeutics	Zileuton	Asthma/COPD
	First Horizon	Sular CR	Antihypertensive
Inhalation	Novartis	Foradil® Certihaler™	Asthma
	AstraZeneca	Pulmicort® HFA	Asthma
	Kos/SkyePharma	Flutiform®	Asthma
	SkyePharma	Formoterol HFA	Asthma
	Novartis	QAB 149	Asthma/COPD
Injectable	Enzon/Mundipharma	DepoCyt®	Oncology
	Endo/Skyepharma	DepoDur™	Post Operative Pain
	Mundipharma/Maruho	DepoBupivacaine™	Local Anaesthetic
	Astralis*	Psoraxine™	Psoriasis
	SkyePharma	HGH	Growth Disorders
	SkyePharma	Interferon alpha-2b	Anti-viral/Oncology
	SkyePharma	GCSF	Oncology
Topical	Bradley/Shire	Solaraze®	Actinic Keratosis
	Dr Reddy's†	Multiple†	Dermal
Solubilisation	First Horizon/SkyePharma	Triglide™	Cardiovascular
	SkyePharma	Propofol IDD-D™	Anaesthesia/Sedation
	Baxter	Multiple	Undisclosed

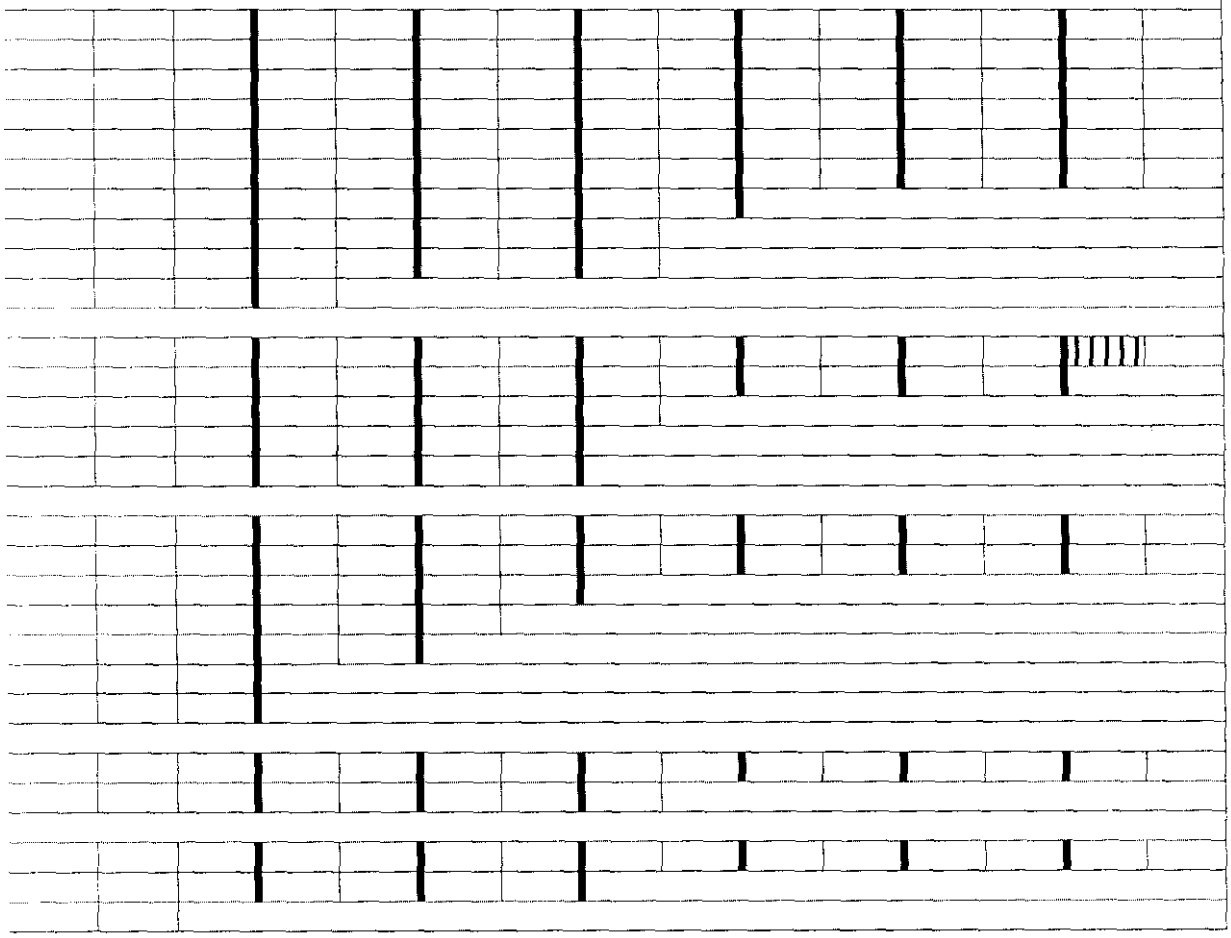
In addition there are a number of early stage and internal development projects at various stages for each of the technology platforms.

Oral	5
Inhalation	2
Injectable	5

* Through a service agreement, SkyePharma is providing development, manufacturing, pre-clinical and clinical development services to Astralis for second generation Psoraxine™, up to completion of Phase II studies. In the event that Phase II studies are successfully completed, Astralis will offer SkyePharma the option to acquire worldwide licensing and distribution rights to Psoraxine™.

† SkyePharma has licensed its dermatology assets to Dr Reddy's. The status of the most advanced product is shown in the above chart.

Feasibility	Phase I	Phase II	Phase III	Filed	Approved	Marketed
In vitro (laboratory) feasibility study to determine whether, under laboratory conditions, the formulation of the product candidate can be achieved.	First stage of human clinical testing for toxicity in healthy human volunteers.	Additional in vivo testing may be performed (also called pre-pivotal trials) involving a small patient population to evaluate the optimal clinical dose.	Trials in an expanded patient population, typically at dispersed sites. All of the improved outcome or new products under development require a Phase III trial. Also called pivotal trials.	SkyePharma or its partners file for regulatory approval in the jurisdictions in which it is intended that the product will be marketed. For example, in the US, this will require filing with the FDA and in the European community with the EMEA.	Approved by the relevant regulatory authority, awaiting launch.	Marketed by partner or licensee.



Products on the Market

Paxil CR™
An oral formulation of GlaxoSmithKline's SSRI antidepressant Paxil®. Our Geomatrix™ technology reduces gastrointestinal side-effects, an issue with all drugs of this class. Paxil™ CR was off the US market between March and June 2005 because of a manufacturing problem at GSK's Puerto Rico plant. Demand for Paxil CR™ has recovered since the product returned to the market but not to the former level.

Solaraze®
A topical treatment for actinic keratosis, a common pre-cancerous skin condition caused by over-exposure to sunlight. Solaraze®, based on our hyaluronic acid gel formulation, is licensed to Bradley Pharmaceuticals in the USA and to Shire Pharmaceuticals in Europe and Australasia.

Xatral® OD
A once-daily oral version of Sanofi-Aventis' alfuzosin for the urinary symptoms of benign prostatic hypertrophy. Xatral® OD has been on the market in Europe and other territories since 2000 and was launched (as Uroxatral®) in the US in November 2003.

DepoCyt®
A treatment for lymphomatous meningitis, a late-stage complication of cancer, based on our sustained-release injectable technology. DepoCyt® is marketed by Enzon Pharmaceuticals in the USA and by Mundipharma International in Europe (as DepoCyte®).

DepoDur™
A sustained-release injectable formulation of morphine. A single epidural injection during surgery provides effective relief of post-operative pain for 48 hours. DepoDur™ was launched at the end of 2004 by our US partner Endo. UK approval was granted recently.

Triglide™
An oral treatment for lipid disorders, Triglide™ employs our IDD-P™ solubilisation technology to overcome the insolubility of fenofibrate, an otherwise valuable treatment for this common condition. Triglide™ was launched in July 2005 by our US partner First Horizon Pharmaceuticals.

SkyePharma uses drug delivery technologies to improve the characteristics of pharmaceutical products. Normally we work with medicines that have already been shown to be safe and effective but which have disadvantages in terms of dosing. By reformulation, we can often improve the therapeutic effect, minimise side-effects and make dosing more convenient for the patient.

Our delivery technologies cover four routes of administration: oral, inhaled, injectable and topical. Together these four routes account for over 90% of all drugs now on the market. Our fifth technology, solubilisation, is designed to overcome a growing problem for the pharmaceutical industry: low bioavailability of many promising drug leads. All of these delivery technologies have now been validated by market approval.

Upcoming Products

Foradil® Certihaler™
A new version of Novartis' long-acting bronchodilator formoterol for asthma. SkyePharma developed not only the multi-dose drypowder inhaler device but also the unique formulation of the drug. The product has now been approved in 24 countries in Europe, the Middle East, Latin America and South Africa and New Zealand and received an "approvable" letter from the FDA in April 2006. In Foradil® Certihaler™ our inhaler and formulation technologies successfully achieve repeat dose consistency. This technology is employed in a second collaboration with Novartis for indacaterol (QAB 149), a novel long-acting bronchodilator.

Propofol IDD-D™
An injectable anaesthetic and sedative. Our formulation was designed to avoid the need for a preservative and to be suitable for long-term use in intensive care units. Although this product completed Phase II trials in 2004, the Phase III trial has not yet commenced and in April 2006 we agreed with our North American partner Endo to terminate the joint development of Propofol IDD-D™.

Pulmicort® HFA-MDI
A new pulmonary formulation of AstraZeneca's Pulmicort™ (budesonide) in an HFA-powered metered-dose aerosol inhaler. AstraZeneca filed for European approval in June 2005 and the first European approval came in February. We have developed this new version of AstraZeneca's asthma drug Pulmicort®. Our aerosol inhaler is powered by environmentally friendly HFA and will allow the current CFC-powered version to be withdrawn.

Requip Once-a-day
A new oral version of GlaxoSmithKline's Requip® for Parkinson's disease. The long-acting formulation should bring therapeutic benefits as well as convenience. Phase III trials of Requip Once-a-day have been completed and we expect GSK to file for approval before year-end. Dopamine agonists like Requip® are increasingly recommended for first-line use in Parkinson's. Our once-daily version addresses the major disadvantage of the current product: the need for dosing three times a day.

Flutiform™

The world market for asthma drugs is expected to exceed $20 billion by 2010, with use in chronic obstructive pulmonary disease (COPD) expected to add a further $10 billion. The fastest-growing part of this market is combination treatments, which combine a long-acting bronchodilator with an inhaled steroid in a single delivery device. Combinations are not only convenient for patients but also optimise the efficacy of the individual agents. Sales of GlaxoSmithKline's combination Advair (Seretide in Europe) already exceed $6 billion and AstraZeneca's Symbicort (which is not yet on the US market) add another $1 billion. By 2010 the combination category is expected to account for over half of the asthma/COPD market by value.

SkyePharma's product Flutiform™ consists of a fixed-dose combination of the bronchodilator formoterol with the inhaled steroid fluticasone in a proprietary metered-dose aerosol inhaler with a dose counter. Formoterol provides 12 hours of bronchodilation and has a rapid onset of action (1-3 minutes). By contrast salmeterol, the bronchodilator used in GlaxoSmithKline's Advair/Seretide, is also a twice-daily product but has the drawback of needing 30-45 minutes after inhalation to take effect. The inhaled steroid fluticasone (a component of Advair/Seretide) is perceived to have a better safety and efficacy profile than budesonide, the steroid used in AstraZeneca's Symbicort, and is the physician-preferred inhaled steroid in the US. The SkyePharma formulation technology employed in Flutiform™ provides patent protection to 2019.

The Phase III trial of Flutiform™, started in February 2006, is on track for our target of filing in the second half of 2007 and US market entry in early 2009. SkyePharma has extensive experience in development of respiratory products and we also consider this to be a low-risk clinical development as both formoterol and fluticasone are already approved entities. We are therefore confident of our ability to meet these timelines.

We believe that Flutiform™ will be at worst the third combination on the US market and differentiated from both Advair and Symbicort. There is potential to position Flutiform™ as "Best in Class" and no other significant competitors are expected to enter the US market before 2012 at the earliest. Furthermore there is limited risk of generic competition in the combination asthma market because there is no recognised test for bioequivalence after inhalation dosing and therefore no basis for approval of an "AB rated" generic inhaled drug in the US market. A generic company would therefore have to conduct clinical trials, which is much more expensive and risky than development of a conventional oral generic drug – so typical generic deep-discount pricing would not be possible. We therefore anticipate a peak sales potential for Flutiform™ well in excess of $1 billion with an appropriate marketing partner.

In September 2005 we therefore decided to raise funds to proceed with Phase III development at our own expense. The Phase III trials will cost in excess of $50 million. This decision kept development under our control and reduced the risk of delays to market entry that could jeopardise the sales potential of Flutiform™. Our decision to proceed with development was vindicated by the excellent terms of a licence agreement with Kos Pharmaceuticals for the US market announced in May 2006. Kos is a highly successful specialty pharmaceutical company and we are confident that we have now found an ideal marketing partner for Flutiform™ in the key US market. We remain in discussions with other potential partners for other major territories.

The Shares

SkyePharma's shares are listed on the London Stock Exchange (where the ticker symbol is SKP). The company's American Depository Receipts ("ADRs") are listed on the US NASDAQ exchange (ticker symbol SKYE). One ADR represents 10 ordinary shares.

Share price performance

World stock markets improved in 2005, although growth was notably stronger outside the USA. Despite continued robust US economic growth, the S&P 500 index only rose by 3%. Smaller capitalisation stocks tracked the majors in 2005, with the US Nasdaq index rising by 1% while the Dow Jones Industrial Average of heavyweight stocks was unchanged. However most European markets achieved double digit gains, with the UK FTSE 100 Index up by 17%, and the Japanese market staged a strong recovery with a 40% gain. The generally strong stock market performance in 2005 was remarkable considering negative factors such as high energy prices, the progressive increase in US interest rates, the terrorist attacks in London and the destruction of New Orleans by hurricane Katrina (and the consequent disruption of the US energy and shipping industries).

In the US, major pharmaceutical stocks remained dogged by investor concerns over drug safety, declining R&D productivity and pressure on prices. In the US the share price of market leader Pfizer fell by 13%, a second successive year of decline, and despite some recovery in other stocks the sector average was down by 1%. By contrast the European pharma companies, less exposed to the US market, had a good year with the sector average up by 28%, outperforming the general market. In the UK GlaxoSmithKline was up by 20% and AstraZeneca by 50%.

Investor sentiment towards SkyePharma in 2005 remained affected by the continuing delay in the identification of a development and marketing partner for Flutiform®, the company's major pipeline product. This culminated in the announcement in September of a discounted Rights Issue when the company decided to raise funds to proceed with the Phase III development at its own expense and seek a marketing partner at a later date. During 2005, SkyePharma's share price fell by 23% from 65 pence to 50 pence. The year's low was 35 pence (in October) and the high 65 pence (in January). For comparison, the broad FTSE All-share index rose by 18% in 2005.

During 2005 the FT Pharmaceutical and Biotechnology sector index, which is heavily weighted towards pharmaceutical companies, staged a recovery to rise by 28%, outperforming the UK market as a whole. Although the SkyePharma share price declined during 2005, the strong gain in 2003 means that over the 2003-05 period the performance has still been similar to that of the Pharma sector.

The final chart compares the performance of SkyePharma shares in 2005 with that of the TechMARK Mediscience index, an index composed of UK companies of similar investment characteristics. It is clear that the broad pattern of performance during the year was similar up to September when the SkyePharma share price was depressed by the announcement of the rights issue.

Market capitalisation

On 30 December 2005 (the last trading day of the year), SkyePharma's market capitalisation was £375 million (US$645 million), compared with £406 million (US$780 million) a year earlier. The chart below shows the trend in the company's market capitalisation in sterling and in US dollars during 2005.

Issued share capital

SkyePharma's issued share capital at the end of 2005 amounted to some 754 million shares (against 622 million shares at the end of 2004). In addition the company had 40 million share options outstanding and certain contingent shares and warrants. The company's share option scheme aims to incentivise staff and to align shareholder and management objectives.

During 2005 SkyePharma had a rights issue, offering 126 million new shares on the basis of one new share at 30 pence per share for every five held. The issue, managed by Credit Suisse, SkyePharma's broker, was fully underwritten and raised £35 million net of expenses. For regulatory reasons, the issue was not available to shareholders in certain countries, including the USA and Canada.

During 2005 SkyePharma also raised £20 million by an issue of 2025 convertible bonds. The £10 million of 2005 convertible bonds that were not exchanged for 2024 bonds in the 2004 exchange offer were repaid. Conversion of the outstanding 2024 and 2025 convertible bonds (using conversion prices that have been automatically adjusted for the 2005 rights issue) would involve the issue of a further 109 million shares.

Shareholders

At the end of 2005, SkyePharma had 17,000 shareholders. Share ownership in SkyePharma is concentrated, with the top 10 shareholders owning 55% of the shares and the 25 largest shareholders owning over 70%. We estimate that approximately 66% of SkyePharma's shares are held by institutional or corporate investors and 34% by private individuals (including holders of the company's ADRs, believed to be primarily owned by US retail investors). Fig 1 shows the distribution of share ownership.

Fig 1: Ownership distribution as at 31 December 2005

Number of shares held	Number of shareholders	% of shareholders	% of shares in issue
Less than 1,000	6892	40.3%	0.5%
1000 - 10,000	8584	50.2%	3.7%
10,000 - 100,000	1297	7.6%	4.3%
100,000 - 1 million	228	1.3%	10.0%
Over 1 million	90	0.5%	81.5%

As in 2004, the international fund manager Fidelity was SkyePharma's largest shareholder, albeit with a somewhat reduced holding of 78 million shares (representing 10.1% of the issued share capital) at the end of the year (this holding has since largely been sold). Two new investors became the second and third largest holders, Insight Investment with 68 million shares (9.0% of the issued share capital) and the specialist Swiss investment fund HBM Bioventures with 64 million shares (8.5% of the issued

share capital). As of 31 December 2005, the 10 largest shareholders collectively owned 412 million shares, over half of the issued share capital (see Fig 2).

Fig 2: Ten largest shareholders[1] as at 31 December 2005

Shareholder	Shareholding[1] (million)	% of shares in issue
Fidelity Investments	78.1	10.1%
Insight Investment	67.8	9.0%
HBM Bioventures	63.8	8.5%
Morley Fund Management	43.6	5.8%
ADRs	37.5	5.0%
Dr Jacques Gonella	37.4	5.0%
Kowa Company	30.0	4.0%
Legal & General Investment Management	27.4	3.6%
J O Hambro Capital Management	15.1	2.0%
BGI	11.1	1.5%

Note 1: The investor holding information in this table is derived from our analysis of the share register, which combines shareholding data and the responses to our enquiries issued under Section 212 of the Companies Act (1985). The reported institutional shareholdings may therefore include funds which are non-beneficially owned and/or those which are managed on a discretionary basis by the investor. As such some institutional shareholdings stated may differ from the figures reported by those institutions on a beneficial ownership basis only.

At the end of 2005, 58% of SkyePharma's shares were held by shareholders domiciled in the United Kingdom, the same proportion as at the end of 2004. The proportion of shares owned by individuals or legal entities domiciled outside the UK was 42%. The chart below (Fig 3) shows the percentage distribution of the shares held by non-UK shareholders by country of domicile, with Switzerland overtaking the USA as the most important country, followed by Japan and Canada.

Investor relations

It is the objective of SkyePharma's management and of its investor relations team to ensure a timely, open, comprehensive and consistent flow of information to investors and the financial community. By this means we aim to help investors to understand the Company's activities and strategic objectives and thereby facilitate the Company's access to capital markets. All information disseminated to institutional investors and analysts by print, email or fax is simultaneously made available on our website (www.skyepharma.com) so that private investors have equal access. We also webcast our regular meetings and teleconferences with analysts and investors and, wherever possible, our presentations at investment conferences.

SkyePharma takes a proactive stance on investor relations, with investor relations offices in London and New York. In 2005 we held 111 one-on-one meetings with shareholders or potential investors. The vast majority of these meetings included an executive management representative. In addition SkyePharma participated in 12 investment conferences in the USA and Europe during the year. The investor relations section of the company's website (which was redesigned during the year) attracted over 55,000 hits in 2005.

Analyst coverage

The sell-side analysts listed below currently issue regular reports on SkyePharma. Please note that any opinions, estimates or forecasts regarding SkyePharma made by these analysts are theirs alone and do not represent opinions, forecasts or predictions of SkyePharma or its management. SkyePharma does not by its reference below or distribution imply its endorsement of or concurrence with such information, conclusions or recommendations.

Nomura CODE Securities (Paul Diggle)
Credit Suisse (Andrew Sinclair)
Evolution Securities (Jonathan Senior)
Jefferies (Robin Campbell)
WestLB (Daniel Wendorff)
Seymour Pierce (Sav Neophytou)

Corporate Social Responsibility

As a pharmaceutical company, our mission is to develop better medicines to improve the treatment of human disease. We believe that this in itself is a worthwhile enterprise. Furthermore, the pharmaceutical industry as a whole is intensively regulated to ensure that all medicinal products are both safe and effective and manufactured to the highest standards. We also recognise that our business will prosper for the long term only if we act in a responsible manner and we are conscious of growing interest among investors and other stakeholders in the compliance of companies with ethical, social and environmental issues.

Ethical issues

We aim to demonstrate and promote the highest standards of honest and ethical conduct throughout our Company. We have established formal policies and procedures, including a Code of Ethics for Senior Financial Officers and a Complaints and Whistleblowing Procedure. A Code of Business Conduct and Ethics has been introduced throughout the Company that complies with or exceeds the requirements of the published US SEC/Nasdaq Code of Business Conduct and Ethics.

Employment issues

SkyePharma is committed to a policy of equal opportunities in its employment practices. We believe that the contribution an employee can make should not be affected by factors such as gender, age, marital status, disability, sexuality, race, colour, religion, ethnic or national origin or any other conditions not relevant to the performance of the job. Our formal Equal Opportunities Policy is posted on the Company's website. We also recognise that a safe, secure and healthy working environment contributes to productivity and improved performance. All employees are encouraged to participate in the Company's share purchase scheme, and we promote internal communication of the Company's progress by means of an "intranet" and our periodic SkyePharma publications, "Skye News" and "Frank Talk".

The Environment

As a Company we are committed to protecting the environment in which we conduct our activities. Our formal Environmental Policy aims to foster a positive attitude towards the environment and to raise the awareness of employees to responsible environmental practices at all sites operated by the Company. We ensure compliance with all relevant legislation and regulatory requirements and where practical and economically viable we develop standards in excess of such requirements. Although we are only a small-scale manufacturer, we aim to set a high standard through continuous improvement in our environmental performance. We now undertake routine monitoring of various measures of our environmental performance at our main R&D and manufacturing sites in Switzerland, France and the USA, the results of which are submitted to external review bodies.

The left-hand chart shows that achieving further environmental improvements was more challenging in 2005 than in the prior year, largely because of product and process mix effects. These had the unfortunate consequence of not only increasing the amount of material that had to be incinerated but also reducing the amount that could legally be recycled. Our choice of production processes for pharmaceuticals is dictated by regulatory bodies and often there is little that we can do to modify our processes. The value of our production nearly quadrupled in 2005 even though there was a 14% decline in production unit volume. Our use of energy declined by 2% although our consumption of water rose by 12%. The amount of waste incinerated increased by 142% and waste disposed by landfill by 27% and there was a 3% decline in the amount of waste recycled. While this is disappointing, the right-hand chart shows that we have made progress in the amount of waste recycled since 2002.

The Community

We aim to be a 'good neighbour' wherever we have business units and to be active participants in the community. While we do not believe that we have a mandate from shareholders for the Company to make charitable donations, we do encourage our employees to support various charitable causes.

Financial Review

Turnover

The Group's revenues continue to be sensitive to the timing and receipt of milestone payments and payments received on the signing of new contracts. Revenues for 2005, at £61.3 million, were 18% below the £75.2 million reported in 2004. This was primarily due to the absence of a licensing transaction on Flutiform™, continuing Paxil CR™ supply problems and slower overall market penetration of Triglide™ and DepoDur™ by marketing partners, partly offset by an increase in manufacturing and distribution revenues. In addition the Company undertook a strategic shift away from licence terms that prioritise upfront payments on signature towards deal structures with higher royalty rates and increased milestone payments tied to product revenue targets. Despite the decline in 2005, revenues have nevertheless increased at a cumulative annual growth rate of 24% since 1996.

The absence of a licensing agreement on Flutiform™ had a double negative impact on SkyePharma in 2005. First, revenues suffered from the absence of the anticipated milestone payment and of a partner's contribution towards continuing development costs of Flutiform™. Secondly, SkyePharma's R&D costs *exceeded budget expectations because of the need* to press ahead with the development programme without a partner in order to avoid the risk of impairment to the commercial potential of this key product if development was delayed.

Contract development and licensing revenue decreased 30% to £27.6 million, compared with £39.4 million in 2004. This was primarily due to the absence of an anticipated milestone from the licensing of Flutiform™ and the change in the structure of our licence agreements described above.

Revenues recognised from milestone payments and payments received on the signing of agreements amounted to £22.1 million in 2005 compared with £33.4 million in 2004. The 2005 total included revenues from First Horizon for the US marketing and distribution rights for Triglide™ triggered by FDA approval in May 2005 from Mundipharma for the licensing of DepoBupivacaine™ for Europe and from Maruho for the licensing of DepoBupivacaine™ for Japan. In addition, £5.7 million of revenue was recognised from GlaxoSmithKline on the phase III clinical trials of Requip (ropinirole), from AstraZeneca on the phase III clinical trials of Pulmicort® HFA and from Novartis on the phase II clinical trials of QAB 149. Research and development costs recharged fell by 8% to £5.5 million, compared with £6.0 million in 2004. This was mainly due to a fall in the costs recharged to Micap plc in respect of the development of their microencapsulation technology which has now been completed.

Royalty income decreased by 16% to £21.7 million, compared with £25.9 million in 2004. Royalty income in 2005 derives principally from Paxil CR™, Xatral® OD, DepoCyt™, Solaraze™, DepoDur™ and Triglide™. Although the Company was able to negotiate an increase in the royalty rate it receives on GlaxoSmithKline's sales of Paxil CR™ from 3% to 4% with effect from March 2005 and also received royalties based on budgeted sales while the product was temporarily off the US market, royalties were still negatively impacted by the continuing supply problems experienced by GlaxoSmithKline. Excluding Paxil CR™, royalties for the balance of SkyePharma's other products grew by 38%. In addition royalty growth was less than anticipated due to slower overall market penetration of Triglide™ and DepoDur™ by marketing partners during the year.

Manufacturing and distribution revenue increased by 21% to £12.0 million, compared with £9.9 million, mainly due to higher production of clinical trial material and launch quantities for Novartis in respect of QAB 149 and Foradil® Certihaler™.

Deferred income
During 2005, there was a net reduction in deferred income of £3.5 million under SkyePharma's revenue recognition policy. The movement in deferred income was:

	31 December 2004 £m	Received* £m	Recognised £m	31 December 2005 £m
Contract development and licensing revenue	14.1	24.1	(27.6)	**10.6**

* Includes exchange adjustments

Cost of sales
Cost of sales comprises research and development expenditures, including the costs of certain clinical trials incurred on behalf of our collaborative partners; the direct costs of contract manufacturing; direct costs of licensing arrangements and royalties payable. Cost of sales increased by 4% to £29.2 million in 2005, compared with £28.2 million in 2004. This was mainly due to an increase in manufacturing and distribution expenses ahead of the approval and launch of Triglide™. The resulting gross profit decreased 32% to £32.1 million, compared with £47.0 million in 2004.

