

Phoqus Pharmaceuticals Limited

Report and Financial Statements

31 December 2005

 ERNST & YOUNG

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Phoqus Pharmaceuticals Limited

Registered No: 3486675

Directors

P G Johnson	(Chief Financial Officer)
A A Jones	(Chief Executive Officer)
D F J Leathers	(Non-Executive Director)
E Moses	(Chairman)

Secretary

P G Johnson

Auditors

Ernst & Young LLP
1 More London Place
London
SE1 2AF

Bankers

HSBC Bank plc
83 Sidcup High Street
Sidcup
Kent
DA14 6DN

Solicitors

Olswang
90 High Holborn
London
WC1V 6XX

Registered office

10 Kings Hill Avenue
Kings Hill
West Malling
Kent
ME19 4PQ

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Directors' report

The Directors present their report and financial statements for the year ended 31 December 2005.

Results and dividends

The loss for the year amounted to £6,511,452 (2004 - £6,535,031). The Directors do not recommend the payment of a dividend.

Principal activities and review of the business

The principal activity of the Company is the development and commercialisation of the electrostatic deposition technology for the manufacture of tablets with tailored appearance and medical properties for the pharmaceutical industry. These are delivered using the four drug delivery systems: Qdis (fast dissolve); Qtrol (modified release); LeQtrados (active dose loading) and UniQ (unique tablet imaging).

The management team consists of Dr Andy Jones, CEO, Dr Peter Johnson, CFO, Dr Marshall Whiteman, VP Technical Development, Dr Paul Jenkins, VP Commercial and Mr Mike Holroyd, VP Engineering.

The Company has made considerable progress during the year further developing relationships with customers. It has also completed the engineering programme that has developed a higher throughput machine capable of operation to 'Good Manufacturing Practice' for commercial use. The machine was dismantled and transported to the Cardinal Health manufacturing facility near Stuttgart in Germany where it will be commissioned during the first half of 2006.

Future developments

The Directors believe that there are sufficient funds to execute the business plan presented to investors during the preparation for the AIM listing of the group.

Research and development

The Company continues to be engaged in R&D activities as evidenced by its expanding patent portfolio. All scientific and engineering staff are engaged on these activities when not servicing customer projects.

Going concern

The Directors have prepared the financial statements on the going concern basis. Their assumptions in continuing to adopt the going concern basis are outlined in the Fundamental Accounting section of Note 1 to the financial statements.

Directors' report

Directors

The Directors who served the Company during the year were as follows:

P G Johnson
A A Jones
D F J Leathers
E Moses

There are no Directors' interests requiring disclosure under the Companies Act 1985. The interests of the Directors in the shares and options of the parent undertaking, Phoqus Group plc, are shown in the report and consolidated financial statements of that Company.

Auditors

A resolution to reappoint Ernst & Young LLP as auditors will be put to the members at the Annual General Meeting.

By order of the Board



P G Johnson
Secretary

31 March 2006

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Statement of Directors' responsibilities in respect of the financial statements

The directors are responsible for preparing the Annual Report and the financial statements in accordance with applicable United Kingdom law and United Kingdom Generally Accepted Accounting Practice.

Company law requires the Directors to prepare financial statements for each financial year which give a true and fair view of the state of affairs of the Company and of the profit or loss of the Company for that year. In preparing those financial statements, the Directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and estimates that are reasonable and prudent;
- state whether applicable accounting standards have been followed, subject to any material departures disclosed and explained in the financial statements; and
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the Company will continue in business.

The Directors are responsible for keeping proper accounting records which disclose with reasonable accuracy at any time the financial position of the Company and to enable them to ensure that the financial statements comply with the Companies Act 1985. They are also responsible for safeguarding the assets of the Company and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

Independent auditors' report

to the members of Phoqus Pharmaceuticals Limited

We have audited the company's financial statements for the year ended 31 December 2005 which comprise the Profit and Loss Account, Statement of Total Recognised Gains and Losses, Balance Sheet, and the related notes 1 to 22. These financial statements have been prepared under the accounting policies set out therein.