Expenses
Selling, marketing and distribution expenses increased significantly to £5.9 million, compared with £1.7 million in 2004. This mainly reflected SkyePharma's contribution towards the initial launch and marketing costs of DepoDur™ and Triglide™. No further marketing contributions are due in respect of DepoDur™ and contributions on Triglide™ will terminate in 2007. The Company's total costs in respect of Triglide™ in 2005 amount to approximately £4.6 million.

Amortisation of intangible assets decreased slightly to £2.1 million, compared with £2.2 million in 2004.

Other administration expenses before exceptionals were £13.8 million in 2005, 12% lower than the £15.6 million reported in 2004, reflecting the first full year of cost savings following the restructuring started in 2004. The exceptional charge of £21.4 million comprises non-cash impairment charges of £19.4 million and abortive transaction costs of £2.0 million. Following the Strategic Review and the Group's decision to focus on its core oral and pulmonary products and to divest its injectable business, the Group no longer views its collaborations with Astralis, Vital Living and Micap as strategic and these investments have therefore been impaired. In addition, as an injectable project, SkyePharma's entitlement to negotiate for commercial rights for Psoraxine™, Astralis' key product, is being offered with the injectable business interests. The remaining £2.0 million exceptional charge relates to legal and professional fees relating to an aborted transaction, as outlined in the Chairman's statement. Other administration expenses including exceptional items increased by £14.9 million to £35.2 million.

SkyePharma's own research and development expenses in the year decreased by £2.0 million to £26.0 million, mainly due to a reduction in expenditure on Pulmicort® HFA, DepoDur™ and other injectable products, partly off set by an increase in expenditure on Flutiform™ and DepoBupivacaine™ in advance of their commencement of phase III clinical trials.

The other expense of £0.4 million comprises a £0.7 million loss due to the movement in the fair value of the Group's investment in GeneMedix plc, partly off set by a £0.3 million profit on disposal of part of the Group's holding of Vectura Group plc shares.

Results
The operating loss before exceptional items was £16.1 million, compared with £0.4 million in 2004, due principally to the reduction in revenue and to increased marketing contributions. The operating loss after exceptionals increased by £34.4 million to £37.5 million, mainly due to the higher exceptional charges and fall in revenue.

The finance costs of £22.3 million (2004: £23.9 million) mainly comprise notional interest on the Paul Capital funding liabilities as well as interest on the convertible bonds. Finance income includes £9.0 million (2004: £6.0 million) in respect of a change in the estimated future payments to Paul Capital.

The Group's share of the losses of Astralis was £0.8 million for 2005, compared with £10,000 in 2004.

The retained loss after exceptionals increased by £32.3 million to £50.9 million, also due to the higher exceptional charges and fall in revenue.

Earnings before interest, tax, depreciation amortisation and exceptionals showed a loss of £8.5 million in 2005, compared with a profit of £7.8 million in 2004.

The loss per share after exceptionals was 8.1 pence, which compares with 3.0 pence in 2004.

Foreign currency movements did not have a material impact on the results of operations in 2005 compared with 2004.

Segment information

Segmental information on revenue and operating loss before exceptionals is as follows:

Revenue	Year ended 31 December 2005 £m	Year ended 31 December 2004 £m
Injectable	**10.5**	25.6
Oral and Inhalation	**50.8**	49.6
	61.3	75.2

Operating loss pre exceptional items		
Injectable	**(18.6)**	(1.4)
Oral and Inhalation	**2.5**	1.0
	(16.1)	(0.4)

Business segment data includes an allocation of corporate costs to each segment.

Balance sheet

The Group balance sheet at 31 December 2005 shows shareholders' equity of £31.9 million (2004: £36.5 million).

In September 2005 the Group raised £34.8 million net of expenses by means of a rights issue of 125,627,357 new Ordinary Shares on the basis of one new share for every five held.

In July 2004 the Group exchanged £49.6 million of its convertible bonds due June 2005 for convertible bonds due May 2024, leaving £9.8 million of the 2005 bonds outstanding. The £49.6 million 2024 convertible bonds were consolidated to form a single series with the £20 million 2024 bonds issued in May 2004. In 2005 the Group issued £20 million 8% convertible bonds due June 2025. In June 2005 the company repaid the £9.8 million balance on the convertible bonds due June 2005. As a result of these transactions the Group has £69.6 million convertible bonds due May 2024 and £20 million convertible bonds due June 2025 outstanding as at 31 December 2005. On the balance sheet these are reflected as £63.6 million in liabilities and £28.4 million in equity.

In addition the Group has Other Borrowings at 31 December 2005 of £44.6 million due to Paul Capital Royalty Acquisition Fund. Whilst the contractual arrangements contemplate the payment of royalties to Paul Capital as outlined in note 23, IAS 39 requires the Company to record a liability equal to the net present value of the royalties the Company expects to pay Paul Capital over the term of the agreement.

Financial assets held at fair value comprise a £3.25 million 5% convertible loan note from GeneMedix plc. This has been recorded at £0.4 million at 31 December 2005, being the lower of cost and net realisable value assuming conversion of the note into GeneMedix ordinary shares.

Liquidity and capital resources

At 31 December 2005 SkyePharma had cash and short term deposits of £34.3 million and no bank overdraft, compared with £15.3 million net cash at 31 December 2004. Bank and other non convertible debt amounted to £9.9 million at 31 December 2005 (2004: £11.1 million), consisting principally of a £6.9 million property mortgage secured on the assets of Jago (2004: £7.4 million). In addition the Company has 6% convertible bonds due May 2024 of £69.6 million (2004: £69.6 million) and 8% convertible bonds due June 2025 of £20.0 million (2004: £Nil). Net debt (excluding the Paul Capital funding liabilities) amounted to £39.2 million (2004: £55.6 million).

In 2005 there was a net cash outflow from operating activities of £7.6 million, compared with £3.7 million in 2004. During the year the Group spent £2.6 million on property, plant and equipment and expenditure on intangible assets of £2.3 million mainly relates to the purchase of licenses to intellectual property in the area of pulmonary delivery. The proceeds on disposal

of the Group's non strategic holding of Vectura shares were £1.6 million.

Cash inflows from financing in 2005 were £30.6 million (2004: £2.9 million). The Group raised £34.8 million net of expenses by means of a rights issue of 125,627,357 new Ordinary Shares. During the year the Group issued £20 million 8% convertible bonds raising £18.8 million net of expenses. In addition the company repaid the £9.8 million balance on the convertible bonds due June 2005.

Borrowings of £7.4 million were repaid in the period (2004: £8.6 million). This primarily comprises Paul Capital's share of the Company's royalty income.

The Group paid £2.0 million of costs relating to an aborted strategic transaction during the year.

International Financial Reporting Standards
The financial information for the year ended 31 December 2005 has been prepared for the first time in accordance with IFRS. In preparing the financial information certain first time adoption provisions have been applied. The Group has established IFRS accounting policies which can be found in note 1. Since the Interim Report 2005 and IFRS restatement announcement in August 2005 the Group has changed its interpretation of the application of IAS 39 to the Paul Capital funding liabilities. The restatement resulted in a decrease in the 2004 net interest expense of £5.2 million and in the liability at 31 December 2004 of £4.3 million. Further information on the impact of our transition to IFRS can be found in note 37.

US GAAP
A reconciliation from IFRS to US GAAP will be included in the Company's Form 20-F to be filed with the SEC in June 2006.

Forward looking statements
The foregoing discussions contain certain forward looking statements and are made in reliance on the safe harbour provisions of the US Private Securities Litigation Act of 1995. Although SkyePharma believes that the expectations reflected in these forward looking statements are reasonable, it can give no assurance that these expectations will materialise. Because the expectations are subject to risks and uncertainties, actual results may vary significantly from those expressed or implied by the forward looking statements based upon a number of factors, which are described in SkyePharma's 20-F and other documents on file with the SEC. Factors that could cause differences between actual results and those implied by the forward looking statements contained in this Annual Report include, without limitation, risks related to the development of new products, risks related to obtaining and maintaining regulatory approval for existing, new or expanded indications of existing and new products, risks related to SkyePharma's ability to manufacture products on a large scale or at all, risks related to SkyePharma's and its marketing partners' ability to market products on a large scale to maintain or expand market share in the face of changes in customer requirements, competition and technological change, risks related to regulatory compliance, the risk of product liability claims, risks related to the ownership and use of intellectual property, and risks related to SkyePharma's ability to manage growth. SkyePharma undertakes no obligation to revise or update any such forward looking statement to reflect events or circumstances after the date of this Annual Report.

> "Excluding Paxil CR™, royalties for the balance of SkyePharma's other products grew by 38%."

Donald Nicholson
Finance Director

Directors and Officers

Dr Jerry Karabelas (aged 53)
Non-Executive Chairman since 2 February 2006, appointed Non-Executive Director in November 2000. Dr Karabelas has more than 23 years' experience in the pharmaceutical industry having spent most of his career with SmithKline Beecham. Dr Karabelas is a partner at Care Capital LLC. He was previously the CEO of Novartis Pharma AG where he had responsibility for pharmaceuticals, R&D, consumer products, and the generics business. He is an external director of the International Partnership for Microbicides and Chairman of Human Genome Sciences. He is also a director of NitroMed Inc., Acura Pharmaceuticals Inc., Inotek Pharmaceuticals Corporation, Anadys Pharmaceuticals Inc., Renovo Ltd., and a member of the scientific advisory board of Epigenesis Pharmaceuticals LLC and CardioKine Inc.

Michael Richard Dywer Ashton (aged 60)
Executive Director. Formerly Chief Executive Officer from November 1998 until 1 March 2006. He was appointed to the Board in March 1997. He has over 33 years of experience in the pharmaceutical industry having worked for Merck Inc., Pfizer Inc., Purepac Inc. and prior to this appointment, Faulding Inc. where Mr Ashton was Chairman, President and CEO. He is a non-executive director of Transition Therapeutics Inc., Astralis Limited, Hikma Pharmaceuticals plc, Proximagen Neuroscience Ltd and Vital Living Inc.

Air Chief Marshal Sir Michael Gordon Beavis (aged 76)
Non-Executive Director, appointed in May 1989 and appointed Senior Independent Non-Executive Director in May 2001. He entered the Royal Air Force in 1947 and retired in 1987, his last appointment being Deputy Commander-in-Chief Allied Forces Central Europe, NATO. He is a defence consultant with Burdeshaw Associates USA, a Companion of the Chartered Management Institute, a Freeman of the City of London and a Liveryman in the Guild of Air Pilots and Navigators.

Dr David Ebsworth (aged 51)
Non-Executive Director, appointed in April 2002. Dr Ebsworth has over 20 years of pharmaceutical industry experience. He provides consultancy services to a variety of clients including venture capital companies. He was chief executive officer of Oxford GlycoSciences PLC until May 2003. Prior to this he held the position of president and general manager of the Pharmaceutical Business Group for Bayer AG in Leverkusen, Germany, and has also worked for Bayer AG in a series of global positions in Canada, Europe and the United States. Dr Ebsworth is non-executive chairman of Wilex AG, Xention Discovery Ltd and Curacyte AG as well as non-executive director of Intercell AG and CuraGen Corporation and held the same office, until 1998, with Schein Pharmaceuticals, Inc. (now known as Watson Pharmaceuticals, Inc.).

R Stephen Harris (aged 63)
Non-Executive Director, appointed in November 1995. He has 40 years' commercial experience in the pharmaceutical industry, having worked for ICI Pharmaceuticals, Merck, Eli Lilly, Boots, Reckitt & Colman and Gensia; and was director of Development and Licensing with Medeva PLC. He is non-executive chairman of Proteome Sciences plc, Sinclair Pharma PLC and Conve Ltd and non-executive director of Advanced Medical Solutions Group PLC, Prophilian PLC, Premier Research PLC and GeneMedix PLC.

Dr Keith Mansford (aged 74)
Non-Executive Director appointed in March 1996. He has over 45 years of experience in the pharmaceutical and biotechnology sectors principally with Beecham Group and SmithKline Beecham. From 1984 to 1992 Dr Mansford was Chairman of Research and Development at Beecham Group and subsequently SmithKline Beecham PLC. He is an External Director of Sepracor Inc, chairman of Protemix Inc, a biotech company based in New Zealand, and Professor of Metabolic Biochemistry at the University of Buckingham.

Alan Bray (aged 61)
Non-Executive Director, appointed in September 2004. Mr Bray is a chartered accountant having retired as a senior partner from Deloitte & Touche LLP's financial services practice in May 2004. Mr Bray has worked with retail and investment banks, insurance companies and asset management firms and was seconded for a time to the Department of Trade and Industry. He was responsible for Deloitte & Touche LLP's risk management policies and procedures in its financial services practice and was a serving member on a DTI Supervisory Board and Audit Committee.

Frank Condella (aged 51)
Became Chief Executive Officer in March 2006 and was appointed to the Board in April 2006. Mr Condella has over 25 years' commercial experience in the pharmaceutical industry, having worked for several major international companies. Prior to joining SkyePharma he served as President of European Operations for IVAX, CEO of Faulding Pharmaceuticals, Vice President of the Specialty Business for Roche, and the Lederle unit of American Home Products. He holds a BS in Pharmacy degree and an MBA from Northeastern University in Boston, Massachusetts.

Dr Ken Cunningham (aged 53)
Became Chief Operating Officer in April 2006. He was appointed to the Board in May 2006. Dr Cunningham is former CEO of Arakis from January 2002 to August 2005; Vice President European Affairs for Alza Corporation and Vice President Clinical Development for Sequus Pharmaceuticals. Previously he held a variety of clinical development and commercial strategy positions in GlaxoWellcome and Warner-Lambert. He is a non-executive director of Xention Discovery Ltd. Dr Cunningham qualified from St Mary's Medical School, London University.

Donald Nicholson (aged 48)
Finance Director, appointed in March 1997, joined the Company in February 1996. He is a member of the Institute of Chartered Accountants of Scotland. He began his professional career with Deloitte Haskins & Sells and has spent over 20 years in healthcare including Wellcome PLC and Corange Ltd, the holding company of Boehringer Mannheim and DePuy, where he was Corporate Strategy & Finance Director.

Douglas Parkhill (aged 54)
Company Secretary, appointed in September 2002. Mr Parkhill is a graduate of Glasgow University and a member of the Institute of Chartered Accountants of Scotland.

Report of the Directors

The Directors present their report on the affairs of the Group, together with the consolidated financial statements and auditors' report for the year ended 31 December 2005.

Principal activities and business review

A review of the Operating and Financial business and future developments of the Group is set out in the Chairman's Statement, Review of Operations and Financial Review.

The principal activities of the Group are the research and development, manufacture and sale of prescription pharmaceutical products.

Results and dividends

The Group made a loss for the year to 31 December 2005 of £50.9 million (2004: £18.6 million). The Directors do not propose to pay a dividend.

Research and development

The Group incurred research and development costs of £26.0 million (2004: £28.0 million) during the year which have been written off to the profit and loss account in accordance with the Group's accounting policy.

Environmental policy

The Company is conscious of its responsibilities in respect of the environment and has produced a group wide environmental policy.

Payment of creditors

The Group's policy is to pay its suppliers within 30 days from receipt of invoice unless otherwise agreed with suppliers prior to goods or services being ordered. Suppliers are made aware of the terms of payment and it is the Company's policy to abide by the agreed terms, subject to the terms and conditions being fulfilled by the supplier. At 31 December 2005, creditor days outstanding in respect of the Company amounted to 26 days (2004: 27 days).

Directors

The membership of the Board on 22 May 2006 was as follows:

Dr Argeris (Jerry) Karabelas
Michael Ashton
Frank Condella
Air Chief Marshal Sir Michael Beavis * †
Alan Bray * •
Dr Kenneth Cunningham
Dr David Ebsworth * † •
Stephen Harris † •
Dr Keith Mansford †
Donald Nicholson
Company Secretary: Douglas Parkhill

* Audit Committee † Remuneration Committee • Nomination Committee

In January 2006 Ian Gowrie-Smith stepped down as Non-Executive Chairman and in February 2006 retired from the Board. Dr Jerry Karabelas was appointed Chairman.

Michael Ashton, Sir Michael Beavis and Dr Keith Mansford will retire from the Board at the conclusion of the Annual General Meeting. Stephen Harris, having served more than nine years as a Non-Executive Director will offer himself for re-election at the Annual General Meeting in accordance with the recommendations of Section A.7.2 of the Combined Code. In the opinion of the Board Stephen Harris has been been key in the development of the Company and continues to provide a worthwhile contribution to its future growth.

The Directors retiring by rotation at the Annual General Meeting are Dr David Ebsworth and Donald Nicholson who, being eligible, offer themselves for re-election. Frank Condella and Dr Ken Cunningham, having been appointed since the last Annual General Meeting, offer themselves for re-election.

Details of Directors' interests in the share capital of the Company together with details of the share incentives granted to them are disclosed in the Remuneration Report on pages 37 to 52 of this Report and Accounts.

As at the date of this report, the Directors of the Company had an interest, beneficially and non-beneficially, in an aggregate of 3,751,168 Ordinary

Shares, representing 0.5% of the Company's issued share capital.

Directors' and officers' liability insurance
During the period under review, the Company and the Group maintained insurance policies for its Directors and officers in respect of liabilities which could arise in the discharge of their duties in the ordinary course of business.

Substantial shareholdings
In addition to Directors' interests as disclosed in the Remuneration Report on pages 37 to 52 the Company has been advised of the following individual interests which at 22 May 2006 exceeded 3% of the Company's issued share capital:

HBM BioVentures (Cayman) Ltd	10.2%
UBS AG and subsidiaries	5.9%
Dr J Gonella	5.0%
HBOS PLC and subsidiaries	4.1%
Kowa Company Limited	4.0%

Authority to make market purchases of Ordinary Shares
As at 31 December 2005 authority given by the shareholders at the 2005 Annual General Meeting for the Company to make market purchases of up to £6,223,987 nominal value of its Ordinary Shares at a price of not more than 105% of the current market price was still in force.

Employees and disabled persons
The Group is committed to a policy of promoting employees' awareness of its activities, encouraging employees' participation in the growth of the Group and welcomes staff input at all levels.

It is recognised that by far the most important form of involvement and information regarding the progress, performance and plans of the Group take place during informal daily discussions between management and other employees. Consultations occur to allow employee opinions to be heard when making decisions affecting their interests. It is Group policy to offer the same opportunity to disabled people as to all others in matters of recruitment and career advancement, provided they have the ability to perform the tasks required, with training where appropriate, and to institute retraining where practical in cases where disability is incurred during employment with the Group.

All employees may have the opportunity to participate in the Company's relevant share incentive schemes and the SkyePharma International Share Purchase Plan described in the Remuneration Report. Employee remuneration is determined on an annual basis by the Remuneration Committee and Executive Committee as appropriate. The Group attracts and retains employees of the highest calibre by offering remuneration that is in line with that offered by industry competitors and local practice in the countries in which it operates.

Charitable and political donations
No contributions were made to charities (2004: £Nil). No contributions were made to political organisations (2004: £Nil).

Close company provisions
The company is not a 'close' company within the meaning of the Income and Corporation Taxes Act 1988, and there have been no changes since the end of the year.

Annual General Meeting
At the forthcoming Annual General Meeting, the Company proposes to seek the usual authority to issue shares, limited disapplication of the statutory pre-emption rights on the issue of new shares and to seek authority to purchase shares in the market subject to compliance with relevant statutory and regulatory requirements. The Company also proposes to ask Members to approve the Remuneration Report of the Company. Further information on these proposals and on the Annual General Meeting is set out in the separate letter from the Chairman, which explains the reasons for these resolutions and also contains the Notice of Annual General Meeting.

Auditors
A resolution to reappoint PricewaterhouseCoopers LLP as auditors to the company will be proposed at the Annual General Meeting.

By order of the Board

Douglas Parkhill
Company Secretary
22 May 2006

Corporate Governance

This section contains the company's reporting disclosures on corporate governance required by the Combined Code on Corporate Governance of the Financial Reporting Council ("the Code") including the required statement of compliance. Comment is also made on compliance with the US laws and regulations that apply to it.

Governance and Policy
The Board is committed to ensuring high standards of corporate governance are maintained by SkyePharma. We believe that visibly high standards result in increased shareholder value and satisfaction.

The Board considers that during 2005 the Company complied with all relevant principles and provisions of the Code.

The Board and its processes
Board Membership
The Board currently comprises 4 Executive and 6 Non-Executive Directors, whose biographical details are listed under 'Directors and Officers' on pages 26 and 27.

The Executive and Non-Executive Directors are subject to retirement by rotation and re-election by shareholders in accordance with the Articles of Association whereby one third of the Directors retire by rotation each year. Michael Ashton, Sir Michael Beavis and Dr Keith Mansford will retire from the Board at the conclusion of the Annual General Meeting. Steve Harris having served more than nine years as a Non-Executive Director will offer himself for re-election at the Annual General Meeting in accordance with the recommendations of the Code. The Directors retiring by rotation at the Annual General Meeting are Dr David Ebsworth and Donald Nicholson who, being eligible, offer themselves for re-election. Frank Condella and Ken Cunningham having been appointed during the year, will offer themselves for election at the forthcoming AGM.

During the year the Board reviewed the composition of the Board, and the balance of skills, knowledge and experience its members brought, and concluded that the Board was of the appropriate size and balance for the Company though new Executive and Non-Executive Directors would be required due to the Board changes outlined above. The Board is actively recruiting new Board members and will be seeking the views of institutional shareholders prior to their appointment.

Board Balance and Independence
Whilst Chairman, Ian Gowrie-Smith was not considered to be independent due to his shareholding and previous executive employment with the Group. Dr Jerry Karabelas who replaced Ian Gowrie-Smith as Chairman is considered to be independent at the time of his appointment.

The Board considers that the remaining Non-Executive Directors are independent in both judgement and character and that they carry out their duties in an independent manner and provide constructive challenge to decisions. This is due to their ability to:
- rigorously analyse management reports;
- robustly defend their own points of view; and
- critically evaluate the pharmaceutical industry and the Company itself.

The Code indicates that independence may be compromised after nine consecutive years' service with a company. As explained above, Steve Harris has served for more than nine years. The Board believes, however, that he has been key in the development of the Company and he continues to make a valuable contribution to its future growth.

The Role of the Board
The Board of SkyePharma plc is responsible for the Group's system of corporate governance and internal control and is accountable for all its activities.

The Board reviews the operational performance of the Group on a regular basis and also exercises a number of reserved powers including:
- responsibility for setting the strategic direction of the Group;
- approving the key operating plan and annual budget;
- appointment and dismissal of any Board member, senior manager or Company Secretary;
- approving substantial (i.e. over £0.5m) investments;
- authorisation of financing, treasury and risk management policies;
- approving the annual and interim reports;
- approving and monitoring compliance with the Company's Codes of Ethics and Conduct, including whistleblowing procedures;

- ensuring that the Company has adequate internal control systems; and
- establishing committees of the Board (namely, the Audit, Remuneration and Nomination Committees), approving their terms of reference, reviewing their performance and ratifying their decisions.

Board Meetings

The Board meets formally at least eight times a year and ad hoc as required. In 2005 15 meetings were held. These were fully attended, except that Ian Gowrie-Smith, Dr David Ebsworth and Steve Harris were each unable to attend one meeting, whilst Dr Jerry Karabelas was unable to attend four meetings. Mr Torao Yamamoto was unable to attend four meetings prior to his resignation as a director. Directors are fully briefed following any meetings which they were unable to attend. At least one formal Board meeting and strategy day are held abroad each year to enable directors to visit non-UK sites.

Each formal Board meeting considers, as a matter of course, the operational performance of the Company against its strategic plan and annual budget; reports from the Chairs of the Nomination, Remuneration and Audit Committees (if applicable); important forthcoming events and an investor relations report.

Attendance at Board and Committee meetings is set out in the table below:

	Board meetings (max 15)[1]	Audit committee meetings (max 4)[2]	Remuneration committee meetings (max 4)[3]	Nomination committee meetings (max 3)[4]
Chairman				
Ian Gowrie-Smith	14	–	–	2 (Chair)
Executive Directors				
Michael Ashton	15	–	–	–
Donald Nicholson	15	–	–	–
Senior Independent Director				
Sir Michael Beavis	15	4	4 (Chair)	–
Non-Executive Directors				
Alan Bray[5]	15	4 (Chair)	–	3
Dr David Ebsworth[6]	14	4	4	2 (max 2)
R Stephen Harris	14	–	4	3
Dr Jerry Karabelas[8]	11	3	–	3
Dr Keith Mansford	15	–	4	–
Torao Yamamoto[9]	2 (max 6)	–	–	–

1 The Company Secretary also attended all Board meetings.
2 At the invitation of the Chairman of the Audit Committee, the Chief Executive Officer, Finance Director, Company Secretary and external auditors were also invited to attend the Committee meetings.
3 At the invitation of the Chairman of the Remuneration Committee, the Chief Executive Officer and Company Secretary were also invited to attend the Committee meetings except when their remuneration was discussed.
4 At the invitation of the Chairman of the Nominations Committee, the Company Secretary was also invited to attend meetings of the Committee.
5 Alan Bray was appointed to the Nominations Committee during the year.
6 Dr David Ebsworth was appointed to the Nominations Committee during the year.
7 Steve Harris is currently Chair of the Nominations Committee.
8 Dr Jerry Karabelas was appointed as Chairman of SkyePharma PLC on 2 February 2006. He resigned from the Audit Committee on that date and he resigned from Nominations Committee on 15 February 2006.
9 Torao Yamamoto retired as a Director on 18 July 2005.

During the year the Board implemented a new policy of inviting certain key senior management and the new Head of Risk Management to give presentations at Board meetings.

The Non-Executive Directors meet independently of management on a regular basis. In 2005, they met formally four times and informally on an ad hoc basis as required. The members of the Audit Committee also met with the external auditors independently of management on two occasions.

The Board has access to the advice and services of the Company Secretary and are able in the course of their duties, if necessary, to take independent professional advice at the Company's expense within preset limits with prior written approval. Committees have access to such resources as are required to fulfil their duties.

Insurance and Indemnification
The Company maintains directors' and officers' insurance cover, up to a limit of £15m, in respect of any legal actions taken against the directors in connection with their duties. Additionally, the Company indemnifies directors for claims made against them in connection with their duties, except those resulting from their wilful negligence.

Role of Chairman and Chief Executive
The roles of Chairman and Chief Executive are distinct and are held by different people to ensure a clear division of responsibility. The Chairman is responsible for running the Board including ensuring the timely flow of information to Board members and overseeing their development; whilst the Chief Executive is responsible for the day-to-day running of the Company and reporting upon this to the Chairman.

Role of Senior Independent Director
The Senior Independent Non-Executive Director, Sir Michael Beavis, is available to shareholders if they request a meeting, or have concerns which contact through the normal channels has failed to resolve or is inappropriate. He also provides a communication channel between the Chairman and the Non-Executive Directors. In addition, he chairs the Remuneration Committee and so leads the annual performance review of the Chairman.

During the year and in the lead up to the EGM requisitioned by certain institutional shareholders, Sir Michael Beavis (including other Non-Executive Directors where he could not attend) had seven meetings and discussions with large institutional shareholders. In addition to these meetings, Jerry Karabelas had a number of meetings and discussions with institutional shareholders in an effort to avert the need for an EGM. The Company is committed to maintaining a regular dialogue with its shareholders and the process by which this is achieved is explained in more detail below.

Role of the Non-Executive Directors
The role of the Non-Executive Directors is to bring independent judgement to Board deliberations and decisions and to supervise the corporate governance of the Group. The Non-Executive Directors are all experienced and influential individuals whose blend of skills and business experience contributes to the proper functioning of the Board and its Committees, ensuring that matters are fully debated and that no individual or group dominates the Board's decision-making processes.