This report is made solely to the company's members, as a body, in accordance with Section 235 of the Companies Act 1985. Our audit work has been undertaken so that we might state to the company's members those matters we are required to state to them in an auditors' report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the company and the company's members as a body, for our audit work, for this report, or for the opinions we have formed.

Respective responsibilities of Directors and auditors

The directors are responsible for the preparation of the financial statements in accordance with applicable law and United Kingdom Accounting Standards (United Kingdom Generally Accepted Accounting Practice) as set out in the Statement of Directors' Responsibilities.

Our responsibility is to audit the financial statements in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland).

We report to you our opinion as to whether the financial statements give a true and fair view and are properly prepared in accordance with the Companies Act 1985. 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 read the Directors' Report and consider the implications for our report if we become aware of any apparent misstatements within it.

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. 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 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 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.

Independent auditors' report

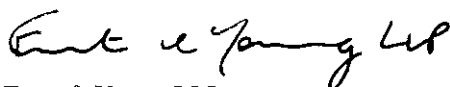
to the members of Phoqus Pharmaceuticals Limited (continued)

Opinion

In our opinion, the financial statements give a true and fair view, in accordance with United Kingdom Generally Accepted Accounting Practice, of the state of the company's affairs as at 31 December 2005 and of its loss for the year then ended and have been properly prepared in accordance with the Companies Act 1985.

Emphasis of matter

In forming our opinion, we have considered the adequacy of the disclosures made in note 1 of the financial statements concerning the fundamental uncertainty as to the Company's medium – term viability until its technology is commercially successful and is capable of revenue generation. The financial statements do not include any adjustments that would result from a failure to develop a commercial product and generate future revenues or any other matters described in Note 1. It is not practical to quantify the adjustments that might be required, but should any adjustments be required they may be significant. In view of the significance of this uncertainty we consider that it should be drawn to your attention but our opinion is not qualified in this respect



Ernst & Young LLP
Registered Auditor
London

9 May 2006

Profit and loss account

for the year ended 31 December 2005

	Notes	2005 £	2004 £
Turnover	2	274,137	300,428
Administrative expenses		(6,004,135)	(6,974,536)
Operating loss	3	(5,729,998)	(6,674,108)
Bank interest receivable	8	98,590	60,494
Interest payable	9	(1,480,811)	(539,551)
Loss on ordinary activities before taxation		(7,112,219)	(7,153,165)
Tax on loss on ordinary activities	10	600,767	618,134
Loss for the financial year	15	<u>(6,511,452)</u>	<u>(6,535,031)</u>

Statement of total recognised gains and losses

There are no recognised gains or losses other than the loss of £6,511,452 attributable to the shareholders for the year ended 31 December 2005 (2004 - loss of £6,535,031).

Balance sheet

at 31 December 2005

	Notes	2005 £	2004 £
ASSETS			
Fixed assets			
Tangible assets	11	2,321,838	2,393,542
Current assets			
Debtors	12	1,301,600	1,108,225
Cash at bank		6,524,674	967,821
		<u>7,826,274</u>	<u>2,076,046</u>
		<u>10,148,112</u>	<u>4,469,588</u>
LIABILITIES			
Capital and reserves			
Called up share capital	13	2,562	2,562
Share premium account	14	13,714,444	13,714,444
Capital redemption reserve	14	4,580,064	4,580,064
Capital contribution reserve	14	207,711	132,711
Profit and loss account	14	(34,583,262)	(28,071,810)
Equity shareholders' funds	15	(16,078,481)	(9,642,029)
Creditors			
Amounts falling due within one year	16	1,258,950	781,072
Amounts falling due after more than one year	17	24,967,643	13,330,545
		<u>26,226,593</u>	<u>14,111,617</u>
		<u>10,148,112</u>	<u>4,469,588</u>

ERNST & YOUNG

Approved by the Board on 31 March 2006


A A Jones
Chief Executive Officer

P G Johnson
Chief Financial Officer

Notes to the financial statements

at 31 December 2005

1. Accounting policies

Fundamental accounting concept

The financial statements have been prepared on a going concern basis.

The Company's strategy is to commercialise the technology it has developed for the manufacture of tablets, the appearance and medical properties of which are tailored to the requirements of customers in the pharmaceutical industry. The historic level of retained losses as at the date of these financial statements represents the Company's investment in costs to achieve this strategy. In order to finance the commercialisation phase of the strategy, the holding company raised £8.8m of funds (net of costs) through a Placing on its admission to AIM. Beyond this phase, there are risk factors inherent in the business and its potential to generate future revenues. As the commercial development phase has not yet been completed as at the date of these financial statements, there is a fundamental uncertainty as to the viability of the Company on a medium-term basis and hence the validity of the basis of preparation of these financial statements.

The Company is dependent on funding from the holding company. The Directors anticipate, based on forecast levels of income and expenditure, that there will be sufficient cash available to allow the holding company to trade as planned and therefore continue to provide funding to the Company to allow it to trade until at least the end of 2007. Thereafter, the Directors believe that sufficient revenues will be generated from operations to ensure that the Company is able to continue in operational existence for the foreseeable future.

The financial statements do not include any adjustments that might be required should the holding company not generate sufficient revenues, free cash flow or raise additional finance through further injections of debt or equity to provide financial support to the Company. It is not practical to quantify the adjustments that might be required to write down the value of assets, reclassify long-term balances as current and recognise any additional liabilities should the going concern basis cease to be appropriate.

Basis of preparation

The financial statements are prepared under the historical cost convention and in accordance with applicable accounting standards.

The following accounting policies have been applied consistently in dealing with items which are considered material in relation to the Company's financial statements.

Cash flow statement

The Company has taken advantage of the exemption from the requirement to prepare a cash flow statement as provided for in financial reporting standard No.1 (Revised 1996) on the grounds that it is 100% owned by Phoqus Group plc which prepares consolidated financial statements that incorporate the Company's results and are publicly available.

Related parties transactions

The Company has also taken advantage of the exemption in financial reporting standard No. 8 "Related party transactions" from disclosing transactions with other companies within the Phoqus Group plc group.

Research and development

Research and development expenditure is written off in the year in which it is incurred.

Notes to the financial statements

at 31 December 2005

1. Accounting policies (continued)

Tangible fixed assets

Tangible fixed assets are recorded at cost less depreciation. Depreciation is calculated so as to write off the cost of such assets, less their estimated residual values, on a straight-line basis over their expected useful economic lives, as follows:

Leasehold improvements	- over the period of the lease
Plant and machinery	- 2-15 years
Office furniture and fittings	- 2-10 years

Assets in the course of construction are not depreciated until they are brought into use.

The carrying values of tangible fixed assets are reviewed for impairment when events or changes in circumstances indicate the carrying value may not be recoverable.

Deferred taxation

Deferred tax is recognised in respect of all timing differences that have originated but not reversed at the balance sheet date where transactions or events have occurred at that date that will result in an obligation to pay more, or a right to pay less or to receive more, tax, with the following exception. Deferred tax assets are recognised only to the extent that the Directors consider that it is more likely than not that there will be suitable taxable profits from which the future reversal of the underlying timing differences can be deducted.

Deferred tax is measured on an undiscounted basis at the tax rates that are expected to apply in the periods in which timing differences reverse, based on tax rates and laws enacted or substantively enacted at the balance sheet date.

Foreign currencies

Transactions in foreign currencies are recorded at the rate ruling at the date of the transaction.

Monetary assets and liabilities denominated in foreign currencies are retranslated at the rate of exchange ruling at the balance sheet date.