Induction and Development
New directors receive formal induction training, including site visits and meetings with the Company's advisers, brokers, auditors and major shareholders, and on-going training is provided as appropriate. This training is customised for each director and varies depending upon their skills, experience and background.

Directors also receive regular updates on changes and developments in the business, legislative and regulatory environments.

Directors are able to identify and suggest any further training requirements which they feel are needed during their annual performance reviews with the Chairman.

Board Evaluation
The Board conducts an annual, formal evaluation of its own performance and that of its committees and of individual directors. This is conducted via anonymised questionnaire devised in accordance with the Higgs Report. Feedback on collective performance is collated and presented to the Board and actions to improve are agreed and implemented.

Directors are invited to focus specifically on areas requiring priority action and to give honest and constructive suggestions/comments so that the Board can review its performance in a thorough and thoughtful manner.

Board Committees
There are three main Committees, all of which operate within written terms of reference. The terms of reference are available on the company website (www.skyepharma.com) and upon request from the Company Secretary. Details of Committee membership can be found in the table on page 31 which shows attendance at Board and Committee meetings in 2005.

No director can attend meetings where he could have a conflict of interest.

Audit Committee
The Audit Committee currently consists of three Non-Executive Directors: Alan Bray, Sir Michael Beavis and Dr David Ebsworth, all of whom the Board has determined to be independent.

The Committee is chaired by Alan Bray, a chartered accountant who as a recently retired senior partner of Deloitte & Touche LLP, has recent and relevant financial experience as recommended in the Code and meets the requirements of section 407 of the Sarbanes-Oxley Act 2002 ("Sarbanes-Oxley") that defines a "financial expert".

The external auditors, Chief Executive Officer and Finance Director are normally invited to attend meetings and, following each meeting, the Committee and external auditors meet with no executives present.

During the year the Audit Committee met four times. The meetings were fully attended by all Committee members, except that Dr Jerry Karabelas was unable to attend one meeting, and the conclusions were presented to the full Board.

The Committee's terms of reference include:
- reviewing the interim and full year results;
- approving the Interim and Annual Report and Accounts and Form 20-F prior to their submission to the Board;
- considering any material matters affecting the Company;
- any matters raised by or relating to, including the appointment or removal of, the external auditors;
- responsibility for approving non-audit work to be undertaken by the company's auditors. This process, which involves obtaining written approval from the Audit Committee, ensures auditor objectivity and independence is safeguarded;
- responsibility for the company's complaints and whistleblowing policy, which allows staff to raise concerns about possible improprieties; and
- reviewing the functioning of the risk management department, which was created in 2005.

Policy on Non-Audit Services
The guidelines set out in the company's policy on engaging the external auditors to provide non-audit services include ascertaining that: the skills and experience of the external auditors make them a suitable supplier of the non-audit services; adequate safeguards are in place so that the objectivity and independence of the audit are not compromised; and the fee levels relative to the annual audit fee are within the limits set by the Committee.

Remuneration Committee
The Remuneration Committee currently consists of Sir Michael Beavis, who chairs the Committee, Dr David Ebsworth, Steve Harris and Dr Keith Mansford.

During the year the Remuneration Committee met four times. The meetings were fully attended by all Committee members and the conclusions were presented to the full Board.

The Chief Executive Officer may be invited to attend Remuneration Committee meetings, other than when his own remuneration is discussed. No director is involved in deciding his own remuneration.

The scope and authority of the Committee and the means by which the Company applies the principles of the Code in respect of remuneration policy are set out in the Remuneration Report which is presented on pages 37 to 52.

The Committee is advised by Halliwell Consulting, an independent executive remuneration and share schemes consultancy, which provides no other services to the Company.

Nomination Committee
The Nomination Committee consisted of Ian Gowrie-Smith, who chaired the Committee until his resignation in January 2006, Steve Harris who is currently Chairman, Dr Jerry Karabelas (prior to his resignation in January 2006) as well as Alan Bray and David Ebsworth who were both appointed to the Committee in 2005.

During the year the Nomination Committee met three times. The meetings were fully attended by all eligible Committee members and the conclusions were presented to the full Board.

The Committee's terms of reference include:
- regularly reviewing the Board structure, size and composition;
- identifying and nominating candidates for the approval of the Board;
- ensuring plans are put in place for succession of the executive directors; and
- making recommendations upon the reappointment of the directors upon retirement whether by virtue of rotation, age or length of service.

During the year the Committee searched for successors to retiring Board members and since 31 December 2005 has recommended the appointments of Dr Jerry Karabelas as Chairman, Frank Condella as Chief Executive Officer and Ken Cunningham as Chief Operating Officer. In the lead up to the requisitioned EGM, the Nominations Committee also met with Bob Thian, the requisitionists' candidate for the Board. The motion to appoint Bob Thian was defeated.

Given the specialist nature of the appointments the Board undertook an extensive search for suitable candidates, including discussions with a specialist consultancy firm. The firm drew up a shortlist of candidates who met the criteria set out by the Committee. Candidates were then interviewed by the Nominations Committee prior to their recommendation.

The Nomination Committee is pleased to be able to recommend Frank Condella and Ken Cunningham for election to the Board of SkyePharma PLC.

In preparation for meeting the requirements of Sarbanes-Oxley, the remit of the Nominations Committee has been extended to include all relevant governance matters. Accordingly the committee will be known in future as the Nominations and Governance Committee; details can be found on the Company's web site.

Reappointment
Non-Executive Directors are appointed for an initial term of three years from the annual general meeting following their joining the Board. All directors must stand for reappointment every three years or every year if over the age of 70 or if they have served on the Board for more than nine years.

The Board recommends that Steve Harris be reappointed upon his retirement at the forthcoming AGM.

The terms and conditions of appointment of each Director will be available for inspection at the AGM and at the Company's registered office.

Policy on Other Appointments
The Board believes that Non-Executive Directors should be able to accept other appointments where no conflict of interest arises and provided that the Non-Executive Director is able to maintain his time commitments to the Company. These other appointments enable Non-Executive Directors to accrue further skills and experience from which the Company benefits. This policy is reviewed annually.

Details of any other appointments held by each Non-Executive Director are listed under 'Directors and Officers' on pages 26 and 27.

Internal control framework
Internal Accountability and Risk Management
The Board believes that the Company maintains a sound system of internal control with a view to safeguarding shareholders' investment and the Company's assets. During the year these processes were enhanced with the recruitment of a new Head of Risk Management.

The Board reviews the effectiveness of the system at least annually, covering all material controls including financial, operational and compliance controls and risk management systems, and reports to shareholders that it has done so. The identification and appraisal of risks has been carried out by the Head of Risk Management as part of his work in preparation for meeting the requirements of Sarbanes-Oxley (see below).

SkyePharma operates, and attaches importance to, clear principles and procedures designed to achieve the accountability and control appropriate to a science-based business operating internationally in a highly regulated business sector. SkyePharma has established an organisational structure with clearly drawn lines of accountability and delegation of authority.

Financial results and key operational and financial performance indicators are reported regularly throughout the year and variances from plans and budgets are investigated and reported. The Group has a system of high level financial control procedures which are supplemented by detailed procedures at each operating entity. Compliance with these procedures is monitored by the new Head of Risk Management and the corporate office.

No system can provide an absolute assurance against material misstatement or loss.

Ethics

All Group employees are required to adhere to specified codes of conduct, policies and procedures, *including, but not limited to:*

- Code of Business Conduct and Ethics;
- Code of Ethics for Senior Financial Officers
- Complaints and Whistleblowing Procedure;
- Equal Opportunities Policy; and
- Environmental Policy.

Copies of the above are available on our website (www.skyepharma.com). These policies are all reviewed annually.

Going Concern

The Company's working capital requirements continue to be affected by the timing and receipt of milestone payments and payments received on the signing of new contracts. The Company's future cash flows will also be impacted by the Company's change in strategy as outlined in the EGM notice dated 16 February 2006, principally its stated aim of moving to sustainable profitability in the shortest possible time and its refocus to concentrate on oral and pulmonary products. Consequently the Group's near term working capital requirements are uncertain and sensitive to the timing of a number of initiatives required to provide the financial flexibility to implement the new strategy. These initiatives include the licensing of Flutiform™ in Europe, the divestment of its injectable business interests, which is expected to require shareholder approval, and the delay of certain licensing discussions, such as US licensing for DepoBupivacaine™ pending the divestment of its injectables business.

The Directors have reviewed the working capital requirements of the Group for the next twelve months and have a reasonable expectation that sufficient funds will be raised from these initiatives and have therefore prepared the financial information contained herein on a going concern basis which assumes that the Company will continue in operational existence for the foreseeable future.

Relations with Shareholders

The Company's policy with regard to its investor relations is set out in "The Shares" on page 19.

US law and regulation

A number of provisions of US law and regulation apply to the Company because the shares are listed on NASDAQ.

NASDAQ rules

In general, the rules permit the company to follow UK corporate governance practice instead of those applied in the USA, provided that the company explains any significant variations. There are no significant variations to report.

New rules that came into effect in 2005 require the company to file annual and interim written affirmations concerning the Audit Committee and the Company's statement on significant differences in corporate governance.

Sarbanes-Oxley Act of 2002
Sarbanes-Oxley established new standards for corporate accountability for companies listed in the USA. For accounting periods ending on or after 15 July 2006 (the applicable implementation date for foreign registrants) the company's Form 20-F will contain a report stating the responsibility of management for establishing and maintaining adequate internal control over financial reporting and assessing the effectiveness of the company's internal control over financial reporting.

Although the company is not required to report compliance in its 2005 Form 20-F, management has undertaken a process and believes that it will be in a position to report its compliance by the due date.

A Disclosure Committee was established in 2003 to evaluate the effectiveness of the Group and divisional disclosure controls and procedures; the committee met once in 2005. Additionally in 2005 work has continued to document and test the internal controls structure and procedures to comply with Section 404 of Sarbanes-Oxley.

The Sarbanes-Oxley Steering Committee meets monthly and reports formally to the Audit Committee at its regular meetings. Additionally, the Chairman of the Audit Committee is available on an informal basis to discuss any matters arising between meetings.

Alan Bray
Chairman, Audit Committee
22 May 2006

Statement of Directors' Responsibility in Relation to the Accounts

The Directors are required by law to prepare financial statements for each financial period which give a true and fair view of the state of affairs of the Company and the Group as at the end of the financial period and of the profit or loss of the Group for that period. The Directors confirm that suitable accounting policies have been consistently applied and supported by reasonable and prudent judgements and estimates as necessary; applicable accounting standards have been followed, and the financial statements have been prepared on the going concern basis.

The Directors are responsible for ensuring the maintenance of proper accounting records, which disclose with reasonable accuracy the financial position of the Company and the Group at any time and from which accounts can be prepared to comply with the Companies Act 1985. They are also responsible for ensuring the operation of systems of internal control for safeguarding the assets of the Group and for taking reasonable steps to prevent and detect fraud and other irregularities.

The responsibilities of the auditors in relation to the financial statements are set out in the auditors' report.

The financial statements for the year ended 31 December 2005 are included in the Annual Report 2005, which is published by the Company in hard-copy printed form and on the Company's website on the Internet. The Directors are responsible for the maintenance and integrity of the Annual Report on the website in accordance with UK legislation governing the preparation and dissemination of financial statements. This may differ from legislation in other jurisdictions. Access to the website is available from outside the UK, where comparable legislation may be different.

Dr Jerry Karabelas
Non-Executive Chairman
22 May 2006

Remuneration Report

Introduction
This report sets out the remuneration policy operated by the Company in respect of the Executive Directors, together with disclosures on Directors' remuneration required by The Directors' Remuneration Report Regulations 2002, ("the Regulations"). The auditors are required to report on the 'auditable' part of this Report and to state whether, in their opinion, that part of the Report has been properly prepared in accordance with the Companies Act 1985 (as amended by the Regulations). The Report is therefore divided into separate sections for audited and unaudited information.

The Board have reviewed the Group's compliance with the Combined Code ("the Code") on remuneration related matters. It is the opinion of the Board that the group complied with all remuneration related aspects of the Code during the year.

PART 2 OF THE REGULATIONS – UNAUDITED INFORMATION

Remuneration Committee
The Remuneration Committee is responsible for developing policy on remuneration for Executive Directors and Key Executives below Board level and for determining specific remuneration packages for each of the Executive Directors.

The Remuneration Committee is chaired by Sir Michael Beavis and its other members are Dr David Ebsworth, Mr Steve Harris and Dr Keith Mansford. The Remuneration Committee members have no personal financial interest other than as shareholders in matters to be decided, no potential conflicts of interests arising from cross directorships and no day-to-day involvement in running the business.

When the Remuneration Committee is considering matters concerning key executives below Board level advice is sought from other Executive Directors. Where Executive Directors have attended a Remuneration Committee meeting there was no discussion relating to their own remuneration and benefits. The Remuneration Committee received wholly independent advice on executive compensation and incentives from Halliwell Consulting during the year. No other services were provided to the Company by Halliwell Consulting during the year.

The Remuneration Committee is formally constituted with written Terms of Reference. The terms of reference are available from the Company's website (www.skyepharma.com) and are also available by request from the Company Secretary.

The Committee met four times during 2005 with each member attending all the meetings.

Background
The Remuneration Committee found it increasingly difficult in 2005 to find a suitable comparator group for benchmarking the Company's Executive remuneration for the following reasons:

- the stage of development of the Company as it transitions to a speciality pharmaceutical company;
- the large number of drug delivery businesses which are part of larger pharmaceutical companies or are private limiting the availability of accurate benchmarking data; and
- the changes to the UK Biotechnology and Pharmaceutical Sector over the last three years resulting in the disappearance of a number of the original Comparator Group companies. For example there are now five less UK pharmaceutical companies in the Comparator Group.

The change in balance of the Comparator Group towards US companies exaggerates a problem that has always been recognised by the Remuneration Committee; which is in summary:

- US companies pay less salary than their UK counterparts but grant significantly more share based compensation;
- SkyePharma PLC as a UK listed company cannot grant the levels of share based compensation provided by its US counterparts due to UK corporate governance best practice.

In the past the solution adopted by the Remuneration Committee has been to set the Company's salary policy at the mid-point between the median and upper quartile compared to the Comparator Group. The changes in the Comparator Group over the period now means that the historic mid-point is higher than the current position as a result of the disappearance of a significant number of the UK constituents of the Comparator Group.

This problem had been anticipated and recognised by the Company and substantial work was done to look at a viable comparator group for the future. However, it was decided by the Remuneration Committee and the Board that during the strategic review and subsequent to the disposal of SkyePharma Inc. it was premature to change the Comparator Group until the future shape of the Company crystallised at which point a more appropriate group of companies could be selected.

Therefore during 2005 the Remuneration Committee adopted the following approach:

Element	Benchmark	Reason
Salary	FTSE Mid 250 & Comparator Group	The relative lack of UK members in the Comparator Group and the different salary policies adopted by the US members.
Bonus	Comparator Group	The Remuneration Committee felt that there was sufficient commonality between the practice of the UK and US members of the Comparator Group to safeguard the Company's and shareholders' interests when benchmarking.
Total Short-Term Remuneration Available	Comparator Group	The Remuneration Committee benchmarked short-term remuneration available against the Comparator Group to ensure that taking into account the FTSE Mid 250 when benchmarking salary did not result in any ratchetting up of compensation levels.
Pension	FTSE Mid 250	US company pension practice is not comparable to UK practice and therefore the relative lack of UK companies in the Comparator Group meant that it was not viable as a benchmark.
Total Compensation	Comparator Group	The Remuneration Committee benchmarked total compensation against the Comparator Group to ensure that taking into account the FTSE Mid 250 when benchmarking salary and pension did not result in any ratchetting up of compensation levels.

Comparator Group

The current constituents of the Comparator Group are

Acambis Plc	CAT Group Plc	Nektar Therapeutics Inc
Alizyme Plc	Cephalon Inc	Noven Pharmaceuticals Inc
Alkermes Inc	Elan Corporation Plc	QLT Inc
Andrx Corporation Inc	Emisphere Technologies Inc	Sepracor Inc
AstraZeneca Plc	Enzon Pharmaceuticals Inc	Shire Pharmaceuticals Group Plc

It should be noted that during 2006 the Remuneration Committee is intending to conduct a full review of its remuneration policy including:

- the constituents of the Comparator Group;
- policy for each element of the compensation package; and
- the type and operation of its Executive share incentives (the current approval for the SkyePharma PLC Deferred Share Bonus Plan (the "DSB") and the Schedule to this Plan – the SkyePharma PLC 2004 Long-Term Incentive Plan (the "LTIP") finishes at the 2006 AGM).

The Remuneration Committee will consult fully with the Company's shareholders during this review.

Remuneration Policy Overview

For 2005 the Remuneration Committee's policy was to set the main elements of the remuneration package at the following quartiles in comparison to the Company's Comparator Group:

Base Salary	Annual Bonus potential	Share Incentives	Total Compensation
Between Median and Upper Quartile	Upper Quartile	Lower Quartile	Lower Quartile -Median

The international nature of some of the companies in the Comparator Group means that the Company cannot provide comparative levels of share incentives under current UK corporate governance best practice. While the share incentives are at the lower quartile based on the Comparator Group, they would be at the median level in a wholly UK context.

In order to remain attractive to the type of executive talent required to grow the Company, the Remuneration Committee has determined to set the base salaries between the median and upper quartile compared to the Comparator Group (median when looking at the FTSE Mid 250).

The objective of the remuneration policy is to provide remuneration packages that will:

- motivate and encourage superior performance;
- allow the Company to retain the talent needed to execute its business strategy;
- enable the Company to be competitive when recruiting appropriate skilled and experienced newcomers; and
- align rewards with the interests of shareholders.

It is the aim of the Remuneration Committee to encourage and reward superior performance by Executives with that performance being based on the measurable delivery of good financial performance and the delivery of strong returns to shareholders. The Remuneration Committee believes that the current policy continues to retain and motivate the Executives appropriately while enforcing a strong pay for performance culture within the Company.

The Remuneration Committee will continue to review the policy on an annual basis to ensure that it is in line with the Company's objectives and shareholders' interests.

The Executive Directors do not hold any executive outside appointments nor do they retain any earnings in respect of any non-executive appointments on behalf of the Company.

Fixed v Performance Pay

The tables below illustrate the balance between fixed and performance related (variable) compensation and the total expected value of the remuneration package for each Executive Director for the year ended 31 December 2005:

Executive	Fixed	Variable
Michael Ashton CEO	40%	60%
Donald Nicholson FD	39%	61%

Fixed compensation comprises salary, benefits and pension contributions. Variable compensation comprises the maximum annual bonus potential in relation to the year ended 31 December 2005 and the expected value of the LTIP Award and DSB Matching Share Award.

Changes to the Executive Team

The table below sets out the changes to the Executive Team of the Company and summaries the remuneration terms on which the relevant individual has joined or left the Company:

Relevant Date	Joining / Departing / Change	Name & Position	Standard Salary / Fees p.a	Special Company Package	Arrangements
2 February 2006	Change	Dr Jerry Karabelas (new Chairman)	£70,000	n/a	No
1 March 2006	Joining	Frank Condella (new CEO)	£450,000	Yes	Yes (see below)
24 April 2006	Joining	Dr Ken Cunningham (new COO)	£250,000	Yes	Yes (see below)
13 February 2006	Departing	Ian Gowrie-Smith (former Chairman)	£140,000	n/a	No (see note 1 below)
30 November 2006	Departing	Michael Ashton (former CEO)	£466,000	Yes	No (see note 2 below)

Notes:

1. *Ian Gowrie-Smith on stepping down from the Board was paid his fees for the period ending on the date of the 2006 AGM. The Remuneration Committee felt this was appropriate as it had been agreed with Ian Gowrie-Smith that he would step down at the 2006 AGM. Ian Gowrie-Smith agreed to step down earlier at the request of the Board and in the best interests of the Company and therefore the Remuneration Committee felt it was equitable to pay the fees for the original agreed period.*
2. *Michael Ashton's twelve month notice period started on 30 November 2005. The Board has decided that Michael Ashton should conduct specific projects for the Company during his notice period (including but not limited to assistance in the disposal of SkyePharma Inc.) and therefore Michael Ashton will remain an employee of the Company throughout his notice period. Michael Ashton will continue to be provided with his current compensation package during his notice period (except he will not be granted an award under the LTIP). Michael Ashton will receive no compensation on his cessation of employment although he will be treated as a good leaver under the relevant share plans due to his retirement.*

Special Arrangement New Appointments

On appointment Frank Condella and Dr Ken Cunningham were offered the opportunity to participate in the following one-off incentive arrangement following their appointment. Both Executives took advantage of this opportunity by purchasing the maximum value of shares. The main terms of the arrangement were:

- *the ability to purchase a maximum of one third* of their annual salary in shares of the Company out of their own personal resources;
- the Company will provide a maximum of two matching shares for every share purchased:
  - 50% of these matching shares will be released to the relevant Executive on the first anniversary *of their grant i.e. a 1:1 match if:*
    - he retains the shares he purchased for this period; and
    - remains employed by the Company;
  - the balance of these matching shares will be released to the relevant Executive on the second anniversary of their grant i.e. a 2:1 match if:
    - he retains the shares he purchased for this period; and
    - remains employed by the Company.

The Remuneration Committee took the following *factors into account in determining this arrangement:*

- a desire to encourage the new Executives to build up a meaningful interest in the shares of the Company in order to assist them in satisfying the Company's shareholding requirement;
- it is a standard element of compensation packages offered by the Company's US competitors to *provide significant sign-on grants to new* executives of options and restricted shares awards which are not subject to any co-investment requirement or corporate performance conditions. This is not considered best practice in the UK. Therefore the Remuneration Committee was required to offer some incentive in order to be *competitive taking into account the employment* potential for both candidates in the US;
- the Remuneration Committee felt that the requirement to make a meaningful investment at their own cost in the Company's shares demonstrated an immediate commitment by the Executives to the Company and is consistent with the objective of aligning Executives' and shareholders' interests; and
- *comparatively the maximum value of the one-off* award of matching shares of 66% of salary is modest.

Elements of Executives' Remuneration

Basic Salary

Policy: – Between Median and Upper Quartile

Base salaries are set by reference to being between the Median and Upper Quartile compared to the Company's international Comparator Group. A number of constituents of this Comparator Group provide share awards and options of many multiples greater than would be accepted by UK institutional shareholders. Therefore, while the Remuneration Committee firmly sets the balance of the Executives' packages in favour of performance, salaries are set at above median to ensure a competitive overall position (particularly as the incentives are based on a multiple of this salary). In addition in determining the salaries for FY2006 the Committee took into account the levels paid in the FTSE Mid 250 for the reasons set out earlier in this Report.

When determining the salary of the Executive Directors the Remuneration Committee also takes into consideration:

- levels of annual increases in pay for companies within the Comparator Group;
- the performance of the individual Executive Director;
- the individual Executive Director's experience and responsibilities; and
- pay and conditions throughout the Company.

The following table shows the salary quartiles for members of the Comparator Group and the FTSE Mid 250 (in brackets) for the year ended 31 December 2005:

Quartile in Comparator Group (FTSE Mid 250)	Michael Ashton Chief Executive Officer	Donald Nicholson Finance Director
Upper Quartile	£410,000 (£506,000)	£245,000 (£319,000)
Median	£360,000 (£416,000)	£200,000 (£255,000)
Lower Quartile	£320,000 (£341,000)	£190,000 (£215,000)
Actual Salary	£440,000	£250,000
%age Rise	5.9%	6%
Salary for FY2006	£466,000	£265,000

The following table sets out the salary rises in the Comparator Group and the FTSE Mid 250 (in brackets) for the year ended 31 December 2005:

Quartile in Comparator Group (FTSE Mid 250)	Michael Ashton Chief Executive Officer	Donald Nicholson Finance Director
Upper Quartile	9% (10%)	7% (10%)
Median	7% (8%)	6.5% (7%)
Lower Quartile	5% (4%)	6% (4%)
Actual Rise for FY 2006	5.9%	6%

As a consequence of corporate activity in the year ended 31 December 2005, five international companies, with market attributes similar to the Company, have dropped out of the Comparator Group. This has had a major impact on the salary quartiles within the Comparator Group. The upper quartile salary levels for Chief Executives have fallen by 13.8% from 2004 to 2005 and by 24.9% for Finance Directors.

Due to the reasons set out above the Remuneration Committee therefore took both the actual salary levels and the percentage rises in both the Comparator Group and FTSE Mid 250 when determining the salaries for the Executive Directors for FY2006. In order to ensure that salary levels did not escalate during this period of corporate change for the Company the Remuneration Committee set the rises at around the lower quartile of both comparators.

Annual Performance Related Bonus

Policy: – Upper Quartile Bonus Potential

The Committee's policy is to set the maximum annual bonus potential at the upper quartile in relation to the Comparator Group. Bonuses are not pensionable. The maximum bonus potential available for the Executive Directors is 100% of salary. The maximum bonus potential available for the Executive Directors for the year ending 31 December 2006 remains the same. Executive Directors participate in the SkyePharma PLC Deferred Share Bonus Plan. The objectives of the Plan are:

- to ensure the satisfaction of stretching performance targets before bonuses are earned;
- to provide an element of bonus earned in shares;
- to provide a retention mechanism for Executives by rewarding the retention of the share element of their bonus provided additional performance conditions are satisfied; and
- to provide a Plan which assists Executives in meeting their minimum shareholding requirements.

The following table summarises the main features of the Plan (all percentages in the table are percentages of basic salary):

Bonus	Performance Condition	Executive Directors
Maximum Annual Bonus Potential		100%
Cash Element (paid net of tax through payroll at the end of the financial year)	Annual Performance Targets (see table below)	50%
Executive Shares (acquired net of tax and held in the Plan)		50%
Matching Shares (calculated on the pre-tax amount of bonus used to acquire the Executive Shares)	Will only be released if the following conditions are satisfied over the three year holding period from the date of award: - continued employment by the Executive; - median TSR[1] performance over the holding period (and consistent underlying financial performance of the Company); - retention by the Executive of the associated Executive Shares.	50%

1 Total Shareholder Return ("TSR") – is a measure showing the return on investing in one share of the Company over the performance period (the return is the value of the capital gain and reinvested dividends). It is normally used comparatively and the company which achieves the best return is ranked number one.

In accordance with the terms of the bonus schedules for 2005, the Chief Executive Officer and Finance Director are both entitled to a bonus of 25% of salary.

%age of Salary	Michael Ashton	Donald Nicholson
Maximum Bonus Potential	100%	100%
2005 Bonus Paid – Cash Element	12.5%	12.5%
2005 Bonus Paid – Executive Share Element	12.5%	12.5%
2005 Bonus Paid (Cash & Executive Shares)	25% (£110,000)	25% (£62,500)
Expected Value of Matching Shares on Award*	11% (£49,000)	11% (£28,000)

* The expected value of the Matching Shares was calculated by taking the face value of the maximum number of shares which could be awarded and discounting this value by the probability of the performance condition being satisfied at the end of the three year holding period in accordance with the IFRS2.

The following table shows the level of performance achieved against the budgeted targets set at the beginning of the year ended 31 December 2005 and the bonus earned for achieving that level of performance:

Performance Measure	Budget Target (Maximum %)	*Michael Ashton* Chief Executive Officer Bonus Earned (%age of Salary)	*Donald Nicholson* Finance Director Bonus Earned (%age of Salary)
Financial/Strategic/ Operational Targets for 2005	65%	20%	20%
Milestones	15%	5%	5%
Company's share price being *greater than the average* appreciation for the companies constituting the Comparator Group	10%	0%	0%
Objective Personal Targets	10%	0%	0%
TOTAL AS %AGE OF SALARY	**100%**	**25%**	**25%**

Bonus targets are reviewed and agreed by the Remuneration Committee at the beginning of each financial year. The performance measures for the bonus are reviewed annually by the Remuneration Committee to ensure that they are appropriate to the current market conditions and position of the Company, so that they continue to remain challenging.