All differences are taken to the profit and loss account.

Finance lease agreements

Where the Company enters into a lease which entails taking substantially all the risks and rewards of ownership of an asset, the lease is treated as a finance lease. The asset is recorded in the balance sheet as a tangible fixed asset and is depreciated in accordance with the above depreciation policies. Future instalments under such leases, net of finance charges, are included with creditors. Rentals payable are apportioned between the finance element, which is charged to the profit and loss account on a straight line basis, and the capital element which reduces the outstanding obligation for future instalments.

Operating lease agreements

Rentals payable under operating leases are charged in the profit and loss account on a straight line basis over the lease term.

Notes to the financial statements

at 31 December 2005

1. Accounting policies (continued)

Pension costs

The Company is a member of a group personal pension scheme. Employees contribute at various rates, which are partially matched by the Company and charged to the profit and loss account as they become payable in accordance with the rules of the scheme.

Finance and warrants

Finance secured with the issue of warrants is accounted for in accordance with FRS 25. The finance proceeds are allotted between debt and warrants; the value of warrants is accounted for in reserves and the discount on issue of the debt is treated as a finance cost and apportioned to accounting periods so that the total finance cost on the debt will have a constant relationship to the outstanding obligation.

Employee Benefit Trust

Contribution payments made to the Trust are charged to the profit and loss account when they are appointed to or for the benefit of specific individuals. Administration expenses deducted from the contributions by the Trustees are also charged to the profit and loss account as incurred. Funds unappointed at the balance sheet date are included in the financial statements, although the Company's access to these funds is subject to the agreement of the Trustees of the Trust.

2. Turnover

Turnover arises from the provision of services to client companies in respect of the application of the Company's technology to the client's active materials, and comprises the value of invoiced sales, less value added tax. All turnover arises from continuing activities.

Revenue is recognised by reference to the terms and conditions of the contract. Revenue related to the achievement of objectives is recognised when those objectives are met, whilst revenue related to time is recognised over the period of the contract.

An analysis of turnover by geographical market is given below:

	2005 £	2004 £
United Kingdom	91,060	260,819
USA	166,200	—
Europe	16,877	—
Japan	—	39,609
	<u>274,137</u>	<u>300,428</u>

3. Operating loss

This is stated after charging:

	2005 £	2004 £
Auditors' remuneration - audit services	42,500	12,000
- non-audit services	—	14,500
Depreciation of owned fixed assets	191,597	352,893
Depreciation of assets held under finance leases	175,395	72,259
Loss on disposal of fixed assets	33,539	129,513
Operating lease rentals - land and buildings	401,800	308,563
Net loss on foreign currency translation	<u>4,534</u>	<u>4,343</u>

Auditors' remuneration for 2004 includes assistance with the year-end process and preparation of the Company's Corporation Tax return and VAT advisory services. The VAT advisory services received during 2004 were not required in 2005.

Notes to the financial statements

at 31 December 2005

4. Staff costs

	2005 £	2004 £
Wages and salaries	1,440,460	1,599,503
Social security costs	168,843	179,636
Other pension costs	75,254	85,644
	<u>1,684,557</u>	<u>1,864,783</u>

The monthly average number of employees during the year amounted to 29 (2004 - 37).

5. Directors' emoluments

	2005 £	2004 £
Emoluments	<u>291,750</u>	<u>274,415</u>

The amounts in respect of the highest paid Director are as follows:

	2005 £	2004 £
Emoluments	<u>148,572</u>	<u>140,350</u>

No pension contributions are made in respect of Directors.

Employee Benefit Trust

In addition to the Directors' emoluments set out above, £177,880 (2004 - £170,430) of the amount paid by the Company into the Employee Benefit Trust during the year has been allocated by the Trustees indirectly for the benefit of the Directors. The amount in respect of the highest paid Director during the year was £90,330 (2004 - £64,130). The amounts will be chargeable to taxation at the time of distribution.