Share Incentives

Policy: - Lower Quartile

Overview

The Remuneration Committee aims to provide annual awards to Executive Directors at the lower quartile level compared to the international Comparator Group. The Remuneration Committee believes that this level is competitive having due consideration to the level of grants in the UK Biotechnology and Pharmaceutical Sector but is relatively low in comparison to the US components of the Comparator Group.

Grants during the Year ending 31 December 2005

Maximum Face Value Granted (%age Salary)	Performance Condition
100%	TSR performance of the Company over the three year performance period compared to the Comparator Group[1]. 30% of the Award will be released for median level performance with full release for upper quartile performance. Straight line release between points.

Details of Awards are on page 51.

Breakdown of the Award	Michael Ashton	Donald Nicholson
LTIP Award Face Value* £ (and as %age Salary)	£440,000 (100%)	£250,000 (100%)
Expected Value** of LTIP Award (and as %age of Salary)	£344,000 (78%)	£196,000 (78%)
Lower Quartile Comparator Group Face Value (and as %age of Salary)	£692,000 (243%)	£553,000 (206%)
Executive Shareholding Requirement as a %age of Salary to be built up by end of 2008/2009 (current shareholding in bold[2])	100% **(78%)**	100% **(150%)**

* Face value for an option is the exercise price multiplied by the number of shares subject to the option. For an LTP Award or a DSB Matching Share Award it is the market value of a share on the date of grant multiplied by the number of shares subject to the award.

** The expected value was calculated by taking the face value of the shares on the date of award and discounting this value by the probability of the performance condition being satisfied at this date (in accordance with the principles of IFRS 2).

1 The Remuneration Committee will satisfy itself that the recorded TSR is a genuine reflection of the underlying financial performance of the Company by considering the Company's performance against financial measures such as turnover, profitability and cash flow.

2 The salary for the year ended 31 December 2005 was used for the calculation; the share price used of £0.4975 was the price of a Company share on 31 December 2005.

The Remuneration Committee believes that comparative total shareholder return is the most appropriate measure to align shareholders' and Executives' interests. Comparative TSR was selected as the performance condition for LTIP Awards by the Remuneration Committee as it ensures that, before being entitled to receive any of their LTIP Awards, the Executives outperform their international peers over the measurement period in delivering shareholder value irrespective of general market conditions. It should be noted that the real value received by the Executives under the share incentive arrangements will be dependent upon the degree to which the associated performance conditions have been satisfied at the end of the three year performance period and the share price of the Company at this time.

Performance Measurement

Halliwell Consulting, the Remuneration Committee's advisors will calculate the TSR in accordance with the rules of the LTIP and sign-off these figures prior to the release of any award. Performance conditions under the LTIP are not subject to re-testing.

Dilution

The following table sets out the current level of dilution against the ABI limits for all share plans as at 31 December 2005:

Maximum	Current Dilution over rolling ten year period	Additional Dilution in Year
10% dilution in ten years for all share schemes	9.1%	0.6%
5% dilution in ten years for all executive share schemes	4.0%	0.6%

In accordance with the ABI guidelines the Company can issue a maximum of 10% of its issued share capital in a rolling ten year period to employees

under all its share plans. In addition, of this 10% the Company can only issue 5% to satisfy awards under discretionary or executive plans. The additional dilution reflects the commitments the Company has made under its share plans during the financial year.

Pension

Policy: – Median

The Company makes contributions into individual personal pension schemes for the Executives at a defined percentage of salary, excluding bonus and other forms of remuneration. The Executive Directors do not participate in any Company sponsored pension plans and are expected to make their own pension arrangements:

	Michael Ashton	Donald Nicholson
Actual Contribution	£77,000	£43,750
%age of Salary	17.5%	17.5%

Benefits in Kind

Benefits comprise a car allowance, private medical insurance and a living allowance for the Chief Executive Officer Michael Ashton.

Total Value of Remuneration Package for Executive Directors

Policy: – Lower Quartile to Median

The following table shows the value of each of the main elements of the remuneration package provided to the Executive Directors during the year ended 31 December 2005. It should be noted that the largest elements of the package – the expected value of LTIP grants and Matching Share awards are based on a series of assumptions and may not equate to the actual value received by the Executive Directors on release. In addition, all share incentives will only be provided to an Executive Director if the attached performance conditions have been satisfied (see above) and are also dependent on the share price in three years time.

Executive Directors	Salary	Bonus Paid	Expected Value of Matching Shares	Benefits	Expected Value of LTIP	Pension	TOTAL	Median in Comparator Group
Michael Ashton	£440,000	£110,000	£49,000	£48,000	£344,000	£77,000	£1,068,000	£1,500,000
Donald Nicholson	£250,000	£62,500	£28,000	£10,000	£196,000	£43,750	£590,250	£673,000

Other Remuneration Matters

All Employee Share Schemes

The following table summarises the main features of the Company's all employee share arrangements and their current status:

Name	Status	Eligibility	Main Features	%age of Employees Participating
ISPP[1]	Operated during year ended 31 December 2005 and will be operated for year ending 31 December 2006.	All employees of the Company including the Executive Directors.	In the UK the Plan provides employees with the opportunity of purchasing £1,500 of shares a year out of pre-tax salary and providing additional matching shares on a 1:1 ratio. These matching shares will be normally released three years after they have been awarded provided that the associated shares purchased by the employee have been retained and provided the employee is still employed by a Group Company at this time. Equivalent Plans have been introduced in Switzerland, France and the US.	30%

1 SkyePharma PLC International Share Purchase Plan ("ISPP").

Executive Directors' Contracts

All Executive Directors' contracts are for a fixed period of one year from date of appointment, and will continue thereafter unless terminated by at least 12 months' written notice. This arrangement is in line with best corporate practice for listed companies. In the event of the termination of an Executive's contract, salary and benefits will be payable during the notice period. However, all Executive Directors will be expected to mitigate their loss in accordance with general legal principles in the event of their cessation of employment.
The Remuneration Committee will apply phasing of payments of notice on cessation in line with the combined ABI and NAPF guidelines, subject to existing contractual constraints. The Remuneration Committee will ensure that there have been no unjustified payments for failure on an Executive Director's termination of employment. There are no special provisions in the contracts of employment extending notice periods on a change of control, liquidation of the Company or cessation of employment.

Name	Company Notice Period	Contract date	Unexpired term of contract (months)
Michael Ashton**	12 months	28 April 2000	Not applicable
Donald Nicholson	12 months	28 February 1996	Rolling Contract*
Frank Condella	12 months	27 February 2006	Rolling Contract*
Dr Ken Cunningham	12 months	1 March 2006	Rolling Contract*

* Contract will continue until terminated on notice by either the Company or the Executive Director.
** Michael Ashton's notice period will be completed on 30 November 2006 at which point his employment with the Company will cease.

Non-Executive Chairman

For the year ended 31 December 2005 the fee for the Non-Executive Chairman, Ian Gowrie-Smith was £140,000 per annum. This fee is determined by the Board after taking into consideration the fee levels of the Non-Executive Chairman in the Comparator Group and the FTSE All Share Pharmaceutical and Biotechnology Sector. The Non-Executive Chairman does not participate in any bonus, share incentive or pension arrangement. On 23 January 2006 the Company announced that Ian Gowrie-Smith was stepping down from this role of Non-Executive Chairman. On 2 February 2006, Dr AN Karabelas was appointed as Non-Executive Chairman. Dr Karabelas will receive an annual basic fee of £70,000 for his provision of services as Non-Executive Chairman. Ian Gowrie-Smith resigned from the Board on 13 February 2006.

Non-Executive Directors

Policy: – Median
The fees paid to the Non-Executive Directors are determined by the Board. Non-Executive Directors are remunerated at a basic rate, plus a fixed amount for membership of Board Committees, adjusted for the acceptance of additional and specific responsibilities. Some of the fees may be payable in the form of shares on the request of the Non-Executive Directors. The table below details the payments made during the year. Non-Executive Directors do not participate in the Company's share schemes, nor do they receive pension contributions or a bonus.

Name	Basic Fee Rate (£)	Committee Fees (£)	Total (£)
IR Gowrie-Smith	£140,000	–	£140,000
Sir Michael Beavis	£45,000	£13,000	£58,000
Dr DR Ebsworth	£45,000	£8,333	£53,333
RS Harris	£45,000	£6,000	£51,000
Dr KR Mansford	£45,000	£4,000	£49,000
Dr AN Karabelas	£45,000	£6,000	£51,000
A Bray	£45,000	£9,333	£54,333
T Yamamoto[1]	£24,719	–	£24,719

1 Torao Yamamoto resigned from the Board on 18 July 2005.

The following table sets out the median levels of fees in the Comparator Group for Non-Executive Directors:

Role	Median Total Fee (£)	Median %age Rise
Non-Executive Chairman	£80,000	10%
Committee Chairman	£71,500	10%
Non-Committee Director	£46,500	10%

Non-Executive Directors are appointed for three years, except for those aged over 70 who offer themselves for re-election annually. Non-Executive Directors do not have service contracts (see below).

Name	Company Notice Period	Effective Date of Contract	Unexpired term of contract (months) at 31 December 2005 or date of appointment if later
IR Gowrie-Smith[1]	1 Month	6 June 2004	18
Sir Michael Beavis	1 Month	6 June 2004	18
Dr AN Karabelas	1 Month	2 February 2006	36
Dr DR Ebsworth	1 Month	11 April 2005	28
RS Harris	1 Month	6 June 2004	18
Dr KR Mansford	1 Month	6 June 2004	18
A Bray	1 Month	29 September 2004	21

1 As stated above, Ian Gowrie-Smith, resigned from the Board on 13 February 2006

Total Shareholder Return Performance Graph

The graph below shows the Company's performance, measured by total shareholder return ("TSR"), compared to the constituents of the FTSE Pharmaceutical and Biotechnology Index and the Comparator Group over the past 5 years:

The Remuneration Committee consider the FTSE Pharmaceutical and Biotechnology Index a relevant index for total shareholder return comparison disclosure required under the Directors' Remuneration Report Regulations 2002 as the index members represent the broad range of UK quoted pharmaceutical companies. As detailed earlier in the report the Company considers its TSR performance for LTIP Awards in comparison to that of a Comparator Group.

PART 3 OF THE REGULATIONS – AUDITED INFORMATION

Directors' Remuneration

The table below sets out details of the Directors' emoluments for the years ended 31 December 2005 and 31 December 2004.

	2005				2004			
Directors	Fees & Salary £'000	Benefits £'000	Bonuses £'000	Total £'000	Fees & Salary £'000	Benefits £'000	Bonuses £'000	Total £'000
Executive Directors								
M Ashton	440	48	110	598	420	48	63	531
D Nicholson	250	10	63	323	236	10	59	305
				921				836
Non-Executive Directors								
IR Gowrie-Smith*	140	–	–	140	289	7	–	296
Sir Michael Beavis	58	–	–	58	54	–	–	54
RS Harris	51	–	–	51	49	–	–	49
Dr AN Karabelas	51	–	–	51	49	–	–	49
Dr KR Mansford	49	–	–	49	47	–	–	47
Dr DR Ebsworth	53	–	–	53	59	–	–	59
A Bray*	54	–	–	54	12	–	–	12
T Yamamoto*	25	–	–	25	44	–	–	44
				1,402				1,446

* IR Gowrie-Smith was an Executive Director to 23 June 2004, A Bray was appointed on 29 September 2004, T Yamamoto resigned on 18 July 2005

Bonuses for Executive Directors exclude the value of Matching Shares which will be provided by the Company at the end of the three year holding period, subject to the satisfaction of certain conditions.

Pensions

Contributions made to defined contribution pension schemes on behalf of the Executive Directors are set out below.

Directors	Contributions made in 2005 £'000	Contributions made in 2004 £'000
IR Gowrie-Smith	n/a	34
M Ashton	77	63
D Nicholson	44	35

Total Directors' emoluments, excluding pension contributions, amounted to £1,402,122 (2004: £1,445,941).

Directors' Interests

The following tables set out the interests of Directors *(including the interests of their immediate families* and persons connected with the Directors) as at 31 December 2005 and 31 December 2004. All interests are beneficial unless otherwise stated below. Interests in Ordinary Shares include shares acquired by the Executive Directors, other than Matching Shares not yet released, under the Deferred Share Bonus Plan and Share Purchase Plan.

	At 31 December 2005		
Directors	Ordinary Shares	ADRs	Convertible Bonds
Executive Directors			
M Ashton	687,674	–	–
D Nicholson [1]	753,531	–	–
Non-Executive Directors			
IR Gowrie-Smith [2]	7,452,744	–	20,000
Sir Michael Beavis [3]	372,356	–	–
RS Harris	157,299	–	–
Dr AN Karabelas	6,667	–	–
Dr KR Mansford [4]	81,531	–	–
Dr DR Ebsworth [5]	108,000	–	–
A Bray [6]	120,000	–	–
	9,739,802	–	20,000

	At 31 December 2004		
Directors	Ordinary Shares	ADRs	Convertible Bonds
Executive Directors			
M Ashton	362,349	–	–
D Nicholson	281,255	–	–
Non-Executive Directors			
IR Gowrie-Smith	6,539,665	–	20,000
Sir Michael Beavis	210,297	–	–
RS Harris	131,083	–	–
Dr AN Karabelas	6,667	2,000	–
Dr KR Mansford	67,943	–	–
Dr DR Ebsworth	45,000	–	–
A Bray	–	–	–
T Yamamoto	–	–	–
	7,644,259	2,000	20,000

1 546,604 of the Ordinary Shares beneficially owned by Mr D Nicholson are registered in the name of TD Waterhouse Nominees (Europe) Limited.

2 1,376,361 of the Ordinary Shares in which Mr Gowrie-Smith is shown above as having an interest are owned by and registered in the name of Walkvale Limited. The entire issued share capital of Walkvale Limited is held on behalf of The I R Gowrie-Smith Family Trust, the beneficiaries of which are certain members of Mr Gowrie-Smith's family. 393,832 Ordinary Shares are registered in the name of Pellinore Holdings Limited. All of the existing Ordinary Shares registered in the name of Pellinore Holdings Limited are owned by Cangary Limited as trustee of the IR Gowrie-Smith Family Trust. 4,671,904 Ordinary Shares are registered in the name of Estuary Investments Limited. The entire issued share capital of Estuary Investments Limited is also held on behalf of The I R Gowrie-Smith Family Trust, the beneficiaries of which are certain members of Mr Gowrie-Smith's family. 520,000 Ordinary Shares and the 20,000 convertible bonds due 2024 are registered in the name of J M Finn Nominees account, Thornaby.

3 The Ordinary Shares beneficially owned by Sir Michael Beavis are registered in the name of Dunlaw Nominees Limited.

4 6,000 of the Ordinary Shares beneficially owned by Dr Mansford are registered in the name of Sharelink Nominees Limited.

5 94,000 of the Ordinary Shares beneficially owned by Dr D Ebsworth are registered in the name of HSBC Global Custody Nominee (UK) Limited and 9,600 in the name of Vidacos Nominees Limited.

6 120,000 of the Ordinary Shares beneficially owned by A Bray are registered in the name of Strand Nominees Limited.

Save as disclosed in this paragraph, no interest exists which the Company is required pursuant to Section 325 of the Act to enter in the register maintained pursuant to that Section.

Holdings under the SkyePharma PLC Deferred Share Bonus Plan and the SkyePharma PLC Share Purchase Plan:

The following table illustrates as at 31 December 2005:

1) the number of Executive Shares and Matching Shares which were awarded under the DSB in 2005; and
2) the total number of Matching Shares awarded in 2005 in relation to the employee purchased shares under the Share Purchase Plan.

	SkyePharma PLC Deferred Share Bonus Plan		SkyePharma PLC
Directors	Executive Shares	Matching Shares	Share Purchase Plan
M Ashton	57,520	101,563	2,880
D Nicholson	53,762	94,927	2,880

The Executive Shares and Matching Shares under the Deferred Share Bonus Plan were awarded on 2 February 2005 at an adjusted share price of 62.00 pence. The Matching Shares awarded under the Share Purchase Plan were awarded on a monthly basis (the range over the year was between 37.5 pence and 64.5 pence) in conjunction with the monthly share purchases.

The following table sets out the total number of Matching Shares under the DSB and Matching Shares under the Share Purchase Plan conditionally held by the Executive Directors as at 31 December 2005 (including those shares conditionally awarded in 2005):

Directors	Deferred Share Bonus Plan	Lapsed During the Year ending 31 December 2005	Share Purchase Plan	Lapsed During the Year ending 31 December 2005
IR Gowrie-Smith	133,250	–	–	–
M Ashton	412,582	–	7,895	–
D Nicholson	278,265	–	7,895	–

It should be noted that the Matching Shares under the DSB shown above have been adjusted accordingly (number of shares under award adjusted by a factor of 1.041758) to reflect the rights issue in November 2005.

Holdings by Trustees

The SkyePharma PLC Share Purchase Plan Trust supports the purchases of shares for the UK element of the SkyePharma PLC International Share Purchase Plan. The General Employee Benefit Trust supports purchases of shares for the Option Schemes, the DSB (including the LTIP Schedule) and the international elements of the Share Purchase Plan. The following table illustrates the holdings as at 31 December 2005:

Directors	SkyePharma PLC Share Purchase Plan Trust	SkyePharma P. C General Employee Benefit Trust
Nominee/Non Beneficial Interest	94,890	2,630,177
Unallocated or Conditional Grants	85,018	3,258,794
Total	**179,908**	**5,888,971**

Notes:

1 The Trustees of the SkyePharma PLC Share Purchase Plan Trust are M Ashton and D Nicholson. They have no beneficial interests in the shares held within the Trust except relating to their own participation in the SkyePharma PLC International Share Purchase Plan.
2 The Trustees of the SkyePharma PLC General Employee Benefit Trust are Northern Trust Fiduciary Services (Guernsey) Limited.
3 The market value of the shares held in the above trusts at 31 December 2005 was £3,019,267.

As a result of transactions since 31 December 2005, the holdings in the Trusts as at 22 May 2006 are as follows:

Directors	SkyePharma PLC Share Purchase Plan Trust	SkyePharma P. C General Employee Benefit Trust
Nominee/Non Beneficial Interest	95,254	2,492,320
Unallocated or Conditional Grants	94,722	3,258,251
Total	**189,976**	**5,750,571**

Options over Shares in the Company

Ordinary Options over shares of 10p each:

Directors	1 January 2005	Granted	Lapsed	31 December 2005	Exercise price	Date from which options can be exercised	Expiry date	Performance Condition (see note)
IR Gowrie-Smith	1,234,568	–	1,234,568	–	–	–	–	1
	575,539	–	575,539	–	–	–	–	1
	1,008,313	–	1,008,313	–	–	–	–	2
	1,178,022	–	1,178,022	–	–	–	–	2
	2,016,306	–	–	2,016,306	44.64p	07-04-06	07-10-06	2
M Ashton	665,763	–	–	665,763	89.27p	31-03-01	31-03-08	1
	907,841	–	–	907,841	66.71p	19-04-02	19-04-09	1
	904,752	–	–	904,752	77.37p	12-06-04	12-06-11	2
	1,052,328	–	112,627	939,701	69.40p	12-04-05	12-04-12	2
	1,774,349	–	–	1,774,349	44.64p	07-04-06	07-04-13	2
D Nicholson	555,604	–	–	555,604	71.99p	29-04-99	29-04-06	1
	89,614	–	–	89,614	89.27p	31-03-01	31-03-08	1
	179,872	–	–	179,872	66.71p	19-04-02	19-04-09	1
	465,301	–	–	465,301	77.37p	12-06-04	12-06-11	2
	541,197	–	57,923	483,274	69.40p	12-04-05	12-04-12	2
	985,750	–	–	985,750	44.64p	07-04-06	07-04-13	2

Super Options over shares of 10p each

Directors	1 January 2005	Granted	Lapsed	31 December 2005	Exercise price	Date from which options can be exercised	Expiry date	Performance Condition (see note)
IR Gowrie-Smith	2,385,009	–	2,385,009	–	–	–	–	3
M Ashton	2,129,659	–	–	2,129,659	54.40p	25-05-04	25-05-09	3
D Nicholson	1,064,830	–	–	1,064,830	54.40p	25-05-04	25-05-09	3

Performance Condition 1 – Options granted may be exercised only if, over a period of three consecutive years, the shareholder return of the Company exceeds the growth in the FTSE All Share Index over the same period.

Performance Condition 2 – Options granted vest after three years on a scale between 0% and 100% depending on the Company's performance relative to the performance of a Comparator Group of companies.

Performance Condition 3 – Options granted may be exercised only if, over a period of five consecutive years, the shareholder return of the Company lies within the top quartile growth of the FTSE 250 Share Index over the same period.

It should be noted that the options shown above have adjusted accordingly (number of options and exercise prices adjusted by a factor of 1.041758) to reflect the rights issue in November 2005.

No options were granted to or exercised by any Director during the year.

Options granted were for nil consideration.

All options held by and granted to the Executives are subject to the performance conditions and terms of the SkyePharma Executive Share Option Scheme, the European and North American Scheme and the SkyePharma PLC 1999 Share Option scheme.

LTIP Awards over shares of 10p each

Executive Directors	Date of Grant	Share Price at Date of Grant (Adjusted)	Value of Shares Conditionally Awarded £'000	Value of Shares Conditionally Awarded %age of Salary at date of Grant	Value of Shares Conditionally Awarded Adjusted Number	Date of the end of the Holding Period
M Ashton	05-05-04	57.52p	420	100%	729,787	05-05-07
	03-06-05	51.76p	440	100%	850,100	03-06-08
D Nicholson	05-05-04	57.52p	235	100%	409,262	05-05-07
	03-06-05	51.76p	250	100%	483,011	03-06-08

Performance Condition – LTIP Awards will only be released if the Company's comparative TSR performance is at the median or above of the Comparator Group at which point 30% of the LTIP Award will be released, with full vesting occurring for upper quartile performance (with straight line vesting between points). In addition, the Company is required to be in profit at the end of the performance period before any LTIP Awards may be released (see unaudited section of the Report for further information).

It should be noted that the LTIP Awards shown above have adjusted accordingly (number of shares conditionally awarded adjusted by a factor of 1.041758) to reflect the rights issue in November 2005.

LTIP awards were made on 24 April 2006 to Frank Condella (1,184,210), Donald Nicholson (697,368) and Dr Kenneth Cunningham (657,894) at a share price of 38 pence.

As at 31 December 2005, none of the Directors had any interests in shares of any other Group company. The market value of Ordinary Shares at 31 December 2005 was 49.75 pence. The market value of Ordinary Shares during 2005 ranged from the lowest closing mid-price of 34.25 pence to the highest closing mid-price of 66.75 pence. The following transactions have taken place since 31 December 2005 in respect of executive share incentives.

SkyePharma PLC Share Purchase Plan – As a result of transactions since 31 December 2005, by the SkyePharma PLC International Share Purchase Plan (an Inland Revenue approved all employee share purchase plan), Michael Ashton and Donald Nicholson, Directors of the Company, as trustees of the Plan became the non-beneficial owners of additional Ordinary Shares of the Company. Of these shares the Directors of the Company have the beneficial interests in Partnership Shares (Ordinary Shares of the Company) set out below as a result of their personal participation in the Plan. In accordance with the rules of the Plan these Directors have been awarded Matching Shares (Ordinary Shares in the Company) on the basis of one Matching Share for each Partnership Share. The beneficial ownership of these Matching Shares will pass to the Directors in three years' time subject to continued employment and the retention of the underlying Partnership Shares.

Directors	Total Number of Partnership Shares	Total Number of Matching Shares
M Ashton	1,239	1,239
D Nicholson	1,239	1,239

Date of Transaction	Total Number of Partnership Shares	Total Number of Matching Shares	Share Price (Acquired/ Awarded at)
1 February 2006	3,019	3,019	43 pence
1 March 2006	3,193	3,193	40.75 pence
3 April 2006	3,073	3,073	38.25 pence
2 May 2006	2,954	2,954	39.75 pence
Total Number of Shares Acquired (Non-Beneficial Interest)	**12,239**	**12,239**	

SkyePharma PLC Deferred Share Bonus Plan – In January 2006 the Remuneration Committee approved bonuses relating to the year 2005 of £110,000 and £62,500 for Michael Ashton and Donald Nicholson respectively, of which 50% of the net bonus was invested in Company shares, the 'Executive Shares'. The pre-tax bonus was used to calculate the number of associated 'Matching Shares' granted. In addition, the qualifying conditions for the grant of Matching Shares made on 31 January 2003 were satisfied resulting in the release of Matching Shares on 31 January 2006. All the Directors determined to pay the tax due on the release from their personal resources and retain 100% of the

Matching Shares released. The following table sets out the grant and release of awards under the DSB since 31 December 2005:

Directors	Date of Grant	Date of Release
IR Gowrie-Smith	–	31 January 2006
Number of Executive Shares	–	133,250
Number of Matching Shares	–	
M Ashton	2 February 2006	31 January 2006
Number Executive Shares	73,750	207,748
Number of Matching Shares	125,000	
D Nicholson	2 February 2006	31 January 2006
Number Executive Shares	41,903	106,841
Number of Matching Shares	71,022	

Performance Condition – Matching Shares granted on 2 February 2006 will only be released if the Company's comparative TSR performance is at the median or above of the Comparator Group. In addition, the Company is required to be in profit at the end of the performance period before any Matching Shares may be released (see unaudited section of the Report for further information).

The share price at which Executive Shares were purchased and Matching Shares awarded was 44 pence. The share price on the release of Matching Shares on 31 January 2006 was 44.5 pence (value of Matching Shares, £59,296 (IR Gowrie-Smith) £92,448 (M Ashton) and £47,544 (D Nicholson)).

Sir Michael Beavis
Chairman, Remuneration Committee
22 May 2006

Independent Auditors' Report to the Members of SkyePharma PLC

We have audited the Group and Parent Company financial statements (the "financial statements") of SkyePharma PLC for the year ended 31 December 2005 which comprise the Group Income Statement, the Group and Parent Company Balance Sheets, the Group and Parent Company Cash Flow Statements, the Group and Parent Company Statement of Recognised Income and Expense and the related notes. These financial statements have been prepared under the accounting policies set out therein. We have also audited the information in the Directors' Remuneration Report that is described as having been audited.

Respective responsibilities of directors and auditors
The directors' responsibilities for preparing the Annual Report, the Directors' Remuneration Report and the financial statements in accordance with applicable law and International Financial Reporting Standards (IFRSs) as adopted by the European Union are set out in the Statement of Directors' Responsibilities.

Our responsibility is to audit the financial statements and the part of the Directors' Remuneration Report to be audited in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland). This report, including the opinion, has been prepared for and only for the company's members as a body in accordance with Section 235 of the Companies Act 1985 and for no other purpose. We do not, in giving this opinion, accept or assume responsibility for any other purpose or to any other person to whom this report is shown or into whose hands it may come save where expressly agreed by our prior consent in writing.

We report to you our opinion as to whether the financial statements give a true and fair view and whether the financial statements and the part of the Directors' Remuneration Report to be audited have been properly prepared in accordance with the Companies Act 1985 and Article 4 of the IAS Regulation. We also report to you if, in our opinion, the Directors' Report is not consistent with the financial statements, if the company has not kept proper accounting records, if we have not received all the information and explanations we require for our audit, or if information specified by law regarding directors' remuneration and other transactions is not disclosed.

We review whether the Corporate Governance Statement reflects the company's compliance with the nine provisions of the 2003 FRC Combined Code specified for our review by the Listing Rules of the Financial Services Authority, and we report if it does not. We are not required to consider whether the board's statements on internal control cover all risks and controls, or form an opinion on the effectiveness of the group's corporate governance procedures or its risk and control procedures.

We read other information contained in the Annual Report and consider whether it is consistent with the audited financial statements. The other information comprises only the Corporate and Financial Highlights, the Chairman's Statement, the Review of Operations, the Financial Review, the Directors' Report, the Corporate Governance Statement and the unaudited part of the Directors' Remuneration Report. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the financial statements. Our responsibilities do not extend to any other information.

Basis of audit opinion
We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements and the part of the Directors' Remuneration Report to be audited. It also includes an assessment of the significant estimates and judgments made by the directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the group's

Independent Auditors' Report to the Members of SkyePharma PLC continued

and company's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements and the part of the Directors' Remuneration Report to be audited are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements and the part of the Directors' Remuneration Report to be audited.

Going concern

We draw your attention to Note 1 of the financial statements which indicates that there is uncertainty as to when certain strategic initiatives may be concluded and their effect on the Group's working capital requirements. By their nature these matters are material and create uncertainty which may cast significant doubt over the Company's ability to continue as a going concern. Our opinion is not qualified in this regard.

Opinion

In our opinion:

- the Group financial statements give a true and fair view, in accordance with IFRSs as adopted by the European Union, of the state of the group's affairs as at 31 December 2005 and of its loss and cash flows for the year then ended;
- the Parent Company financial statements give a true and fair view, in accordance with IFRSs as adopted by the European Union as applied in accordance with the provisions of the Companies Act 1985, of the state of the parent company's affairs as at 31 December 2005 and cash flows for the year then ended; and
- the financial statements and the part of the Directors' Remuneration Report to be audited have been properly prepared in accordance with the Companies Act 1985 and Article 4 of the IAS Regulation.

PricewaterhouseCoopers LLP

PricewaterhouseCoopers LLP
Chartered Accountants and Registered Auditors
London
22 May 2006

Consolidated Income Statement
for the year ended 31 December 2005

	Notes	Year to 31 December 2005 Pre-Exceptional £m	Exceptional (note 5) £m	Total £m	Year to 31 December 2004 Pre-Exceptional £m	Exceptional (note 5) £m	Total £m
Revenue	4	61.3	–	61.3	75.2	–	75.2
Cost of sales		(29.2)	–	(29.2)	(28.2)	–	(28.2)
Gross profit		32.1	–	32.1	47.0	–	47.0
Selling, marketing and distribution expenses		(5.9)	–	(5.9)	(1.7)	–	(1.7)
Administration expenses							
Amortisation of other intangibles		(2.1)	–	(2.1)	(2.2)	–	(2.2)
Other administration expenses		(13.8)	(21.4)	(35.2)	(15.6)	(4.7)	(20.3)
		(15.9)	(21.4)	(37.3)	(17.8)	(4.7)	(22.5)
Research and development expenses		(26.0)	–	(26.0)	(28.0)		(28.0)
Other expense	8	(0.4)	–	(0.4)	0.1	2.0	2.1
Operating loss		(16.1)	(21.4)	(37.5)	(0.4)	(2.7)	(3.1)
Finance costs	9	(22.3)	–	(22.3)	(17.7)	(6.2)	(23.9)
Finance income	9	10.0	–	10.0	8.6	–	8.6
Share of loss in associate	15	(0.8)	–	(0.8)	–	–	–
Loss before income tax		(29.2)	(21.4)	(50.6)	(9.5)	(8.9)	(18.4)
Income tax expense	10	(0.3)	–	(0.3)	(0.2)	–	(0.2)
Loss for the year		(29.5)	(21.4)	(50.9)	(9.7)	(8.9)	(18.6)
Basic and diluted earnings per share	11	(4.7p)	(3.4p)	(8.1p)	(1.6p)	(1.4p)	(3.0p)

All results represent continuing activities.

See Notes to the Financial Statements.

Consolidated Balance Sheet
as at 31 December 2005

	Notes	31 December 2005 £m	31 December 2004 £m
ASSETS			
Non-current assets			
Goodwill	12	68.7	68.7
Other intangible assets	13	26.8	26.7
Property, plant and equipment	14	37.1	40.9
Investments in associates	15	0.2	14.3
Available-for-sale financial assets	16	1.6	5.2
		134.4	155.8
Current assets			
Inventories	18	3.6	1.5
Trade and other receivables	19	14.2	18.2
Financial assets at fair value through profit or loss	20	0.4	1.1
Cash and cash equivalents	21	34.3	15.3
		52.5	36.1
Total Assets		186.9	191.9
LIABILITIES			
Current liabilities			
Trade and other payables	22	(21.0)	(20.6)
Convertible bonds	23, 24	–	(9.4)
Other borrowings	23	(3.4)	(3.9)
Derivative financial instruments	25	–	(0.2)
Deferred income		(7.7)	(11.8)
Provisions	26	–	(0.3)
		(32.1)	(46.2)
Non current liabilities			
Convertible bonds	23, 24	(63.6)	(50.4)
Other borrowings	23	(51.1)	(51.9)
Deferred income		(2.9)	(2.3)
Other non current liabilities		(3.4)	(2.9)
Provisions	26	(1.9)	(1.7)
		(122.9)	(109.2)
Total Liabilities		(155.0)	(155.4)
Net Assets		31.9	36.5
SHAREHOLDERS' EQUITY			
Share capital	28	76.6	63.4
Share premium	30	345.6	321.0
Translation reserve	30	(1.2)	(0.9)
Fair value reserve	30	0.2	(0.5)
Retained losses	30	(427.1)	(378.9)
Other reserves	31	37.8	32.4
Total Shareholders' Equity		31.9	36.5

Approved by the Board of Directors on 22 May 2006 and signed on its behalf by:

J Karabelas
Non-Executive Chairman

D Nicholson
Finance Director

See Notes to the Financial Statements.

Company Balance Sheet
as at 31 December 2005

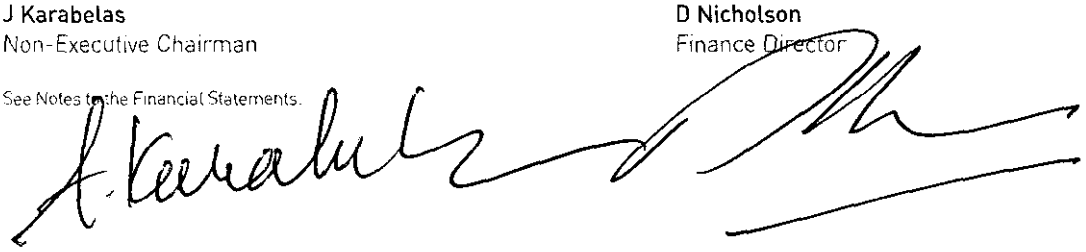
	Notes	31 December 2005 £m	31 December 2004 £m
ASSETS			
Non-current assets			
Property, plant and equipment	14	0.1	0.1
Investments in associates	15	0.2	14.3
Available-for-sale financial assets	16	1.3	3.6
Shares in and loans to Group undertakings	17	339.8	400.8
		341.4	418.8
Current assets			
Trade and other receivables	19	5.7	6.4
Cash and cash equivalents	21	31.6	11.3
		37.3	17.7
Total Assets		378.7	436.5
LIABILITIES			
Current liabilities			
Trade and other payables	22	91.5	80.5
Convertible bonds	23, 24	–	9.4
Other borrowings	23	0.8	1.9
		92.3	91.8
Non-current liabilities			
Other borrowings	23	0.6	–
		0.6	–
Total Liabilities		92.9	91.8
Net Assets		285.8	344.7
SHAREHOLDERS' EQUITY			
Share capital	28	76.6	63.4
Share premium	30	345.6	321.0
Fair value reserve	30	0.2	(0.5)
Retained earnings	30	(146.0)	(49.3)
Other reserves	31	9.4	10.1
Total Shareholders' Equity		285.8	344.7

Approved by the Board of Directors on 22 May 2006 and signed on its behalf by:

J Karabelas
Non-Executive Chairman

D Nicholson
Finance Director

See Notes to the Financial Statements.



Consolidated Statement of Recognised Income and Expense
for the year ended 31 December 2005

	Year to 31 December 2005 £m	Year to 31 December 2004 £m
Net currency translation effect	(0.3)	(2.5)
Fair value movements on available for sale investments	0.2	(0.5)
Actuarial losses on defined benefit plans	--	(0.1)
Net losses recognised directly in equity	(0.1)	(3.1)
Loss for the year	(50.9)	(18.6)
Total recognised income and expense for the year	(51.0)	(21.7)

Company Statement of Recognised Income and Expense
for the year ended 31 December 2005

	Year to 31 December 2005 £m	Year to 31 December 2004 £m
Fair value movements on available for sale investments	0.2	(0.5)
Net profits recognised directly in equity	0.2	(0.5)
Loss for the year	(98.3)	(32.0)
Total recognised income and expense for the year	(98.1)	(32.5)

See Notes to the Financial Statements.

Consolidated Cash Flow Statement
for the year ended 31 December 2005

	Notes	Year to 31 December 2005 £m	Year to 31 December 2004 £m
Cash flow from operating activities			
Cash used in operations	(a)	(7.6)	(3.7)
Income tax paid		(0.3)	(0.2)
Net cash used in operating activities		(7.9)	(3.9)
Cash flows from investing activities			
Purchases of property, plant and equipment		(2.6)	(4.4)
Purchases of intangible assets		(2.3)	(1.4)
Purchase of shares in associates		(0.2)	–
Purchase of available for sale investments		–	(2.2)
Purchase of own shares		(0.4)	–
Proceeds from disposal of available for sale investments		1.6	2.7
Net cash used in investing activities		(3.9)	(5.3)
Cash flows from financing activities			
Gross proceeds from rights issue		37.7	–
Expenses of rights issue		(2.9)	–
Proceeds from issue of ordinary share capital		0.1	0.3
Proceeds from issue of convertible bonds due June 2025		20.0	–
Proceeds from issue of convertible bonds due May 2024		–	20.0
Expenses of issue of convertible bonds due June 2025		(1.2)	–
Expenses of issue and exchange of convertible bonds due May 2024		–	(3.4)
Repayment of convertible bonds due June 2005		(9.8)	–
Repayments of borrowings		(7.4)	(8.6)
Repayment of finance lease principal		–	(0.2)
Interest paid		(6.7)	(5.9)
Interest received		0.8	0.7
Net cash generated from financing activities		30.6	2.9
Effect of exchange rate changes		0.2	(0.4)
Net increase/ (decrease) in cash and cash equivalents		19.0	(6.7)
Cash and cash equivalents at beginning of the year		15.3	22.0
Cash and cash equivalents at end of the year		34.3	15.3

See Notes to the Financial Statements.

Consolidated Cash Flow Statement continued

(a) Cash flow from operating activities

	Year to 31 December 2005 £m	Year to 31 December 2004 £m
Loss for the year	**(50.9)**	(18.6)
Adjustments for:		
Tax	**0.3**	0.2
Depreciation	**6.2**	6.0
Amortisation	**2.1**	2.2
Impairments	**19.4**	3.5
Fair value (gain)/ loss on derivative financial instruments	**(0.3)**	0.5
Finance costs	**22.3**	23.9
Finance income	**(10.0)**	(6.8)
Share of loss in associate	**0.8**	–
Profit on disposal of available for sale financial assets	**(0.3)**	(2.0)
Other non-cash changes	**3.2**	4.0
Operating cash flows before movements in working capital	**(7.2)**	12.9
Changes in working capital		
Increase in inventories	**(2.1)**	(0.2)
Decrease/ (increase) in trade and other receivables	**4.2**	(5.9)
Increase in trade and other payables	**1.2**	4.0
Decrease in deferred income	**(3.4)**	(13.0)
Decrease in provisions	**(0.3)**	(1.5)
Cash used in operations	**(7.6)**	(3.7)

Company Cash Flow Statement
for the year ended 31 December 2005

	Note	Year to 31 December 2005 £m	Year to 31 December 2004 £m
Cash flows from operating activities			
Cash generated from operations	(a)	(13.3)	(15.9)
Cash flows from investing activities			
Purchases of property, plant and equipment		(0.1)	–
Purchase of shares in associates		(0.2)	(0.1)
Proceeds from disposal of available for sale investments		1.6	–
Purchase of available for sale investments		–	(2.0)
Net cash generated from/(used in) investing activities		1.3	(2.1)
Cash flows from financing activities			
Gross proceeds from rights issue		37.7	2.1
Expenses of rights issue		(2.9)	–
Proceeds from issue of ordinary share capital		0.1	–
Repayment of convertible bonds due June 2005		(9.8)	–
Repayment of borrowings		(0.5)	(0.8)
Interest paid		(6.4)	(5.2)
Interest received		14.1	12.0
Net cash generated from financing activities		32.3	8.1
Net increase/(decrease) in cash and cash equivalents		20.3	(9.9)
Cash and cash equivalents at beginning of the year		11.3	21.2
Cash and cash equivalents at end of the year		31.6	11.3

Company Cash Flow Statement continued
for the year ended 31 December 2005

(a) Cash flow from operating activities

	Year to 31 December 2005 £m	Year to 31 December 2004 £m
Loss for the year	**(98.3)**	(32.0)
Adjustments for:		
Impairments	**19.1**	29.1
Provision	**80.0**	-
Fair value gain on derivative financial instruments	**(0.3)**	-
Interest expense	**5.8**	5.9
Interest income	**(14.2)**	(12.0)
Profit on disposal of available for sale financial assets	**(0.3)**	-
Other non-cash changes	**0.9**	3.7
Operating cash flows before movements in working capital	**(7.3)**	(5.3)
Changes in working capital		
Decrease in trade and other receivables	**1.0**	0.4
Decrease in trade and other payables	**(7.0)**	(11.0)
Cash generated from operations	**(13.3)**	(15.9)

See Notes to the Financial Statements.

Notes to the Financial Statements

1 Accounting policies

General information
SkyePharma PLC (the "Company") and its subsidiaries (together the "Group") is a speciality pharmaceutical Group which uses its multiple drug delivery technologies to create a product pipeline for out-licensing to marketing partners.

The Company is incorporated and domiciled in United Kingdom, with its registered office at 105 Piccadilly, London W1J 7NJ.

The principal accounting policies adopted in the preparation of these consolidated financial statements are set out below.

(a) Basis of preparation
In accordance with EU regulations, SkyePharma is required to prepare statutory financial statements which comply with the International Financial Reporting Standards adopted for use in the European Union ("IFRS") starting from the financial year ended 31 December 2005, being the first financial year, commencing after 1 January 2005.

The International Financial Reporting Standards adopted for use in the European Union are similar with the International Financial Reporting Standards as issued by the IASB, except for certain provisions concerning fair value accounting for financial liabilities and hedge accounting, which have no impact on the financial statements of the Group. Consequently, the consolidated IFRS financial statements for the year ended 31 December 2005 are compliant with both the International Financial Reporting Standards as issued by IASB and the version adopted for use in the European Union.

These consolidated financial statements have been prepared in accordance with IFRS and, the interpretations issued by the International Financial Reporting Interpretations Committee ("IFRIC") and with those parts of the Companies Act 1985 applicable to companies reporting under IFRS. The financial statements have been prepared under the historical cost convention, as modified by the revaluation of financial assets and financial liabilities.

The Company's working capital requirements continue to be affected by the timing and receipt of milestone payments and payments received on the signing of new contracts. The Company's future cash flows will also be impacted by the Company's change in strategy as outlined in the EGM notice dated 16 February 2006, principally its stated aim of moving to sustainable profitability in the shortest possible time and its refocus to concentrate on oral and pulmonary products. Consequently the Group's near term working capital requirements are uncertain and sensitive to the timing of a number of initiatives required to provide the financial flexibility to implement the new strategy. These initiatives include the licensing of Flutiform in Europe, the divestment of its injectable business interests, which is expected to require shareholder approval, and the delay of certain licensing discussions, such as US licensing for DepoBupivacaine pending the divestment of its injectables business.

The Directors have reviewed the working capital requirements of the Group for the next twelve months and have a reasonable expectation that sufficient funds will be raised from these initiatives and have therefore prepared the financial information contained herein on a going concern basis which assumes that the Company will continue in operational existence for the foreseeable future. The financial statements do not reflect any adjustments that would be required to be made if they were to be prepared on a basis other than the going concern basis.

Use of estimates
The preparation of the financial statements, in conformity with IFRS, requires the use of estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Although these estimates are based on management's best knowledge of the amount, event or actions, actual results may ultimately differ from those estimates. The areas involving higher degree of judgement or complexity, or areas where assumptions and estimates are significant to the consolidated financial statements are disclosed in Note 3; Critical accounting estimates and judgements.

Company income statement
In accordance with the provisions of section 230 of the Companies Act 1985, no separate income

statement has been presented for the Company. The results for the Company are also presented under IFRS.

(b) IFRS 1 exemptions
IFRS 1; First-time Adoption of International Financial Reporting Standards has been applied in preparing these financial statements. IFRS 1 sets out the procedures that the Group must follow when it adopts IFRS for the first time.

The Group has established its IFRS accounting policies for the year ending 31 December 2005 and applied these standards retrospectively to determine the IFRS opening balance sheet at its date of transition, 1 January 2004, except where permitted or required by IFRS 1 or other applicable standards.

Except as noted below, at the date of transition to IFRS, the Group recognised all assets and liabilities as required by IFRS and derecognised all assets and liabilities not permitted by IFRS. Assets and liabilities were all measured in accordance with IFRS.

The impact of transition from UK GAAP to IFRS on the Group's shareholders' funds as at 1 January 2004 and 31 December 2004, and on the Group's income statement for the year ended 31 December 2004 is discussed in Note 37; Transition from accounting practices generally accepted in the UK to International Financial Reporting Standards.

The adoption of the provisions set out in IFRS 1 are outlined below.

- **Business combinations:** A first-time adopter may elect not to apply IFRS 3; Business Combinations retrospectively to business combinations that occurred before the date of transition to IFRS. The Company elected to take advantage of this exemption, not applying IFRS 3 to the business combinations that occurred before the date of transition. Any unamortised goodwill at 1 January 2004, calculated in accordance with UK GAAP, has been recognised in the IFRS accounts at depreciated cost after taking into account potential adjustments required to comply with IFRS measurement principles.

- **Share-based payments:** A first-time adopter is encouraged, but not required, to apply IFRS 2; Share-Based Payments to equity instruments that were granted on or before 7 November 2002 and not vested at 1 January 2005. The Company elected to adopt full retrospective application of IFRS 2, not taking advantage of the IFRS 1 exemption.

- **Cumulative translation differences:** A first-time adopter need not comply retrospectively with the requirements in IAS 21; The Effects of Changes in Foreign Exchange Rates to classify translation differences as a separate component of equity related to foreign operations and recycle them through the income statement on disposal of the foreign operations. The Group elected not to take advantage of this exemption.

- **Financial instruments:** In its first IFRS financial statements a first time adopter need not restate the comparative information in compliance with IAS 32; Financial Instruments: Disclosure and presentation and IAS 39; Financial Instruments: Recognition and Measurement. The Company elected not to take advantage of this exemption.

(c) Consolidation
The underlying financial statements comprise a consolidation of the accounts of the Company and all its subsidiaries and includes the Group's share of the results and net assets of its associates. The accounts of the Group's subsidiaries and associates are made up to 31 December.

Subsidiaries
Subsidiaries are all entities over which the Group has control. Control is achieved where the Company has the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. Subsidiaries are fully consolidated from the date on which control is transferred to the Group. They are de-consolidated from the date on which control ceases. The results of subsidiaries acquired or disposed during the year are included in the consolidated income statement from the effective date of acquisition or up to the effective date of disposal, as appropriate.

The Group uses the purchase method to account for the acquisition of subsidiaries. The cost of an acquisition is measured as the fair value of the assets given, equity instruments issued and liabilities incurred or assumed at the date of exchange, plus

costs directly attributable to the acquisition. Identifiable assets acquired and liabilities and contingent liabilities assumed in a business combination are measured initially at their fair values at the acquisition date, irrespective of the extent of any minority interest. The excess of the cost of acquisition over the fair value of the Group's share of the identifiable net assets acquired is recorded as goodwill. If the cost of acquisition is less than the fair value of the group's share of the net assets of the subsidiary acquired, the difference is recognised directly in the income statement.

Inter-company transactions, balances and unrealised gains on transactions between Group companies are eliminated. Unrealised losses are also eliminated unless the transaction provides evidence of an impairment of the asset transferred. Subsidiaries' accounting policies have been changed where necessary to ensure consistency with the policies adopted by the Group.

Associates
Associates are all entities over which the Group has the power to exercise significant influence but not control generally accompanying a shareholding of between 20% and 50% of the voting rights. Investments in associates are accounted for by the equity method of accounting and are initially recognised at cost. The Group's investment in associates includes goodwill identified on acquisition.

The Group's share of its associates' post-acquisition profits or losses is recognised in the income statement, and its share of post-acquisition movements in reserves is recognised in reserves. The cumulative post-acquisition movements are adjusted against the carrying amount of the investment. When the Group's share of losses in an associate or joint venture equals or exceeds its interest or participation, including any other unsecured long-term receivables, the Group does not recognise further losses, unless it has incurred obligations or made payments on behalf of the associate or joint venture.

Unrealised gains on transactions between the Group and its associates are eliminated to the extent of the Group's interest in the associates. Unrealised losses are also eliminated unless the transaction provides evidence of an impairment of the asset transferred. Associates' accounting policies have been changed where necessary to ensure consistency with the policies adopted by the Group.

(d) Foreign currency translation
Functional and presentation currency
Items included in the financial statements of each of the Group's entities are measured using the currency of the primary economic environment in which the entity operates ('the functional currency'). The consolidated financial statements are presented in pound sterling, which is the Company's functional and presentation currency.

Transactions and balances
Foreign currency transactions by Group companies are translated in the functional currency at the exchange rate prevailing at the date of the transaction. Foreign exchange gains and losses resulting from the settlement of such transactions and from the translation at year-end exchange rates of monetary assets and liabilities denominated in foreign currencies are recognised in the income statement, except when it relates to items recognised directly in equity e.g. equities classified as available for sale, the exchange component of that gain or loss will be recognised directly in equity.

Group companies
The results and financial position of all the Group entities that have a functional currency different from the presentation currency are translated into the presentation currency as follows:

(i) assets and liabilities for each balance sheet presented are translated at the closing rate at the date of the balance sheet;

(ii) income and expenses for each income statement are translated at average exchange rates; and

(iii) all resulting exchange differences are recognised as a separate component of equity.

On consolidation, exchange differences arising from the translation of the net investment in foreign entities, are taken to shareholders' equity.

Goodwill and fair value adjustments arising on the acquisition of a foreign entity are treated as assets and liabilities of the foreign entity and translated

at the closing rate. On disposal of a foreign entity, accumulated exchange differences are recognised in the income statement in the same period in which the gain or loss on disposal is recognised.

(e) Segment reporting
The Group's primary segment for IFRS segment reporting is the business segment. A business segment is a group of assets and operations engaged in providing products or services that are subject to risks and returns that are different from those of other business segments.

Geographical regions are the secondary reporting segments. A geographic segment is engaged in providing products or services within a particular economic environment that are subject to risks and return that are different from those of components operating in other economic environments.

Segment reporting reflects the internal management reporting structure and the way the business is managed.

(f) Revenue recognition
Revenue comprises the fair value for the sale of goods and services, net of sales taxes, rebates and discounts and after eliminating sales within the Group. Revenue is recognised as follows:

Contract development and licensing
Contract development and licensing income represents amounts earned for services rendered under development and licensing agreements, including up-front payments, milestone payments, technology access fees and research and development costs recharged. Revenues are recognised where they are non-refundable, the Group's obligations related to the revenues have been discharged and their collection is reasonably assured. Refundable contract revenue is treated as deferred until such time that it is no longer refundable. In general up-front payments are deferred and amortised on a systematic basis over the period of development to filing. Milestone payments related to scientific or technical achievements are recognised as income when the milestone is accomplished.

Royalty income
Royalty income is recognised on an accruals basis and represents income earned as a percentage of product sales in accordance with the substance of the relevant agreement.

Manufacturing and distribution
Manufacturing and distribution revenues principally comprise contract manufacturing fees invoiced to third parties and income from product sales. Revenues are recognised upon transfer to the customer of significant risks and rewards, usually upon despatch of goods shipped where the sales price is agreed and collectability is reasonably assured.

(g) Intangible assets
Goodwill
Goodwill represents the excess of the cost of an acquisition over the fair value of the Group's share of the net identifiable assets of the acquired subsidiary at the date of acquisition. Goodwill is tested annually for impairment and carried at cost less accumulated impairment losses. Goodwill is allocated to cash generating units for the purpose of impairment testing. Each of those cash generating units represents the Group's investment in each country of operation.

Intellectual property
Intellectual property comprises acquired patents, trade marks, know-how and other similarly identified rights. These are recorded at their fair value at acquisition date and are amortised on a straight line basis over their estimated useful economic lives from the time they are available for use. The period over which the Group expects to derive economic benefits does not exceed 20 years.

Research and development
Research expenditure is charged to the income statement in the period in which it is incurred. Development expenditure is capitalised when the criteria for recognising as an asset are met – when it is probable that the project will be a success, considering its commercial and technological feasibility and costs can be measured reliably. Regulatory and other uncertainties generally mean that such criteria are not met. Where development costs are capitalised they are amortised over their useful economic lives from product launch. Prior to product launch the asset is tested annually for impairment.

Computer software
Costs that are directly associated with the purchase and implementation of identifiable and unique software products by the Group are recognised as intangible assets. Expenditures that enhance and extend the benefits of computer software programmes beyond their original specifications and lives are recognised as a capital improvement and added to the original cost of the software. Direct costs include the software development employee costs and an appropriate portion of relevant overheads. Software costs are amortised over their useful economic lives, generally a period of 3 to 5 years.

(h) Property, plant and equipment
Property, plant and equipment are stated at the cost of purchase or construction less provision for depreciation and impairment. The cost of property, plant and equipment includes acquisition costs and labour and overhead costs arising directly from the construction or acquisition of an item of property, plant and equipment.

Subsequent costs are included in the asset's carrying amount or recognised as a separate asset, as appropriate, only when it is probable that future economic benefits associated with the item will flow to the Group and the cost of the item can be measured reliably. All other repairs and maintenance expenditures are charged to the income statement during the financial period in which they are incurred.

Depreciation is not provided on freehold land or projects under construction. On other property, plant and equipment, depreciation is provided on the difference between the cost of an item and its estimated residual value, in equal annual instalments over the estimated useful lives of the assets as follows:

Freehold buildings	2% – 5%
Laboratory equipment and machines	10% – 33%
Office and other equipment	10% – 33%
Motor vehicles	20%
Short leasehold property	period of the lease

Assets in the course of construction are depreciated when they have been brought into operational use.

The assets' residual values and useful lives are reviewed, and adjusted if appropriate, at each balance sheet date. An asset's carrying amount is written down immediately to its recoverable amount if the asset's carrying amount is greater than its estimated recoverable amount.

Gains and losses on disposals are determined by comparing the disposal proceeds with the carrying amount and are included in the income statement.

(i) Impairment of assets
Assets that have an indefinite useful life are not subject to amortisation and are tested annually for impairment. Assets that are subject to amortisation or depreciation are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. An impairment loss is recognised for the amount by which the asset's carrying amount exceeds its recoverable amount. The recoverable amount is the higher of an asset's fair value less costs to sell and value in use. Any impairment loss is charged to the income statement in the year concerned. For the purposes of assessing impairment, assets are grouped at the lowest levels for which there are separately identifiable cash in flows (cash-generating units).

The expected cash flows generated by the assets are discounted using asset specific discount rates which reflect the risks associated with the groups of assets. These risks vary with the nature and the location of the cash generating units.