7. Pensions

The Company contributes to a group personal pension scheme operated by Scottish Widows. The employees contribute at various rates which are partially matched by the Company. The cost to the Company for the year was £75,254 (2004 - £85,644) and has been charged to the profit and loss account. Included in accruals and deferred income is £Nil (2004 - £9,041) relating to pension contributions unpaid at the balance sheet date.

8. Interest receivable

	2005 £	2004 £
Bank interest receivable	<u>98,590</u>	<u>60,494</u>

Notes to the financial statements

at 31 December 2005

9. Interest payable

	2005 £	2004 £
On bank loans and overdrafts	165	102
Finance charges payable under finance leases	163,962	41,251
On other loans	1,316,684	498,198
	<u>1,480,811</u>	<u>539,551</u>

10. Tax

(a) Tax on loss on ordinary activities

The R&D tax credit is made up as follows:

	2005 £	2004 £
<i>Current tax:</i>		
UK corporation tax	(600,767)	(618,134)
Total current tax (note 10(b))	<u>(600,767)</u>	<u>(618,134)</u>

(b) Factors affecting current tax credit

The tax assessed on the loss on ordinary activities for the year differs from than the standard rate of corporation tax in the UK of 30% (2004 - 30%). The differences are reconciled below:

	2005 £	2004 £
Loss on ordinary activities before taxation	<u>(7,112,219)</u>	<u>(7,153,165)</u>
Loss on ordinary activities multiplied by standard rate of corporation tax in the UK of 30% (2004 - 30%)	(2,133,666)	(2,145,950)
(Non-taxable income)/expenses not deductible for tax purposes	(2,412)	33
Group relief surrendered	331,486	26,572
Decelerated capital allowances	414,857	141,611
Losses surrendered to research and development tax credit	149,014	154,906
Losses arising in the year not relievable against current tax	639,954	1,204,694
Total current tax (note 10(a))	<u>(600,767)</u>	<u>(618,134)</u>

(c) Deferred tax

The deferred taxation asset not recognised in the financial statements is as follows:

	2005 £	2004 £
Tax losses available	7,029,913	6,389,959
Other timing differences	-	2,712
Capital allowances in advance of depreciation	(143,403)	(660,917)
	<u>6,886,510</u>	<u>5,731,754</u>

Notes to the financial statements

at 31 December 2005

10. Tax (continued)

The deferred tax asset will be realised when the Company has future taxable profits. The asset has not been recognised due to the uncertainties over the timing and nature of such profits.

(d) Factors that may affect future tax charges

The tax losses are available for carry forward and offset against future trading profits for an indefinite period, subject to the agreement of the Inland Revenue and any changes in government tax legislation.

11. Tangible fixed assets

	<i>Assets in the Course of Construction</i>	<i>Leasehold improvements</i>	<i>Plant and machinery</i>	<i>Office furniture and fittings</i>	<i>Total</i>
	£	£	£	£	£
Cost:					
At 1 January 2005	–	902,266	2,307,752	480,602	3,690,620
Additions	22,120	–	292,101	14,606	328,827
Disposals	–	–	(39,836)	(235)	(40,071)
At 31 December 2005	<u>22,120</u>	<u>902,266</u>	<u>2,560,017</u>	<u>494,973</u>	<u>3,979,376</u>
Depreciation:					
At 1 January 2005	–	154,214	821,676	321,188	1,297,078
Provided during the year	–	62,609	246,648	57,735	366,992
Disposals	–	–	(6,297)	(235)	(6,532)
At 31 December 2005	<u>–</u>	<u>216,823</u>	<u>1,062,027</u>	<u>378,688</u>	<u>1,657,538</u>
Net book value:					
At 31 December 2005	<u>22,120</u>	<u>685,443</u>	<u>1,497,990</u>	<u>116,285</u>	<u>2,321,838</u>
At 1 January 2005	<u>–</u>	<u>748,052</u>	<u>1,486,076</u>	<u>159,414</u>	<u>2,393,542</u>

The net book value of assets above includes an amount of £1,843,829 (2004 - £177,032) in respect of assets held under finance leases.