(j) Investments
The Group classifies its investments according to the purpose for which the investments were acquired. Management determines the classification of investments at initial recognition and re-evaluates the designation at every reporting date. The Group has the following categories of investments:

Available-for-sale financial assets
Available-for-sale financial assets are non-derivatives that are not acquired to generate profit from short-term fluctuations in price. They are included in non-current assets unless management intends to dispose of the asset within 12 months of the balance sheet date.

Available-for-sale investments are initially recorded at cost, being the fair value of consideration given, plus transaction costs. Subsequently, available-for-sale

investments comprising marketable equity securities that are traded in active markets are carried at their fair value as of each balance sheet date.

Unrealised gains and losses arising from changes in the fair value of non-monetary securities classified as available-for-sale investments are recognised in equity. When available-for-sale investments are sold or impaired, the accumulated fair value adjustments in equity are recycled into the income statement as gains and losses from investment securities.

The Group assesses at each balance sheet date whether there is objective evidence that a financial asset or a group of financial assets is impaired. If any such evidence exists for available-for-sale financial assets, the cumulative loss – measured as the difference between the acquisition cost and the current fair value, less any impairment loss on that financial asset previously recognised is removed from equity and recognised in the income statement. Impairment losses recognised in the income statement on equity instruments are not reversed through the income statement.

Financial assets at fair value through profit or loss
The Group classifies investments in this category if acquired principally for the purpose of selling in the short term or if so designated by management. Financial assets at fair value through profit or loss are initially recorded, and subsequently carried, at fair value. Realised and unrealised gains and losses arising from changes in the fair value of assets held in this category are included in the income statement in the period in which they arise. Financial assets at fair value through profit or loss are classified as current assets if they are either held for trading or are expected to be realised within 12 months of the balance sheet date.

(k) Inventories
Inventories are stated at the lower of cost and net realisable value. Cost is determined using the first-in-first-out (FIFO) method. The cost of finished goods and work in progress comprises raw materials, direct labour, other direct costs and an appropriate proportion of related production overheads, based on the normal level of production capacity. Net realisable value is the estimated selling price in the ordinary course of business, less applicable variable selling expenses. Provision is made for obsolete, slow-moving or defective items where appropriate.

(l) Trade receivables
Trade receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. They arise when the Group provides money, goods or services directly to a debtor with no intention of trading the receivable. They are included in current assets, except for maturities greater than 12 months after the balance sheet date. These are classified as non-current assets. Trade receivables are recognised initially at fair value less provision for impairment. A provision for impairment of trade receivables is established when there is objective evidence that the Group will not be able to collect all amounts due according to the original terms of the receivables.

(m) Cash and cash equivalents
Cash and cash equivalents are highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value. Cash and cash equivalents are carried in the balance sheet at cost. For the purposes of the cash flow statement, cash and cash equivalents comprise cash at bank and in hand, short term deposits, marketable securities and overdrafts. Bank overdrafts are included within borrowings in current liabilities on the balance sheet.

(n) Borrowings
Borrowings are recognised initially at fair value, net of transaction costs incurred. Borrowings are subsequently stated at amortised cost, any difference between proceeds (net of transaction costs) and the redemption value is recognised in the income statement over the period of the borrowings using the effective interest method. Borrowings are classified as current liabilities unless the Group has an unconditional right to defer settlement of the liability for at least 12 months after the balance sheet date.

(o) Convertible bonds
On issue the debt and equity components of a convertible bond are separated and recorded at fair value net of issue costs. The fair value of the liability portion is determined by applying a market interest rate for an equivalent non-convertible bond to the forecast cash flows under the convertible bond agreement. This amount is recorded as a liability

on an amortised cost basis until extinguished on conversion or maturity of the bonds. The remainder of the proceeds of the bond is allocated to the conversion option which is recognised and included in shareholders' equity, net of income tax effects. The value of the conversion option is not changed in subsequent periods.

(p) Paul Capital funding liabilities

The Group entered into two transactions with Paul Capital Royalty Acquisition Fund ('Paul Capital') in 2000 and 2002. Under these transactions Paul Capital provided a total of $60m in return for the sale of a portion of the potential future royalty and revenue streams on a selection of the Group's products. The proceeds received from Paul Capital meet the definition of a financial liability under IAS 39, and are treated as such and recorded in borrowings at the net present value of royalties expected to be paid to Paul Capital over the term of the agreements at the effective interest rates at inception of the arrangements. Interest is charged on the liability and royalties paid to Paul Capital are treated as repayment of the liability.

(q) Derivative financial instruments

The Group uses derivative financial instruments to manage its exposure to fluctuations in interest and foreign exchange rates. Specifically, the Group uses interest rate swaps, forward currency contracts and currency options.

Derivatives are initially recognised at fair value on the date a derivative contract is entered into and are subsequently re-measured at their fair value. The Group designates certain derivatives as either:

- hedges of the fair value of recognised assets or liabilities (fair value hedge); or
- hedges of highly probable forecast transactions (cash flow hedges).

For relationships where hedge accounting is applied the Group documents at the inception of the transaction the relationship between hedging instruments and hedged items, as well as its risk management objective and strategy for undertaking various hedge transactions and reviews this documentation on an ongoing basis.

Fair value hedge

Changes in the fair value of derivatives that are designated and qualify as fair value hedges are recorded in the income statement, together with any changes in the fair value of the hedged asset or liability that are attributable to the hedged risk.

Cash flow hedge

The effective portion of changes in the fair value of derivatives that are designated and qualify as cash flow hedges are recognised in equity. The gain or loss relating to the ineffective portion is recognised immediately in the income statement. Amounts deferred in equity are recycled in the income statement in the periods when the hedged item will affect profit or loss.

Derivatives that do not qualify for hedge accounting

Changes in the fair value of any derivative instruments that do not qualify for hedge accounting are recognised immediately in the income statement.

(r) Leases

Lease agreements which transfer to the Group substantially all the risks and rewards of ownership of an asset are classified as finance leases. Finance leases are capitalised at the inception of the lease at the lower of the fair value of the leased property, plant and equipment or the present value of minimum lease payments. Each lease payment is allocated between the liability and finance charges so as to achieve a constant rate on the finance balance outstanding. The corresponding rental obligations, net of finance charges, are included in other long-term payables. These payments are split between capital and interest elements using the annuity method. The interest element of the lease rental is included in the income statement. Assets held under finance leases are depreciated on a basis consistent with similar owned assets or the lease term if shorter.

All other leases are classified as operating leases. Payments made under operating leases, net of lease incentives or premiums received, are charged to the income statement on a straight line basis over the period of the lease.

(s) Employee benefits

Pension obligations

The Group operates various defined contribution plans for its employees in the UK and US. The Group's contributions to these plans are charged to the income statement in the period to which they relate, and the assets are held in separate trustee

administered funds. The Group has no further payment obligations once the contributions have been paid.

The Group operates a funded defined benefit scheme in respect of its employees in Switzerland and an unfunded defined benefit scheme in respect of its employees in France.

The liability recognised in the balance sheet in respect of the defined benefit pension plans is the present value of the defined benefit obligations at the balance sheet date less the fair value of plan assets, together with adjustments for unrecognised past service costs. Defined benefit obligations for the schemes are calculated annually by independent actuaries using the projected unit credit method. The present value of the defined benefit obligations are determined by discounting the estimated future cash outflows using interest rates of high quality corporate bonds that are denominated in the currency in which the benefits will be paid, and that have terms to maturity approximating to the terms of the related pension liability. Service costs are included in staff costs and charged to income statement over the remaining average expected service lives of employees.

Actuarial gains and losses arising from experience adjustments and changes actuarial assumptions are charged or credited to equity in the Consolidated Statement of Recognised Income and Expense in the period in which they arise.

The Group recognises actuarial gains and losses arising from experience adjustments and changes in actuarial assumptions directly in equity, in the period they have occurred, in accordance to the alternative treatment allowed by the amendment to IAS 19; Employee benefits – Actuarial gains and losses, group plans and disclosures.

Share-based compensation
Incentives in the form of shares are provided to employees under share option, share purchase and long term incentive plans. The fair value of the employee services received in exchange for the grant of the options and rewards is recognised as an expense. The total amount to be expensed over the vesting period is determined by reference to the fair value of the options granted, which excludes the impact of any non-market vesting conditions (for example, profitability and sales growth targets).

Non-market vesting conditions are included in estimates about the number of options that are expected to become exercisable.

The Group provides finance to an employee share ownership trust to purchase company shares on the open market to meet the Group's obligation to provide shares when employees exercise their options or awards. The costs of running the employee share ownership trust are charged to the income statement as they accrue. Shares held by the employee share ownership trust are deducted from shareholders' equity.

At each balance sheet date, the entity revises its estimates of the number of options that are expected to become exercisable. It recognises the impact of the revision of original estimates, if any, in the income statement, and a corresponding adjustment to equity over the remaining vesting period.

(t) Provisions
Provisions are recognised when the Group has a present legal or constructive obligation as a result of past events, if it is probable that an outflow of resources will be required to settle the obligation and the amount can be reliably estimated. Restructuring charges are provided in the period in which management has committed to a plan and it is probable that an obligation has been incurred that can be reliably estimated. Provisions are not recognised for future operating losses.

(u) Taxation
Current tax is the expected tax payable on the taxable income for the year using the tax rates and laws that have been enacted or substantially enacted at the balance sheet date, and any adjustment to tax payable in respect of previous years.

Deferred income tax is provided in full, using the liability method, on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the consolidated financial statements. Deferred tax assets are recognised to the extent that it is probable that future taxable profits will be available against which the temporary differences can be utilised. Deferred income tax is determined using tax rates that have been enacted or substantially enacted by the balance sheet date. Deferred tax assets and liabilities are not discounted.

(v) Deferred consideration
Provisions for deferred consideration comprise the fair value of contingent consideration arising from acquisitions. The eventual outcome is subject to the Group's future performance and certain contractual terms. Provisions are reviewed annually by the Directors, and changes to the estimated fair value of the contingent consideration are recorded as an adjustment to goodwill or the underlying asset value.

2 Financial risk management

Financial risk factors
The Group holds financial instruments to finance its operations and to manage the currency risk that arises from these operations. It is the Group's policy that no speculative trading in financial instruments shall be undertaken. The Group finances its operations through a combination of equity, convertible bonds, bank loans and other borrowings. The main risks arising from the Group's financial instruments are liquidity risk, foreign currency risk, interest rate risk, credit risk and price risk.

Liquidity risk
The Group's policy is to maintain continuity of funding through a mixture of long-term debt and bank loans, raised to cover specific projects, and through the issue of shares to collaborative partners, where necessary, to finance development contracts. Short-term flexibility is provided through the use of overdrafts.

Foreign currency risk
All of the Group's operations are based overseas in Continental Europe and North America giving rise to exposures to changes in foreign exchange rates notably the Swiss Franc, Euro and US Dollar.
To minimise the impact of any fluctuations, the Group's policy has historically been to maintain natural hedges by relating the structure of borrowings to the trading cash flows that generate them. Where subsidiaries are funded centrally, this is achieved by the use of long-term loans, the exchange differences on which are taken to reserves.
Where it has not been possible to use natural hedges, currency options, accrual forward options and forward currency contracts are used. The Group has used these financial instruments during the year to minimise the currency exposure on operational transactions.

Interest rate risk
The Group borrows at fixed and floating rates of interest as deemed appropriate for its circumstances. Where necessary the Group uses interest rate swaps to achieve the desired interest rate profile.

Credit risk
The Group is exposed to credit related losses in the event of non-performance by third parties to financial instruments. The Group does not expect any third parties to fail to meet their obligations given the policy of selecting only parties with high credit ratings and minimising its exposure to any one institution.

Price risk
The Group is exposed to equity securities price risk because of investments which have been classified on the consolidated balance sheet as at fair value through profit or loss.

Fair value estimation
The fair value of financial instruments traded in active markets (such as trading and available-for-sale securities) is based on quoted market prices at the balance sheet date. The quoted market price used for financial assets held by the Group is the current bid price. Quoted market prices or dealer quotes for similar instruments are used for other financial instruments. The fair value of forward foreign exchange contracts is determined using forward exchange market rates at the balance sheet date. The nominal value less estimated credit adjustments of trade receivables and payables are assumed to approximate their fair values. The fair value of the liabilities for the disclosure purposes is estimated by discounting the future cash flows at the current market interest rates that is available to the Group for similar financial instruments.

3 Critical accounting estimates and judgements

The preparation of the Consolidated Financial Statements requires the Group to make estimates and judgements that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities.
The Group bases its estimates and judgements on historical experience and on various other assumptions that it considers to be reasonable. Actual results may differ from these estimates under different assumptions or conditions.

Revenue recognition
The Group's revenue comprises revenues from contract development and licensing, royalties and manufacturing and distribution. The Group enters a wide variety of collaborative arrangements with its partners from which it may earn all, or some of, these revenue streams. The application of the Group's revenue recognition policy set out earlier in this note to its complex collaboration agreements requires significant estimates and judgement. In particular, in arrangements with multiple deliverables, there may be significant judgement in separating the different revenue generating activities.

Paul Capital funding liabilities
The proceeds received from Paul Capital are treated as a liability under IAS 39 and are recorded within borrowings at the net present value of royalties expected to be paid to Paul Capital at the effective interest rate at inception of the agreement. Therefore in order to be able to record the funding liability significant estimation of certain of the Group's future cash flows is required. Royalty cash flows are periodically reassessed to determine the estimated funding liability. In addition such flows are subject to foreign exchange movements.

Impairment of goodwill
The Group tests annually whether goodwill has suffered any impairment, in accordance with the accounting policy stated earlier in this note. The recoverable amounts of cash-generating units have been determined based on value-in-use calculations. These calculations require the use of estimates. The estimates used in goodwill impairment testing as at 31 December 2005 and 2004 are presented in Note 12; Goodwill.

Impairment of other intangible assets and property, plant ant equipment
The Group tests annually whether other intangible assets and property, plant ant equipment have suffered any impairment, in accordance with the accounting policy stated earlier in this note. These calculations require the use of estimates.

Deferred Consideration
Provisions for deferred consideration payable by the Group comprise the fair value of contingent consideration arising from acquisitions. The eventual outcome is subject to the Group's future performance and certain contractual terms. Provisions are reviewed annually by the Directors, who make significant judgments as to the estimated fair value of the contingent consideration. Based on these judgments, changes to the estimated fair value of the consideration are recorded.

Contingent Liabilities
Provisions for contingent liabilities are dependent upon estimates and assessments of whether the criteria for recognition have been met, including estimates by the Directors as to the probable outcome and the amount of the potential cost of resolution. Any estimate for such an accrual would be developed in consultation with external legal advisors handling the Group's defence in these matters and would be based upon an analysis of potential outcomes.

Pensions
The Group recognises actuarial gains and losses arising from experience adjustments and changes in actuarial assumptions directly in equity, in the period they have occurred, in accordance to the alternative treatment allowed by the amendment to IAS 19; Employee benefits - Actuarial gains and losses, group plans and disclosures. The costs are assessed in accordance with advice received from independent actuaries. These assumptions include inflation rate, rate of increase in salaries, discount rate and expected return on plan assets and are disclosed in Note 27; Retirement benefit obligations. The selection of different assumptions could affect the future results of the Group.

Share based compensation
Incentives in the form of shares are provided to employees under share option, share purchase and long term incentive plans. The fair value of the employee services received in exchange for the grant of the options and rewards is recognised as an expense. The expense is based upon a number of assumptions disclosed in Note 28; Share capital. The selection of different assumptions could affect the future results of the Group.

Amortisation lives
Other intangible assets are recorded at their fair value at acquisition date and are amortised on a straight line basis over their estimated useful economic lives from the time they are available for use. Any change in the estimated useful economic lives could affect the future results of the Group.

Taxation

Current tax is the expected tax payable on the taxable income for the year using the tax rates and laws that have been enacted or substantially enacted at the balance sheet date, and any adjustment to tax payable in respect of previous years. The Group has open tax issues with a number of revenue authorities and, on the basis of external professional advice, continues to believe that it has made adequate provision for any liabilities that may arise from these open assessments. The ultimate liability for such matters may vary from the amounts provided, and is dependent upon negotiations with the relevant tax authorities.

4 Segment information

Primary reporting format – business segments

Based on the risks and returns of the various segments, the Directors consider that the Group's primary reporting format is by business segment with geographical reporting being the secondary format. The Group is a speciality pharmaceutical company, using its multiple drug delivery technologies to create a product pipeline for out-licensing to marketing partners. The business segments consist of the Injectable business and the Oral and Inhalation business. Business segment data includes an allocation of corporate costs to each segment on an appropriate basis. There are no material inter-segment transfers. The geographic segments of UK, Europe, North America and Rest of the World reflect the Group's most significant regional markets. Revenue is shown by business segment, revenue stream and location of customer. Other geographic information is provided by location of operation. All Group activities are continuing operations.

Revenue by business segment:

	Year ended 31 December 2005 £m	Year ended 31 December 2004 £m
Injectable	**10.5**	25.6
Oral and Inhalation	**50.8**	49.6
	61.3	75.2
Revenue earned can be analysed as:		
Contract development and licensing		
Milestone payments	**22.1**	33.4
Research and development costs recharged	**5.5**	6.0
	27.6	39.4
Royalties	**21.7**	25.9
Manufacturing and distribution	**12.0**	9.9
Total revenue	**61.3**	75.2

Operating loss by business segment:

	Year ended 31 December 2005 £m	Year ended 31 December 2004 £m
Injectable	(18.6)	(1.4)
Oral and Inhalation	2.5	1.0
Operating loss pre exceptional items	(16.1)	(0.4)
Exceptional items	(21.4)	(2.7)
Operating loss	(37.5)	(3.1)
Share of loss in associate	(0.8)	–
Net interest	(12.3)	(15.3)
Tax	(0.3)	(0.2)
Loss after tax	(50.9)	(18.6)

Total assets by business segment:

	Year ended 31 December 2005 £m	Year ended 31 December 2004 £m
Injectable	57.1	60.4
Oral and Inhalation	93.3	95.6
Total operating assets	150.4	156.0
Investments in associates	0.2	14.3
Available-for-sale financial assets	1.6	5.2
Financial assets at fair value through profit and loss	0.4	1.1
Cash and cash equivalents	34.3	15.3
Total assets	186.9	191.9

Total liabilities by business segment:

	Year ended 31 December 2005 £m	Year ended 31 December 2004 £m
Injectable	(40.1)	(30.5)
Oral and Inhalation	(41.4)	(54.0)
Total operating liabilities	(81.5)	(84.5)
Short-term borrowings: convertible bonds	–	(9.4)
Short-term borrowings: other	(2.7)	(3.9)
Long-term borrowings: convertible bonds	(63.6)	(50.4)
Long-term borrowings: other	(7.2)	(7.2)
Total liabilities	(155.0)	(155.4)

Property, plant and equipment and intangible assets by business segment:

	Year ended 31 December 2005 £m	Year ended 31 December 2004 £m
Additions		
Injectable	1.8	2.3
Oral and Inhalation	3.3	4.9
	5.1	7.2
Depreciation and Amortisation		
Injectable	(1.9)	(1.9)
Oral and Inhalation	(6.4)	(6.3)
	(8.3)	(8.2)

Investments in associates by business segment:

	Year ended 31 December 2005 £m	Year ended 31 December 2004 £m
Injectable	0.2	14.3
Oral and Inhalation	–	–
	0.2	14.3

Secondary reporting format – geographic

Revenue by location of customer:

	Year ended 31 December 2005 £m	Year ended 31 December 2004 £m
UK	23.9	15.2
Europe	23.8	26.0
North America	8.7	29.2
Rest of World	4.9	4.8
	61.3	75.2

Total assets by location of operation:

	Year ended 31 December 2005 £m	Year ended 31 December 2004 £m
UK	37.7	30.0
Europe	56.9	89.7
North America	92.3	72.2
	186.9	191.9

Property, plant and equipment and intangible asset additions by location of operation:

	Year ended 31 December 2005 £m	Year ended 31 December 2004 £m
Europe	3.3	4.9
North America	1.8	2.3
	5.1	7.2

5 Exceptional items

	Year ended 31 December 2005 £m	Year ended 31 December 2004 £m
Impairments	(19.4)	(3.5)
Abortive transaction costs	(2.0)	–
Restructuring costs	–	(1.2)
Profit on disposal of available-for-sale investment	–	2.0
Convertible bonds exchange		(6.2)
	(21.4)	(8.9)

Following the Strategic Review and the Group's decision to focus on its core oral and pulmonary products and to divest its injectable business, the Group no longer views its collaborations with Astralis, Vital Living and Micap as strategic and these investments have therefore been impaired resulting in an exceptional charge of £19.4 million. See notes 15; Investments in associates and 16; Available for sale financial assets. During the year the Group incurred £2.0 million legal and professional fees relating to an aborted strategic transaction.

Exceptional items for 2004 include a charge of £3.5 million relating to the impairment in the investment in Vital Living and £1.2 million relating to the reorganisation of some research and development operations and other business functions. In addition, £2.0 million relates to the profit on disposal of the Group's investment in Transition Therapeutics and a charge of £6.2 million relates to the exchange of convertible bonds.

6 Operating expenses

	Year ended 31 December 2005 £m	Year ended 31 December 2004 £m
Cost of sales	29.2	28.2
Selling, marketing and distribution expenses	5.9	1.7
Depreciation	6.2	6.0
Amortisation	2.1	2.2
Research and development expenses	26.0	28.0
Loss/ (gain) on financial assets at fair value through profit or loss	0.7	(0.1)
Fair value (gain)/ loss on derivative financial instruments	(0.3)	0.5
Profit on disposal of available for sale financial assets	(0.3)	–
Other operating expenses	8.1	9.1
Operating expenses before exceptional items	77.6	75.6
Impairments	19.4	3.5
Abortive transaction costs	2.0	–
Restructuring costs	–	1.2
Profit on disposal of available for sale financial assets	–	(2.0)
Total operating expenses	99.0	78.3

Services provided by the Group's auditor and network firms

It is the Group's policy to employ the auditors on assignments additional to their statutory audit duties where their expertise and experience with the Group are important, principally tax advice and due diligence reporting on acquisitions, or where they are awarded assignments on a competitive basis. During the year the Group (including its overseas subsidiaries) obtained the following services from the Group's auditor at costs detailed below:

	Year ended 31 December 2005 £m	Year ended 31 December 2004 £m
Audit services		
statutory audit	0.4	0.3
audit related regulatory reporting	0.2	0.2
Further assurance services	1.2	1.0
Tax services		
compliance services	–	0.1
advisory services	0.2	0.6
	2.0	2.2

Included in the analysis above are audit fees paid to the Group's auditor in the UK of £227,000 (2004: £177,000) of which £15,000 (2004: £14,000) was paid in respect of the parent company. Also included above are fees paid to the Group's auditor in respect of non-audit services in the UK of £1,295,000 (2004: £1,141,000).

7 Staff costs

	Year ended 31 December 2005 £m	Year ended 31 December 2004 £m
Wages and salaries	19.7	19.2
Equity settled share based payments	1.9	2.9
Social security costs	2.9	2.9
Pensions		
– defined benefit plans	0.2	0.7
– defined contribution plans	0.7	1.3
Other benefits	0.8	–
	26.2	27.0

The average number of people, including executive directors, employed by the Group during the period was 457 persons (2004: 438 persons) and the Company numbers 18 persons (2004: 18 persons).

Average number of employees by business segment:

	Year ended 31 December 2005	Year ended 31 December 2004
Injectable	129	113
Oral and Inhalation	328	325
	457	438

The Group's key management comprises only Directors and Director' remuneration for the year is shown in the audited part of the Remuneration Report.

8 Other income and expenses

	Year ended 31 December 2005 £m	Year ended 31 December 2004 £m
(Loss)/ gain on financial assets at fair value through profit or loss	(0.7)	0.1
Profit on disposal of available-for-sale investment	0.3	2.0
	(0.4)	2.1

9 Finance costs and income

	Year ended 31 December 2005 £m	Year ended 31 December 2004 £m
Interest and similar expense:		
Interest:		
- bank borrowings	(0.5)	(0.7)
- Paul Capital arrangements	(12.7)	(11.3)
- interest on convertible bonds	(5.8)	(5.7)
	(19.0)	(17.7)
Foreign exchange on Paul Capital arrangements	(3.3)	-
Fair value losses on financial instruments:		
- loss on exchange of convertible bonds	-	(6.2)
Total interest and similar expense	(22.3)	(23.9)
Interest and similar income:		
Paul Capital change in estimated future payments	9.0	6.0
Other interest income	1.0	0.8
Foreign exchange on Paul Capital arrangements	-	1.8
Total interest and similar income	10.0	8.6

10 Income tax

	Year ended 31 December 2005 £m	Year ended 31 December 2004 £m
Current income tax expense:		
Foreign tax	0.3	0.2

There was no deferred tax component in the tax charge.

Foreign tax relates principally to withholding tax paid on remittance of royalties to Switzerland which is not recoverable.

The tax on the Group's losses before tax differs from the theoretical amount that would arise using the standard rate of corporation tax in the UK. The differences are explained below:

	Year ended 31 December 2005 %	Year ended 31 December 2004 %
Rate of corporation tax in the UK	30.0	30.0
Effects of:		
Adjustments in respect of foreign tax rates	(4.4)	17.2
Adjustment to tax in respect of prior periods	–	(0.1)
Expenses not deductible for tax purposes	(7.1)	(8.2)
Tax losses for which no deferred tax asset was recognised	(19.6)	(40.0)
Tax losses utilised	1.0	1.9
Capital allowances utilised	–	0.2
Withholding taxes	(0.6)	(0.7)
Other	0.1	(1.3)
Effective tax rate	(0.6)	(1.0)

The Group has estimated total tax losses available to be set off against future taxable profits of £280.0 million (31 December 2004: £271.1 million). These losses arise primarily in Switzerland and the US. Of the £280.0 million of losses carried forward, £22.0 million expire in 2006, £65.1 million expire between 2007 and 2009, £191.6 million expire from 2010 onwards and £1.3 million of losses may be carried forward indefinitely. The Group also has other tax allowances available of £59.8 million (31 December 2004: £56.6 million)

No deferred tax asset has been recognised, given the uncertainty of the recoverability of the Group's tax losses carried forward.

11 Earnings per share

	Year ended 31 December 2005 £m	Year ended 31 December 2004 £m
Attributable loss before exceptional items	(29.5)	(9.7)
Exceptional items	(21.4)	(8.9)
Basic and diluted attributable loss	(50.9)	(18.6)

	Number m	Number m
Basic and diluted weighted average number of shares in issue	624.9	615.2
Loss per Ordinary Share before exceptional items	(4.7p)	(1.6p)
Exceptional items	(3.4p)	(1.4p)
Basic and diluted loss per Ordinary Share	(8.1p)	(3.0p)

There is no difference between basic and diluted loss per share since in a loss making year all potential shares from convertible bonds, stock options, warrants and contingent issuance of shares are anti dilutive.

Shares held by the SkyePharma PLC General Employee Benefit Trust have been excluded from the weighted average number of shares.

12 Goodwill

Group	As at 31 December 2005 £m	As at 31 December 2004 £m
Cost		
Beginning of the year	**82.7**	82.7
Additions during the year	**–**	–
Exchange differences	**–**	–
End of the year	**82.7**	82.7
Accumulated impairment and depreciation		
Beginning of the year	**14.0**	14.0
Amortisation charge	**–**	–
Exchange differences	**–**	–
End of the year	**14.0**	14.0
Net book value		
Beginning of the year	**68.7**	68.7
End of the year	**68.7**	68.7

Goodwill arose on the acquisition of SkyePharma Inc (£35.6 million), SkyePharma Canada Inc (£29.2 million) and SkyePharma AB (£3.9 million) and has been allocated to the following business segments/ cash-generating units:

	As at 31 December 2005 £m	As at 31 December 2004 £m
Injectables	**38.6**	38.6
Oral and Inhalation	**30.1**	30.1
	68.7	68.7

Goodwill is not amortised but is tested annually for impairment or more frequently if there are indications that goodwill might be impaired. Value in use calculations are generally utilised to calculate recoverable amount.

Value in use is calculated as the net present value of the projected risk-adjusted cash flows of the cash-generating unit to which goodwill is allocated. The cash flow projections are based on the most recent business plans approved by management which cover a period of 10 years, and are adjusted where necessary to take account of longer patent lives. The discount rate applied may vary depending on the risk profile of the asset being valued but is typically 15%, which is the Group's average pre-tax discount rate derived from a capital asset pricing model.

The key assumptions for the value in use calculations are those regarding the launch dates of products, their growth rates, the discount rates used and the period over which the cash flows are projected. The assumptions made reflect past experience, market research and expectations of future market trends.

Goodwill was tested for impairment both at 31 December 2005 and 31 December 2004. No impairment was identified.

13 Other intangible assets

Group	Intellectual property £m	Software costs £m	Development costs £m	Total £m
Cost				
At 1 January 2004	36.1	0.8	0.7	37.6
Exchange differences	–	–	(0.1)	(0.1)
Additions during the year	2.9	0.1	–	3.0
At 31 December 2004	39.0	0.9	0.6	40.5
Exchange differences	0.2	–	0.4	0.6
Additions during the year	1.8	0.1	–	1.9
At 31 December 2005	**41.0**	**1.0**	**1.0**	**43.0**
Accumulated impairment and depreciation				
At 1 January 2004	10.4	0.6	0.5	11.5
Exchange differences	0.1	–	–	0.1
Amortisation charge	2.0	0.1	0.1	2.2
At 31 December 2004	12.5	0.7	0.6	13.8
Exchange differences	(0.1)	–	0.4	0.3
Amortisation charge	2.0	0.1	–	2.1
At 31 December 2005	**14.4**	**0.8**	**1.0**	**16.2**
Net book value				
At 31 December 2005	**26.6**	**0.2**	**–**	**26.8**
At 31 December 2004	**26.5**	**0.2**	**–**	**26.7**
At 31 December 2003	**25.7**	**0.2**	**0.2**	**26.1**

There are no intangible assets with indefinite useful lives. All amortisation charges in the year have been charged through administrative expenses.

Intellectual property acquired during 2005 mainly relates to the purchase of licenses to intellectual property in the area of pulmonary delivery.

Included within intellectual property is £2.0 million of assets which are not yet in use. These assets have not been amortised but have been tested for impairment consistent with the method set out for goodwill in note 12. No impairment was identified.

14 Property, plant and equipment

Group	Land and buildings £m	Laboratory equipment and machines £m	Assets under construction £m	Office and other equipment £m	Motor vehicles £m	Total £m
Cost						
At 1 January 2004	31.9	35.6	3.0	3.0	0.3	73.8
Exchange	–	0.2	(0.2)	(0.1)	–	(0.1)
Additions	0.5	2.9	0.6	0.1	0.1	4.2
Transfers	0.6	1.8	(2.5)	0.1	–	–
Disposals	(0.1)	(0.2)	–	(0.1)	(0.1)	(0.5)
At 31 December 2004	32.9	40.3	0.9	3.0	0.3	77.4
Exchange	(0.7)	(0.6)	0.1	–	–	(1.2)
Additions	0.2	1.4	1.4	0.2	–	3.2
Transfers	–	0.1	(0.1)	–	–	–
Disposals	(0.1)	(0.1)	(0.1)	(0.2)	(0.1)	(0.6)
At 31 December 2005	**32.3**	**41.1**	**2.2**	**3.0**	**0.2**	**78.8**
Depreciation						
At 1 January 2004	9.9	18.6	–	2.2	0.1	30.8
Provided in the year	2.0	3.6	–	0.4	–	6.0
Disposals	(0.1)	(0.1)	–	(0.1)	–	(0.3)
At 31 December 2004	11.8	22.1	–	2.5	0.1	36.5
Exchange	(0.4)	(0.2)	–	–	–	(0.6)
Provided in the year	2.1	3.8	–	0.3	–	6.2
Disposals	(0.1)	–	–	(0.3)	–	(0.4)
At 31 December 2005	**13.4**	**25.7**	**–**	**2.5**	**0.1**	**41.7**
Net book value						
At 31 December 2005	**18.9**	**15.4**	**2.2**	**0.5**	**0.1**	**37.1**
At 31 December 2004	**21.1**	**18.2**	**0.9**	**0.5**	**0.2**	**40.9**
At 31 December 2003	**22.0**	**17.0**	**3.0**	**0.8**	**0.2**	**43.0**

All depreciation charges in the year have been charged through administrative expenses.

Included in freehold property is an amount of £4.9 million (2004: £5.1 million) in respect of land which is not depreciated.

At 31 December 2005, the carrying amount of the Group's laboratory equipment and machines includes an amount of £Nil (2004: £1.2 million) and motor vehicles an amount of £0.1 million (2004: £0.1 million) in respect of assets held under finance leases and hire purchase arrangements.

At 31 December 2005, the net book value of the tangible assets pledged as collateral in the framework of various borrowing agreements (disclosed in Note 23; Borrowings) was £1.9 million (2004: £2.1 million). The Group did not identify any tangible assets temporarily idle as at the balance sheet date.

Company	Land and buildings £m	Office and other equipment £m	Total £m
Cost			
At 1 January 2004	0.1	0.3	0.4
Additions	–	–	–
At 31 December 2004	0.1	0.3	0.4
Additions	0.1	–	0.1
Disposals	(0.1)	–	(0.1)
At 31 December 2005	**0.1**	**0.3**	**0.4**
Depreciation			
At 1 January 2004 and 31 December 2004	0.1	0.2	0.3
Provided in the year	–	0.1	0.1
Disposals	(0.1)	–	(0.1)
At 31 December 2005	**–**	**0.3**	**0.3**
Net book value			
At 31 December 2005	**0.1**	**–**	**0.1**
At 31 December 2004	**–**	**0.1**	**0.1**
At 31 December 2003	**–**	**0.1**	**0.1**

15 Investments in associates

Group	As at 31 December 2005 £m	As at 31 December 2004 £m
Beginning of the year	14.3	–
Reclassification of investment as associate	–	14.2
Additions	3.0	0.1
Share of loss	(0.8)	–
Impairment	(16.3)	–
End of the year	**0.2**	14.3

The investment in Astralis Limited was recorded at £0.2 million at 31 December 2005 (2004: £14.3 million) and had a market value of £0.4 million (2004: £9.6 million). Following the Strategic Review and the Group's decision to focus on its core oral and pulmonary products and to divest its injectable business, the Group no longer views its collaboration with Astralis as strategic. This combined with the current uncertainties concerning Astralis' financial position resulted in the Group impairing its investment to its estimated fair value.

Company	As at 31 December 2005 £m	As at 31 December 2004 £m
Beginning of the year	14.3	–
Reclassification of investment as associate	–	14.2
Additions	3.0	0.1
Impairment	(17.1)	–
End of the year	**0.2**	14.3

16 Available for sale financial assets

Group	As at 31 December 2005 £m	As at 31 December 2004 £m
Beginning of the year	5.2	22.0
Exchange	0.1	-
Reclassification as associate	-	(14.2)
Additions	0.1	2.0
Disposal	(1.8)	(0.6)
Impairments	(2.6)	(3.5)
Revaluation surplus/ (deficit) transfer	0.6	(0.5)
End of the year	1.6	5.2

Company	As at 31 December 2005 £m	As at 31 December 2004 £m
Beginning of the year	3.6	16.3
Reclassification as associate	-	(14.2)
Additions	0.1	2.0
Disposal	(1.8)	-
Revaluation surplus/ (deficit) transfer	(0.6)	(0.5)
End of the year	1.3	3.6

Group and Company

Available for sale financial assets comprise the following unlisted securities:

Vectura Group plc

Vectura is a UK emerging pharmaceutical company traded on the Alternative Investment Market. Vectura is developing a range of inhaled drugs for the treatment of lung diseases and conditions where delivery via the lungs can provide significant benefits, such as rapid onset of action, improved efficacy and improved tolerability compared with current therapies. During 2005 the Group sold 2 million ordinary shares in Vectura for £1.6 million. As at 31 December 2005 the remaining holding was 1.2 million ordinary shares. The investment was recorded at £1.0 million at 31 December 2005 (2004: £2.0 million). In January 2006 the Group sold the remaining 1.2 million ordinary shares.

Vital Living Inc

Vital Living primarily develops and markets evidence-based nutriceuticals. These are developed for incorporation by physicians into a standard physician/ patient program, supported by a specially designed compliance regimen. Vital Living is based in the US. During 2005 the Group received 2,101,422 Vital Living common shares with a value of £68,000 ($120,000) in lieu of interest due on the 12% senior secured convertible notes. As at 31 December 2005 the total SkyePharma holding was 16,993,599 common shares, 1 million series D convertible preferred shares, $1 million 12% senior secured convertible notes due 2008 and 4 million warrants expiring 2008, representing approximately 17.2% of the common shares. The investment in Vital Living was recorded at £0.4 million at 31 December 2005 (2004: £1.7 million). The Company recorded £0.1 million at 31 December 2005 (2004: £0.1 million). Following the Strategic Review and the Group's decision to focus on its core oral and pulmonary products and to divest its injectable business, the Group no longer views its collaboration with Vital Living as strategic and this investment has therefore been impaired.

Micap plc

Micap plc is a UK science-based technology company traded on the Alternative Investment Market. As at 31 December 2005 the total SkyePharma holding was 5,238,334 ordinary shares and 1,830,000 convertible shares, representing approximately 9.4% of the ordinary share capital. The investment in Micap recorded at £0.2 million at 31 December 2005 (2004: £1.5 million). Following the Strategic Review and the Group's decision to focus on its core oral and pulmonary products and to divest its injectable business, the Group no longer views its collaboration with Micap as strategic and this investment has therefore been impaired.

Cade Struktur Corp

Cade Struktur was formerly a drug delivery company engaged in research and development and worldwide commercialisation of pharmaceutical formulations. The current business is the development, financing and completion of industrial and infrastructure projects in Europe. As at 31 December 2005, the total SkyePharma holding of Cade Struktur, a Canadian company, was 869,086 shares, representing approximately 10.1% of the ordinary share capital. The shares were originally acquired consequent upon the acquisition of the assets of Hyal Pharmaceutical Corp. SkyePharma has not attributed a fair value to these shares and they have been recorded at £Nil (2004: £ Nil).

17 Shares in and loans to Group undertakings

Company	Shares in Group undertakings £m	Loans to Group undertakings £m	Total £m
Beginning of the year	163.5	237.3	400.8
Additions	–	19.0	19.0
Provision	–	(80.0)	(80.0)
End of the year	163.5	176.3	339.8

Following the Strategic Review the Company has reviewed the funding of its overseas subsidiaries and recorded a provision in respect of recoverability of loans to Group undertakings of £80.0 million.

Principal subsidiaries are detailed in note 35; Principal subsidiaries.

18 *Inventories*

Group	As at 31 December 2005 £m	As at 31 December2004 £m
Raw materials and consumables	2.1	1.2
Work in progress	1.0	0.2
Finished goods	1.0	0.1
	4.1	1.5
Inventory provisions	(0.5)	–
	3.6	1.5

The cost of inventories recognised as an expense and included in cost of sales is disclosed in Note 6; Operating expenses.

19 Trade and other receivables

	Group As at 31 December 2005 £m	Group As at 31 December 2004 £m	Company As at 31 December 2005 £m	Company As at 31 December 2004 £m
Trade receivables	2.4	3.5	–	–
Less provision for impairment	(0.1)	–	–	–
Net trade receivables	2.3	3.5	–	–
Amounts owed by subsidiary undertakings	–	–	5.2	5.2
Other receivables	2.2	1.9	0.5	1.0
Interest receivable	0.6	0.4	–	–
Prepayments and accrued income	9.1	12.4	–	0.2
	14.2	18.2	5.7	6.4

20 Financial assets at fair value through profit and loss

	Group As at 31 December 2005 £m	Group As at 31 December 2004 £m
Beginning of the year	1.1	1.0
Revaluation to fair value	(0.7)	0.1
End of the year	0.4	1.1

Financial assets at fair value through profit or loss comprise 5% convertible loan notes due at par in June 2007. The notes were received from GeneMedix plc in 2002 as an initial payment under an agreement to jointly develop an extended release formulation of Interferon alpha-2b using SkyePharma's DepoFoam technology. The notes are convertible at any time, at SkyePharma's option, into between approximately 8.3 million and 11.2 million GeneMedix ordinary shares. There are no restrictions or a lock-up period on conversion of the notes. GeneMedix can elect to redeem in cash some or all of the notes on conversion. The notes were designated as at fair value through profit or loss on initial recognition.

21 Cash and cash equivalents

	Group As at 31 December 2005 £m	Group As at 31 December 2004 £m	Company As at 31 December 2005 £m	Company As at 31 December 2004 £m
Cash at bank and in hand	26.8	15.3	24.1	11.3
Short term deposits	7.5	–	7.5	–
	34.3	15.3	31.6	11.3

The short term deposit is a dual currency deposit of sterling versus US dollars, which earns an effective interest rate of 10.5%. If the sterling/US dollar spot rate is at or above 1.75 at expiry, the £7.5 million deposit will be returned in US dollars at 1.75 ($13.1 million), otherwise it will be returned in sterling.

22 Trade and other payables

	Group As at 31 December 2005 £m	Group As at 31 December 2004 £m	Company As at 31 December 2005 £m	Company As at 31 December 2004 £m
Trade payables	6.8	6.7	0.6	0.6
Amounts owed to subsidiary undertakings	–	–	89.7	77.3
Other taxation and social security costs	2.0	1.2	0.1	0.1
Accruals	12.2	12.7	1.1	2.5
	21.0	20.6	91.5	80.5

23 Borrowings

	Group As at 31 December 2005 £m	Group As at 31 December 2004 £m	Company As at 31 December 2005 £m	Company As at 31 December 2004 £m
Current				
Convertible bonds due June 2005	–	9.4	–	9.4
Bank borrowings	2.3	3.5	0.8	1.9
Property mortgage	0.3	0.3	–	–
Paul Capital funding liabilities	0.7	–	–	–
Finance lease liabilities	0.1	0.1	–	–
Other current borrowings	3.4	3.9	0.8	1.9
Total current borrowings	3.4	13.3	0.8	11.3
Non-current				
Convertible bonds due May 2024	50.8	50.4	–	–
Convertible bonds due June 2025	12.8	–	–	–
	63.6	50.4	–	–
Bank borrowings	0.6	–	0.6	–
Property mortgage	6.6	7.1	–	–
Paul Capital funding liabilities	43.9	44.7	–	–
Finance lease liabilities	–	0.1	–	–
Other non-current borrowings	51.1	51.9	0.6	–
Total non-current borrowings	114.7	102.3	0.6	–
Total borrowings	118.1	115.6	1.4	11.3

Bank borrowings

At 31 December 2005 bank borrowings include two amounts due to the Basellandschaftliche Kantonalbank of £0.9 million (CHF 2 million) and £0.7 million (CHF 1.5 million) (2004: £0.9 million (CHF 2 million) and £0.7 million (CHF 1.5 million)). Both loans can be terminated with six weeks notice by either party and bear interest at 6.5% and 6.0% respectively. Both loans are secured on the assets of Jago and the £0.7 million (CHF 1.5 million) loan is guaranteed by SkyePharma PLC.

The Group had a loan as at 31 December 2005 with GE Capital Corp of £1.4 million ($2.4 million) (2004: £1.9 million ($3.7 million)). The loan is secured by certain assets of SkyePharma Inc, SkyePharma US Inc and SkyePharma PLC. The loan bears interest at 8.0% and is repayable by instalments until September 2007.

Convertible bonds

Convertible bonds are disclosed in Note 24; Convertible bonds.

Property mortgage

At 31 December 2005, the Group had a property mortgage facility with the Basellandschaftliche Kantonalbank of £6.9 million (CHF 15.5 million) (2004: £7.4 million (CHF 16.1 million)). The mortgage is in two tranches, both secured by the assets of Jago. The first tranche of £2.7 million (CHF 6.2 million) bears interest at 2.75% and is repayable by instalments over 20 years semi-annually. The second tranche of £4.1 million (CHF 9.3 million) bears interest at 2.75% and is repayable by instalments over 50 years semi-annually.

Paul Capital funding liabilities

The Group entered into two transactions with Paul Capital Royalty Acquisition Fund ('Paul Capital') in 2000 and 2002. Under these transactions Paul Capital provided a total of $60 million in return for the sale of a portion of the potential future royalty and revenue streams on a selection of the Group's products.

Whilst the contractual arrangement with Paul Capital is a royalty agreement under which royalties are payable on revenues earned and payments received, the proceeds received from Paul Capital meet the definition of a financial liability under IAS 39, and are treated as a financial liability. Royalties paid to Paul Capital are treated as repayment of the liability and interest is charged on the liability using the effective interest rate at inception of each agreement. The estimated future payments to Paul Capital are discounted using each contract's original effective interest and any adjustment is recognised as income or expense in the income statement

Finance lease liabilities

Obligations under hire purchase and finance leases are secured upon the assets to which they relate and as at 31 December 2005 £Nil (2004: £0.1 million (SKR 0.9 million)) is guaranteed by SkyePharma PLC.

Maturity analysis of non-current borrowings

	As at 31 December 2005			
	1 to 2 Years £m	2 to 5 Years £m	Over 5 Years £m	Total £m
Convertible bonds	–	–	63.6	63.6
Bank borrowings	0.6	–	–	0.6
Property mortgage	0.3	0.8	5.5	6.6
Paul Capital funding liabilities	4.9	22.1	16.9	43.9
Non-current borrowings	5.8	22.9	86.0	114.7

	As at 31 December 2004			
	1 to 2 Years £m	2 to 5 Years £m	Over 5 Years £m	Total £m
Convertible bonds	–	–	50.4	50.4
Property mortgage	0.3	0.8	6.0	7.1
Paul Capital funding liabilities	10.6	21.5	12.6	44.7
Finance lease liabilities	0.1	–	–	0.1
Non-current borrowings	11.0	22.3	69.0	102.3

Currency analysis of borrowings

	As at 31 December 2005			
	Sterling £m	$US £m	*Swiss francs* £m	*Total* £m
Convertible bonds	63.6	–	–	63.6
Bank borrowings	–	0.6	–	0.6
Property mortgage	–	–	6.6	6.6
Paul Capital funding liabilities	–	43.9	–	43.9
Total borrowings	63.6	44.5	6.6	114.7

	Sterling £m	$US £m	Swiss francs £m	As at 31 December 2004 Total £m
Convertible bonds	50.4	–	–	50.4
Property mortgage	–	–	7.1	7.1
Paul Capital funding liabilities	–	44.7	–	44.7
Finance lease liabilities	–	–	0.1	0.1
Total borrowings	50.4	44.7	7.2	102.3

Interest rate analysis

	Sterling %	$US %	As at 31 December 2005 Swiss francs %
Convertible bonds	8.9 / 9.5 / 13.3	–	–
Bank borrowings	–	8.0	–
Property mortgage	–	–	2.8
Paul Capital Funding liabilities	–	24.0/30.0	–

	Sterling %	$US %	As at 31 December 2004 Swiss francs %
Convertible bonds	8.9 / 9.5 / 13.3	–	–
Property mortgage	–	–	2.8
Paul Capital Funding liabilities	–	24.0/30.0	–
Finance lease liabilities	–	–	6.5

Fair values

At 31 December 2005, the carrying amount of non-current liabilities, compared with the fair value was as follows:

	Carrying Amount £m	Fair Value £m
Convertible bonds	63.6	83.5
Bank borrowings	0.6	0.6
Property mortgage	6.6	6.6
Paul Capital funding liabilities	43.9	43.9
	114.7	134.6

At 31 December 2004, the carrying amount of non-current liabilities, compared with the fair value was as follows:

	Carrying Amount £m	Fair Value £m
Convertible bonds	50.4	85.9
Property mortgage	7.1	7.1
Paul Capital funding liabilities	44.7	44.7
Finance lease liabilities	0.1	0.1
	102.3	137.8

Undrawn facility

At 31 December 2005 the Group had an overdraft facility of £1.3 million (CHF 3 million) (2004: £1.4 million, CHF 3 million) with the Basellandschaftliche Kantonalbank secured on the assets of Jago.

24 Convertible bonds

In June 2005 the Group issued £20 million 8% convertible bonds, with a first put after five years by the holder of the bonds, and a final maturity of June 2025. The bonds are convertible at the option of the holder into SkyePharma Ordinary Shares at an initial conversion price of 77 pence at any time prior to maturity. The bond contains a price reset feature such that if on 3 June 2006 the Company's average share price for the preceding 10 days (reset price) is less than the conversion price, then the conversion price shall be adjusted to the reset price subject to a maximum reduction of 25% in the conversion price. Unless previously redeemed or converted, the bonds will be redeemed by the Group at their principal amount in June 2025. The convertible bonds existing at 31 December 2005, due in May 2024, were not affected by this transaction.

On 19 June 2005 £9.8 million of convertible bonds due June 2005 were redeemed in full by the Company at their principal amount.

As a result of these transactions the Group has £69.6 million convertible bonds due May 2024 at a conversion price of 95 pence, and £20 million convertible bonds due June 2025 at a conversion price of 77 pence.

25 Derivative financial instruments

Group and Company	As at 31 December 2005 £m	As at 31 December 2004 £m
Interest rate swap	–	(0.2)
Total derivative financial instrument liabilities	–	(0.2)

The Group's policy is to hedge interest rate exposures through the use of interest rate swaps and currency exposures through the use of currency options, accrual forward options and forward currency contracts. None of these derivative financial instruments qualify to be treated as hedges and accordingly gains and losses are recorded in the income statement.

26 Provisions

Group	Pension £m	Restructuring £m	Total £m
At 1 January 2005	1.7	0.3	2.0
Actuarial gains/ losses	0.3	–	0.3
Charge for the year	(0.1)	–	(0.1)
Utilised	–	(0.3)	(0.3)
At 31 December 2005	**1.9**	**–**	**1.9**

	As at 31 December 2005	As at 31 December 2004
Current (restructuring)	–	0.3
Non-Current (pension)	**1.9**	1.7
	1.9	2.0

Pension provision

The pension provision relates to the retirement commitments under its defined benefit schemes in respect of its employees in Switzerland and France.

Restructuring provision

The restructuring provision relates to the reorganisation of research and development operations and other business functions involving reductions in staff at most sites.

27 Retirement benefit obligations

Defined contribution plans

The Group operates various defined contribution plans for its employees in the UK and US. The Group's contributions to these plans are charged to the income statement in the period to which they relate, and the assets are held in separate trustee administered funds. The income statement charge related to defined contributions plan is disclosed in Note 7: Staff costs.

Defined benefit plan

The Group operates unfunded defined benefit schemes in respect of its employees in Switzerland and France.

The liabilities of the defined benefit schemes operated by the Group are presented below:

	As at 31 December 2005 £m	As at 31 December 2004 £m
Balance sheet obligations for:		
Defined benefit pension benefits	**1.9**	**1.7**

The amounts recognised in the balance sheet are determined as follows:

	As at 31 December 2005 £m	As at 31 December 2004 £m
Present value of funded obligations	6.4	6.3
Fair value of plan assets	(5.3)	(5.3)
	1.1	1.0
Present value of unfunded obligations	0.8	0.7
Liability in the balance sheet	**1.9**	1.7

The amounts recognised in the income statement are as follows:

	Year ended 31 December 2005 £m	Year ended 31 December 2004 £m
Current service cost	0.3	0.2
Interest cost	0.3	0.3
Expected losses on assets	(0.2)	(0.2)
Total included in staff cost	**0.4**	0.3

The actuarial return on plans assets was £0.2 million (2004: £0.2 million).

The movement in the defined benefit obligation over the year is as follows:

	Year ended 31 December 2005 £m	Year ended 31 December 2004 £m
Beginning of the year	7.0	6.7
Exchange adjustment	(0.1)	(0.1)
Current service cost	0.3	0.2
Contributions	(0.3)	(0.3)
Interest on pension scheme liabilities	0.3	0.3
Expected losses on assets	(0.2)	(0.2)
Actuarial losses recognised in equity	0.2	0.4
End of the year	**7.2**	7.0

The movement in the fair value of the plan assets over the year is as follows:

	Year ended 31 December 2005 £m	Year ended 31 December 2004 £m
Beginning of the year	5.3	4.7
Exchange adjustment	(0.1)	0.3
Current service cost	0.3	0.2
Interest on pension scheme liabilities	0.3	0.3
Benefits paid	(0.7)	(0.5)
Actuarial gains recognised in equity	0.2	0.3
End of the year	5.3	5.3

At 31 December 2005 and 2004 actuarial valuations were performed by professionally qualified actuaries on the present value of the accrued liabilities calculated under the projected unit method. The principal assumptions made by the actuaries were:

	2005 % per annum	2004 % per annum
Inflation rate	1.9	2.0
Rate of increase in salaries	2.3	2.5
Discount rate	3.7	4.0
Expected return on plan assets	2.0	2.4

Assumptions regarding future mortality experience are set based on advice in accordance with published statistics and experience in Switzerland and France.

	2005 years	2004 years
Male	17.3	17.3
Female	20.8	20.8

	2005 £m	2004 £m
Actuarial gains recognised in equity	0.3	–
Cumulative actuarial gains recognised in equity	0.3	–

Plan assets are comprised as follows:

	2005 £m	2004 £m
Equity	4.7	4.3
Other	0.6	1.0
	5.3	5.3

Expected contributions to post employment benefit plans for the year ending 31 December 2006 are £0.6 million.

28 Share capital

Group and Company	31 December 2005 Number of shares	31 December 2004 Number of shares	31 December 2005 £m	31 December 2004 £m
Authorised				
Ordinary Shares of 10p each	1,102,000	1,102,000	110.2	110.2

	Ordinary Shares of 10p each Number	Nominal value £m	Deferred 'B' Shares of 10p each Number	Nominal value £m	Total nominal value £m
At 1 January 2004	618,669,940	61.9	12,000,000	1.2	63.1
Exercise of share options	478,803	–	–	–	–
Issue of shares to Research Development Foundation	3,250,000	0.3	–	–	0.3
At 1 January 2005	622,398,743	62.2	12,000,000	1.2	63.4
Rights issue	125,627,357	12.6	–	–	12.6
Acquisition of shares in Astralis	5,482,238	0.6	–	–	0.6
Exercise of share options	255,808	–	–	–	–
At 31 December 2005	753,764,146	75.4	12,000,000	1.2	76.6

The Group raised £34.8 million net of expenses by means of a rights issue of 125,627,357 new ordinary shares.

The Group also issued 5,482,238 Ordinary Shares to two former Astralis Directors to acquire 11,160,000 common shares in Astralis.

Deferred 'B' shares

In July 2000, 12 million deferred 'A' and 12 million deferred 'B' shares were issued to Dr Gonella, the vendor of Jago, under a settlement agreement that established the full and final settlement of the deferred consideration payable on the acquisition of Jago. The holders of deferred 'A' and 'B' shares have no rights to participate in the profits of the Company, no voting rights and on a winding up or other return of capital only receive the nominal value of their shares if the holders of Ordinary Shares in the capital of the Company have received the sum of £1 million per Ordinary Share. Under the terms of the settlement agreement, following the US launch and first commercial sale of Paxil CR by GlaxoSmithKline in 2002, the 12 million deferred 'A' shares were automatically converted into 12 million Ordinary Shares.

The 12 million deferred 'B' shares automatically convert to 12 million Ordinary Shares on the Company's receipt of a royalty statement under the current license agreement stating that reported sales of Paxil CR have exceeded $1,000 million during any calendar period prior to 1 January 2006 or exceeded $337 million between 1 January 2006 and 3 May 2006. The conditions have not been met and the deferred 'B' shares will be transferred to the Company Secretary for no consideration for him to hold as custodian.

Warrants

The Company has the following warrants outstanding:

(a) 'D' and 'E' warrants

The 'D' and 'E' warrants were issued in March 2002 as part of the consideration for the agreement with Paul Capital to fund new product development. The 'D' and 'E' warrants entitle the holders to subscribe for a total of 5 million Ordinary Shares at any time during the period to 31 December 2008 at an exercise price of 73.75 pence per Ordinary Share. A value of £0.3 million, deemed to be the fair value of the 'D' and 'E' warrants, has been recorded in Other Reserves.

(b) 'F' warrants

The 'F' warrants were issued in December 2003 as part of the £2.7 million ($5 million) loan with GE Capital Corp. The 'F' warrants entitle the holders to subscribe for a total of 300,000 Ordinary Shares at any time until the repayment date of the loan at an exercise price of £1.20 per Ordinary Share. A value of £39,000, deemed to be the fair value of the F warrants, has been recorded in Other Reserves.

(c) Other warrants
Warrants were issued in December 1999 as part of the acquisition of DepoTech and entitle the holders to subscribe for 371,353 Ordinary Shares at any time during the period beginning 31 December 1999 and ending on 25 February 2005 at an exercise price of $1.142 (59.5 pence) per Ordinary Share. All of these warrants lapsed unexercised on 25 February 2005.

Potential Issues of ordinary shares

(a) Employee share schemes
The Group encourages employee participation in its shares through ownership and continues to operate various incentive schemes whereby Directors and employees are to able to acquire shares, and potential shares, in the Company. Further details are provided in Note 29; Share based payments.

(b) Deferred consideration on acquisition of Krypton
The deferred consideration on the acquisition of Krypton provides that a maximum of 37.5 million Ordinary Shares would be issued contingent on a change in control of the Company at a share price of not less than 80 pence compounded at an annual rate of 10% (£2.08 as at 31 December 2005), or satisfaction of various conditions and hurdles which lapsed on 31 December 2003. No provision for deferred consideration has been recognised as at 31 December 2005.

(c) Paul Capital Royalty Acquisition Fund
In March 2002 the Group announced a second transaction with Paul Capital Royalty Acquisition Fund under which SkyePharma would issue Ordinary Shares up to a value of $7.5 million if royalties and milestones received by SkyePharma in respect of those products included in the transaction were not in excess of minimum annual payments required to be made to Paul Capital. During 2005 the royalties received by SkyePharma were substantially in excess of the minimum payments required to be made to Paul Capital, consequently the Company has not recognised a provision.

29 Share based payments
The Group operates various share based compensation plans as follows:

Option schemes
Options granted to UK and European employees are only exercisable between the third and tenth anniversary of the date of grant, and are subject to the Company's Code of Business Conduct and Ethics for dealing in Shares, and the Model Code. Options granted to US employees prior to 2001 vest at 25% per annum from the date of grant and there were no performance criteria. UK and European options granted prior to 2001 may only be exercised if the growth in the Company's share price over a consecutive three-year period exceeds the growth over the same period in the FTSE All Share Index. This criteria was satisfied for the first time in March 2000. Employees with options that are within their exercise period are now able to exercise those options within any one-year period from the date the performance condition is satisfied. Super Options are exercisable after five years and are subject to higher performance conditions in accordance with those recommended by the Association of British Insurers.

Following changes to the option plans approved at the Annual General Meeting in June 2001, options granted to Directors and senior employees since that date are subject to performance conditions linked to the total shareholder return of a comparator group of companies, and are not subject to retesting. Options granted to other US employees continue to vest at 25% per annum with no performance criteria, and other European employees who are not Directors or senior employees can exercise their options after three years and are not subject to performance conditions. The Group's option plans are detailed further in the Remuneration Report. It is the intention of the Group that no further options grants will be made under any of the option plans.

The following table summarises the activity in share options for the year to 31 December 2005:

	Share options	Option price
At 1 January 2004	**52,345,218**	**44.8p – 93.0p**
Exercised	(478,803)	44.8p – 66.5p
Cancelled or expired	(3,883,170)	46.5p – 91.3p
At 31 December 2004	**47,983,245**	**44.8p – 93.0p**
Exercised	(255,808)	46.5p – 55.6p
Forfeited	(9,654,453)	46.5p – 92.0p
Cancelled or expired	(2,171,974)	46.5p – 92.0p
Rights issue adjustment (see below)	1,596,534	1.8p – 3.7p
At 31 December 2005	**37,497,544**	**43.0p – 89.3p**
Exercisable	**22,180,175**	**43.0p – 89.3p**

The weighted average exercise price as at 31 December 2005 was 58.6 pence.

The market value of Ordinary Shares as at 31 December 2005 was 49.75 pence. The market value of Ordinary Shares during 2005 ranged from the lowest closing mid-price of 34.25 pence to the highest closing mid-price of 66.75 pence per share. No options were granted during the current year.

At 31 December 2005 the following Ordinary Shares were under option to employees or former employees of the Group:

Normal expiry date	Option price for each Ordinary Share of 10p	Number of options over Ordinary Shares of 10p
29 April 2006	72.0p	930,937
7 April 2007	63.8p	529,100
28 January 2008	49.0p	129,254
31 March 2008	89.3p	829,615
5 October 2008	43.0p	570,128
19 April 2009	66.7p	2,272,318
25 May 2009	54.4p	5,076,891
7 September 2009	54.6p	199,044
6 June 2010	87.6p	442,185
3 November 2010	78.4p	1,411,387
12 June 2011	77.4p	4,066,007
31 October 2011	53.4p	913,309
12 April 2012	69.4p	4,847,662
24 May 2012	75.4p	447,637
25 September 2012	49.6p	1,114,377
7 April 2013	44.6p	13,570,809
26 September 2013	59.5p	146,884
		37,497,544

Following completion of the Company's Rights Issue announced on 28 September 2005 the number and exercise price applicable to options were adjusted to take account of the dilution in the value of options caused by the Rights Issue. The number of options was increased by 4% and the exercise price was reduced by 4%.

As stated above, no options were granted to employees in 2004 or 2005. For those options granted in prior years which impact the income statement, fair values were determined using an option pricing model based

on Black-Scholes but adjusted to model the particular features of the options. The fair value of these options is consistent with the values previously disclosed for SEC filing purposes.

The Rights Issue had no effect on the fair value of options.

The total expense relating to share based payments, which are all equity settled transactions, is disclosed in Note 7; Staff costs.

Deferred Share Bonus Plan ("DSB")

Under the rules of this plan, Directors and senior employees receive conditional rights to acquire Ordinary Shares in the Company, at the prevailing market rates at the time of grant. Eligible employees are awarded rights to acquire a maximum number of shares at the beginning of a three year period, a proportion of which they will be entitled to receive at the end of that period depending on the extent to which the performance conditions set by the Remuneration Committee at the time the allocation is made are satisfied. If the performance conditions are not satisfied the share award will lapse. Awards are either linked to the deferral of annual bonus (DSB Matching Share Awards) or stand alone share awards (LTIP Awards). Further information on awards and performance conditions are detailed in the Remuneration Report.

	LTIP Awards	DSB Matching Share Awards
Outstanding At 1 January 2005	**3,679,499**	**2,046,093**
Granted	3,979,684	640,103
Rights Issue Adjustment	301,830	90,299
Forfeited	–	–
Cancelled or expired	518,084	88,801
Released	–	434,395
At 31 December 2005	**7,442,929**	**2,253,299**

Following completion of the Company's Rights Issue announced on 28 September 2005 the number of shares comprising the LTIP Awards and DSB Matching Share Awards was adjusted to take account of the dilution in the value of conditional shares caused by the Rights Issue. The number of shares under award was increased by 4%.

For the purposes of IFRS 2 the fair values of LTIP Awards and DSB Matching Shares Awards have been determined using a Monte Carlo Simulation model. The Monte Carlo Simulation model takes into account the comparative total shareholder return performance element attaching to these share awards. The following table sets out the assumptions used in determining the fair value of these share awards:

		LTIP Awards	DSB Matching Share Awards
Model			Monte Carlo Simulation
Rationale			This model takes into account the market based performance conditions (comparative TSR) attaching to the LTIP Awards and DSB Matching Share Awards.
Date of Grant	3 June 2005	9 June 2005	2 February 2005
Share Price on Grant (£)	0.54	0.53	0.64
Exercise Price	nil	nil	nil
Expected Dividend Yield	n/a	n/a	n/a
Expected Volatility	47.23%	47.18%	48.96%
Risk Free Interest Rate	4.22%	4.73%	4.57%
Expected Life	3 years	3 years	3 years
Fair Value (£)	0.40	0.40	0.57

The excepted volatility is calculated as the historic volatility of the Company share return over the three years prior to each grant date.

In determining the charge to the income statement, the Company has assumed that the number of share awards that will ultimately vest is reduced by 5% per annum.

The Rights Issue had no effect on the fair value of LTIP Awards and DSB Matching Share Awards.

The total expense relating to share based payments, which are all equity settled transactions, is disclosed in Note 7: Staff costs.

International Share Purchase Plan ("ISPP")

All employees are eligible to participate in the ISPP whereby employees buy shares in the Company. These shares are called Partnership Shares and are held in trust on behalf of the employee. For every Partnership Share bought by the employee the Company will give the employee one share free of charge (Matching Shares). The employees have to take their shares out of the plan on leaving the Company and will not be entitled to the Matching Shares if they leave within three years of buying the Partnership Shares. In addition, the Company can also award employees rights to acquire up to a maximum of £3,000 of shares (Free Shares). There are no vesting conditions attaching to the Free Shares other than being continuously employed by a Group company on the third anniversary of the date of grant.

	Matching Shares	Free Shares
Outstanding At 1 January 2005	**348,831**	**30,411**
Granted	211,460	-
Rights Issue Adjustment	n/a	2,723
Forfeited	-	-
Cancelled or expired	41,109	7,855
Released	88,347	-
At 31 December 2005	**430,835**	**25,279**

Following the completion of the Company's Rights Issue announced on 28 September 2005 the number of shares applicable to Free Shares was adjusted to take account of the dilution in the value of conditional shares caused by the Rights Issue. The number of shares under award was increased by 4%.

For the purposes of IFRS 2 the fair value of these Matching Shares and Free Shares is determined as the market value of the shares at the date of grant. In determining the charge to the income statement, the Company has assumed that the number of share awards that will ultimately vest is reduced by 10% per annum.

The Rights Issue had no effect on the fair value of the Free Shares.

The total expense relating to share based payments, which are all equity settled transactions, is disclosed in Note 7: Staff costs.

30 Reserves

Group	Share premium £m	Translation reserve £m	Fair value reserve £m	Retained losses £m
At 1 January 2004	**319.3**	**(1.6)**	**–**	**(364.3)**
On issue of shares to Research Development Foundation	1.5	–	–	–
Exercise of share options	0.2	–	–	–
Exchange adjustments	–	(2.5)	–	–
Revaluation deficit transfer	–	–	(0.5)	–
Loss for the year	–	–	–	(18.6)
Share based payments charge	–	–	–	4.1
Pension actuarial losses	–	–	–	(0.1)
At 31 December 2004	**321.0**	**(0.9)**	**(0.5)**	**(378.9)**
Rights issue	25.1	–	–	–
Expenses of rights issue	(2.9)	–	–	–
Acquisition of shares in Astralis	2.3	–	–	–
Exercise of share options	0.1	–	–	–
Exchange adjustments	–	(0.3)	–	–
Impairments	–	–	0.5	–
Revaluation surplus transfer	–	–	0.2	–
Loss for the year	–	–	–	(50.9)
Share based payments charge	–	–	–	2.4
Purchase of own shares	–	–	–	(0.4)
Repayment of convertible bonds due June 2005	–	–	–	0.7
At 31 December 2005	**345.6**	**(1.2)**	**0.2**	**(427.1)**

Company	Share premium £m	Fair value reserve £m	Retained losses £m
At 1 January 2004	**319.3**	**–**	**(18.4)**
On issue of shares to Research Development Foundation	1.5	–	–
Exercise of share options	0.2	–	–
Revaluation deficit transfer	–	(0.5)	–
Loss for the year	–	–	(32.0)
Share based payments charge	–	–	1.1
At 31 December 2004	**321.0**	**(0.5)**	**(49.3)**
Rights issue	25.1	–	–
Expenses of rights issue	(2.9)	–	–
Acquisition of shares in Astralis	2.3	–	–
Exercise of share options	0.1	–	–
Impairments	–	0.5	–
Revaluation surplus transfer	–	0.2	–
Loss for the year	–	–	(98.3)
Share based payments charge	–	–	1.3
Purchase of own shares	–	–	(0.4)
Repayment of convertible bonds due June 2005	–	–	0.7
At 31 December 2005	**345.6**	**0.2**	**(146.0)**

As permitted by Section 230 of the Companies Act 1985, the Income Statement of the Company is not presented. The loss of the Company for the year ended 31 December 2005 was £98.3 million (2004: £32.0 million).

31 Other reserves

Group	Merger reserve £m	Warrants reserve £m	Equity of convertible bonds £m	Total other reserves £m
At 1 January 2004	**9.0**	**0.4**	**0.7**	**10.1**
Exchange and issue of convertible bonds due May 2024	–	–	22.3	22.3
At 31 December 2004	**9.0**	**0.4**	**23.0**	**32.4**
Issue of convertible bonds due June 2025	–	–	6.1	6.1
Repayment of convertible bonds due June 2005	–	–	(0.7)	(0.7)
At 31 December 2005	**9.0**	**0.4**	**28.4**	**37.8**

The merger reserve relates to the acquisition of Krypton Limited during 1996. The warrant reserve relates to the 'D', 'E' and 'F' warrants described in note 28; Share capital. The equity element of the convertible bonds reserve relates to the convertible bonds due May 2024 and June 2025.

Company	Merger reserve £m	Warrants reserve £m	Equity of convertible bonds £m	Total other reserves £m
At 1 January 2004 and 31 December 2004	**9.0**	**0.4**	**0.7**	**10.1**
Repayment of convertible bonds due June 2005	–	–	(0.7)	(0.7)
At 31 December 2005	**9.0**	**0.4**	**–**	**9.4**

32 Commitments

	Group As at 31 December 2005 £m	Group As at 31 December 2004 £m	**Company As at 31 December 2005 £m**	Company As at 31 December 2004 £m
Commitments under operating leases				
Operating leases on land and buildings:				
In one year or less	**2.3**	2.5	**–**	0.6
In two to five years	**10.4**	10.7	**–**	–
In five years or more	**14.6**	15.6	**0.3**	–
	27.3	28.8	**0.3**	0.6
Other operating leases:				
In one year or less	**0.1**	–	**–**	–
	0.1	–	**–**	–

In addition the Group has committed to undertake certain clinical trials on behalf of its partners under development and licensing agreements.

The Group is committed to make certain payments to third parties contingent upon future events such as the approval and launch of products.

33 Contingencies

At 31 December 2005 the Company had provided guarantees on various bank borrowings of its subsidiaries as set out in Note 23; Borrowings.

In common with most business enterprises, Group companies are subject to a number of claims from third parties, the outcome of which cannot at present be determined but which are not considered to be material in the context of these financial statements. Provisions have been made in these financial statements for any liabilities which are expected to materialise from such claims.

34 Related Parties

Group

Directors' transactions

At the end of December 1998, Ian Gowrie-Smith (through a family-owned trust) acquired a 51% interest in 10 East 63rd Street Inc., the company which owns 10 East 63rd Street, a property in New York. In December 2002 Mr. Gowrie-Smith acquired a further 49% interest. SkyePharma PLC has been in occupation of approximately half of that property since January 1997, subject to tenancy agreements based upon independent valuation. In August 2003 the Company took occupation of the entire building under an eight-year tenancy agreement, at which time the annual rent was increased from $420,000 per annum to $720,000 per annum until August 2008, and $942,500 per annum from August 2008 to August 2011. A portion of these premises is currently sub-let by the Group.

Company

The Company has issued share options to employees of subsidiary undertakings and in accordance with IFRS 2 has made a charge of £1.3 million (2004: £1.1million).

The Company has charged £1.6 m (2004: £1.9m) to subsidiary undertakings and the Company was charged £0.5 m (2004: £0.3m) by subsidiary undertakings for corporate services provided.

The Company has intercompany loans and accounts with its subsidiary undertakings and details can be found in notes 17; Shares in and loans to Group undertakings, 19; Trade and other receivables and 22; Trade and other payables. Interest is charged on inter company loans and accounts at 0.5% above one month LIBOR or 1.0% above three month LIBOR and totalled £7.5m for the year (2004: £9.1m).

The Group's key management comprises only Directors and Director' remuneration for the year is shown in the audited part of the Remuneration Report.

There are no material balances held with associates at the year ended 31 December 2005 or 2004.

35 Principal subsidiaries

Subsidiary undertakings

Company	Country of incorporation	% held of nominal value and voting rights	Principal activities
SkyePharma Canada Inc.*	Canada	100%	Research and development
SkyePharma Production SAS*	France	100%	Manufacturing of pharmaceuticals
SkyePharma (Jersey) Limited*	Jersey	100%	Issue of bonds
Krypton Limited	Gibraltar	100%	Exploitation of intellectual property
SkyePharma AB*	Sweden	100%	Research and development
Jago Holding AG	Switzerland	100%	Holding company
Jagotec AG	Switzerland	100%	Exploitation of intellectual property
SkyePharma AG	Switzerland	100%	Research and development
SkyePharma Holding AG*	Switzerland	100%	Holding company
SkyePharma Holding Inc.*	US	100%	Holding company
SkyePharma Inc.	US	100%	Development of pharmaceuticals
SkyePharma US Inc.	US	100%	Development of pharmaceuticals and licensing

* Directly held by the Company.

Associates

Company	Country of incorporation	% held of nominal value and voting rights	Principal activities
Astralis Limited	US	40%	Research and development

36 Subsequent event

In May 2006 SkyePharma announced that it had entered into an agreement with Kos Pharmaceuticals Inc to jointly develop Flutiform®. Kos will have exclusive rights to market Flutiform® in the US and a right of first negotiation in Canada. SkyePharma could receive up to $165 million in milestone payments on achievement of all regulatory and revenue targets (of which $25 million has been paid up front) together with royalties starting in the mid teens on sales by Kos.

37 Transition from accounting practices generally accepted in the UK to International Financial Reporting Standards

The Group reported under UK GAAP in its financial statements for the year ended 31 December 2004. The Group is required under the Listing Rules to report under IFRS for the year ending 31 December 2005 and present comparatives for the year ended 31 December 2004. Consequently, the Group's date of transition to IFRS is 1 January 2004.

Set out below are reconciliations of total equity and reserves and income from UK GAAP to IFRS.

Total equity and reserves

	Notes	31 December 2004 £m	1 January 2004 £m
Total equity and reserves as reported under UK GAAP		**63.6**	**84.9**
Adjustments to conform to IFRS			
Revenue recognition	(a)	(6.7)	(19.6)
Sale of royalty interests to Paul Capital	(b)	(39.0)	(36.1)
Goodwill amortisation	(d)	4.1	–
Convertible bonds	(e)	16.4	1.5
Fixed assets investments	(f)	(0.5)	–
Other financial instruments	(g)	(0.2)	0.4
Pensions	(h)	(1.2)	(1.3)
Total equity and reserves under IFRS		**36.5**	**29.8**

Loss for the year

	Notes	Year ended 31 December 2004 £m
Loss for the year as reported under UK GAAP		**(24.3)**
Adjustments to conform to IFRS		
Revenue recognition	(a)	13.1
Sale of royalty interests to Paul Capital	(b)	(1.7)
Share based payments	(c)	(2.8)
Goodwill amortisation	(d)	4.1
Convertible bonds	(e)	(6.5)
Other financial instruments	(g)	(0.5)
Loss for the year under IFRS		**(18.6)**

Cash flow statement

The transition from UK GAAP to IFRS does not change any of the cash flows of the Group. The IFRS cash flow statement is similar to UK GAAP, but presents various cash flows in different categories and in a different order from the UK GAAP cash flow statement. All of the IFRS accounting adjustments net out within cash generated from operations, except for the inclusion of the repayment of the Paul Capital funding liabilities.

The IFRS adjustments set out in the reconciliations are explained below:

(a) Revenue recognition
Under UK GAAP SkyePharma has generally recognised up front payments immediately in full where there are no material future obligations and the payments are non-refundable, on the basis that the up front payment relates to past services. Under IFRS up front payments will generally be deferred and amortised on a systematic basis over the period of product development to filing. However, the accounting for each agreement will continue to be determined on an individual basis.

The IFRS restatement increases revenue in the year to 31 December 2004 by £13.1 million so reducing operating and retained loss by £13.1 million. This relates to up front payments that have been previously recognised in the UK GAAP financial statements in earlier years but which under IFRS would not have been recognised in full, but deferred across the period of development to filing. The restatement increases deferred income at 31 December 2004 by £6.7 million (2003: £19.6 million).

(b) Sale of royalty interests to Paul Capital
The Group entered into two transactions with Paul Capital Royalty Acquisition Fund ('Paul Capital') in 2000 and 2002. Under these transactions Paul Capital provided a total of $60 million in return for the sale of a portion of the potential future royalty and revenue streams on a selection of the Group's products. Under UK GAAP the proceeds received from Paul Capital are treated as a sale and recorded as operating income and the royalties are expensed when incurred.

Under IFRS the proceeds received from Paul Capital meet the definition of a financial liability under IAS 39, and are treated as such. No operating income is recognised, royalties paid to Paul Capital are treated as repayment of the liability and in addition interest is imputed on the liability using the effective rate as at inception of the agreement. The contractual arrangement with Paul Capital is unaffected by this change in accounting and the arrangement remains a royalty agreement under which royalties are payable on revenues earned and payments received. The liability has no face amount but represents the net present value of royalties we expect to pay Paul Capital over the term of the agreement, discounted at the effective rate at inception of the agreement.

The IFRS restatement increases the loss in the year to 31 December 2004 by £1.7 million and decreases net assets at 31 December 2004 by £39.0 million (2003: £36.1 million).

(c) Share based payments
IFRS 2 requires that for share option awards to employees, the fair value of the employee services received should be measured by reference to the fair value of the share option at the grant date. This differs significantly from the treatment under UK GAAP where the charge to the profit and loss account was based on the difference between the fair value of the shares at the date of grant and the exercise price. Since SkyePharma has historically granted employee options where the share price at the date of grant equals the exercise price, there has been no charge recorded under UK GAAP.

SkyePharma has adopted full retrospective application of IFRS 2. The IFRS restatement results in an additional charge to the income statement in the year to 31 December 2004 of £2.8 million, increasing both operating and retained loss. The restatement has no impact on net assets.

(d) Goodwill amortisation
Under UK GAAP goodwill has been amortised over its estimated expected useful life which the Directors determined as 20 years. Under IFRS, goodwill is considered to have an indefinite life and so is not amortised, but is subject to annual impairment testing. Therefore the annual goodwill charge made under UK GAAP will

not be recorded under IFRS from 1 January 2004, the IFRS transition date. The IFRS restatement results in a reduction in the amortisation charge in the year to 31 December 2004 of £4.1 million thereby reducing both operating and retained loss.

(e) Convertible bonds
Under UK GAAP the total net proceeds of the convertible bond issues in 2000 (due in 2005) and 2004 (due in 2024) were recorded as debt. Under IFRS the conversion feature of each of the bonds must be split from the debt and classified as equity. The net impact of the changes to IFRS and in particular the split of the equity component of each bond has led, at 31 December 2004, to a reduction in the carrying value of convertible debt of £16.4 million (2003: £1.5 million) and a corresponding increase in equity. While the carrying value of the convertible debt in the balance sheet is reduced, the amount of debt repayable at maturity is unchanged and consequently under IFRS the Group records higher interest charges in each year to maturity or conversion.

In the year to 31 December 2004, the impact of these factors led to an additional interest charge of £0.3million. The terms of the debt are unaffected and the physical cash payments due remain the same; as such the cost of the debt in cash terms is unaffected.

During the year to 31 December 2004 the Group exchanged £49.6 million of the convertible bonds due 2005 for bonds due 2024 in the same amount, leaving £9.8 million 2005 bonds outstanding. Under UK GAAP no gain or loss arose on the exchange. However un-amortised issue costs of £0.3 million were written off under UK GAAP as exceptional interest charge. Under IFRS the refinancing of the £49.6 million convertible is treated as an extinguishment of the original debt and the issue of new debt recorded at fair value since the discounted present value of the cash flows of the two instruments differ by more than 10% (2005 Bond replaced by a 2024 Bond). The extinguishment and debt issue costs lead to the additional charge of £6.2 million recorded in the IFRS income statement in 2004.

In total the IFRS adjustments on the convertible bonds result in an additional interest charge in the 2004 income statement of £6.5 million and an increase in net assets at 31 December 2004 by £16.4 million. Of the £6.5m additional interest charge, £0.3m relates to the IFRS accounting for convertible bonds in general and £6.2 million is an additional charge caused by the 2004 refinancing of SkyePharma's convertible bond due 2005.

(f) Fixed assets investments
Under UK GAAP fixed asset investments are stated at the lower of cost and net realisable value. Under IFRS most of SkyePharma's investments are classified as 'Available-for-sale financial assets' and as such stated at fair value with any unrealised gains or losses recorded in equity. The IFRS restatement reduces net assets at 31 December 2004 by £0.5 million (2003: £Nil) and does not effect the income statement.

(g) Other financial instruments
Under UK GAAP, periodic gains and losses on interest and foreign currency derivatives designated as hedges are not recognised until the operational transactions to which they are linked occur. No derivatives have qualified as hedges under IFRS and therefore in accordance with IAS 39 such instruments have been recognised at fair value at the balance sheet date with gains and losses being recorded in the income statement.

SkyePharma is adopting full retrospective application of IAS 32 and IAS 39 and has therefore restated its opening balance and 2004 result accordingly. This restatement has led to an additional charge in the year to 31 December 2004 of £0.5 million, increasing both operating and retained loss. As at 31 December 2004 the IFRS restatement reduces net assets by £0.2 million (2003: £0.4 million increase).

(h) Pensions
The IFRS adjustment on pensions relates to the Company's pension schemes in Switzerland and France. In accordance with IFRS 1, the Group has fully recognised all actuarial gains and losses on its pension schemes in Switzerland and France at 1 January 2004, its transition date. Ongoing actuarial gains and losses will be recognised in the Statement of Recognised Income and Expenditure.

(i) Other
Under IFRS the Group is required to capitalise research and development costs when the criteria laid out in IAS 38 are met. The Group has reviewed its historical research and development projects and determined that no expenditure incurred to date meets the criteria for capitalisation in IAS 38. However the Group will continue to review its development expenditure against the relevant criteria and will capitalise such expenditure when it is appropriate.

Company

Total equity and reserves

	31 December 2004 £m	1 January 2004 £m
Total equity and reserves as reported under UK GAAP	**349.6**	**373.1**
Adjustments to conform to IFRS		
Share based payments	(1.1)	–
Convertible bonds	(3.1)	1.5
Fixed assets investments	(0.5)	–
Other financial instruments	(0.2)	0.4
Total equity and reserves under IFRS	**344.7**	**375.0**

Loss for the year

	Year ended 31 December 2004 £m
Loss for the year as reported under UK GAAP	**(26.9)**
Adjustments to conform to IFRS	
Share based payments	(1.1)
Convertible bonds	(3.8)
Other financial instruments	(0.2)
Loss for the year under IFRS	**(32.0)**

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