12. Debtors

	2005 £	2004 £
Trade debtors	156,762	20,563
Other debtors and deposits	338,708	209,174
Prepayments and accrued income	205,363	260,354
Research and development tax credit receivable	600,767	618,134
	<u>1,301,600</u>	<u>1,108,225</u>

Included within other debtors and deposits is £173,961 (2004 - £160,910) relating to deposits that are repayable in more than one year.

Notes to the financial statements

at 31 December 2005

13. Share capital

		2005		Authorised 2004
	No.	£	No.	£
Ordinary shares of £0.01 each	458,705,000	<u>4,587,050</u>	458,705,000	<u>4,587,050</u>

		2005		Allotted, called up and fully paid 2004
	No.	£	No.	£
Ordinary shares of £0.01 each	256,188	<u>2,562</u>	256,188	<u>2,562</u>

14. Reserves

	Share premium account £	Capital redemption reserve £	Capital contribution reserve £	Profit and loss account £
At 1 January 2005	13,714,444	4,580,064	132,711	(28,071,810)
Loan warrants	—	—	75,000	—
Loss for the year	—	—	—	(6,511,452)
At 31 December 2005	<u>13,714,444</u>	<u>4,580,064</u>	<u>207,711</u>	<u>(34,583,262)</u>

5. Reconciliation of movements in shareholders' funds

	2005 £	2004 £
Loss for the financial year	(6,511,452)	(6,535,031)
Loan warrants	75,000	—
Opening shareholders' equity deficit	(9,642,029)	(3,106,998)
Closing shareholders' equity deficit	<u>(16,078,481)</u>	<u>(9,642,029)</u>

16. Creditors: amounts falling due within one year

	2005 £	2004 £
Other loans	41	41
Obligations under finance leases (note 18)	473,030	33,997
Trade creditors	455,636	504,067
Amounts owed to group undertakings	41,982	21,982
Other taxation and social security	52,983	46,785
Accruals and deferred income	235,278	174,200
	<u>1,258,950</u>	<u>781,072</u>

Notes to the financial statements

at 31 December 2005

17. Creditors: amounts falling due after more than one year

	2005 £	2004 £
Obligations under finance leases (note 18)	845,263	24,200
Amounts owed to Group undertakings	24,122,380	13,306,345
	<u>24,967,643</u>	<u>13,330,545</u>

The other loans are secured by a floating charge over the Company's assets and the finance lease over specific assets.

18. Obligations under finance leases

The maturity of these amounts is as follows:

	2005 £	2004 £
Amounts payable:		
Within one year	473,030	33,997
In two to five years	845,263	24,200
	<u>1,318,293</u>	<u>58,197</u>

19. Commitments under operating leases

At 31 December 2005 the Company had annual commitments under non-cancellable operating leases as set out below.

	<i>Land and buildings</i>	
	2005 £	2004 £
Operating leases which expire:		
In two to five years	107,225	232,164
In over five years	82,617	80,222
	<u>189,842</u>	<u>312,386</u>

20. Capital commitments

Amounts contracted for but not provided in the financial statements amounted to £88,480 (2004 - £nil).

21. Related party transactions

During the year one Company Director was paid for consultancy services and/or other expenses totalling £269 (2004 - two directors and £803) to the Company over and above their duties as Directors. A Director of the Company is also a director of a company that has a substantial interest in a joint development agreement recently signed with the Company. In the future there may be royalty payments due to the Company but to date no transactions have occurred and there are £nil balances between the two companies (2004 - £nil).

22. Ultimate parent undertaking

The Company's immediate and ultimate parent undertaking and controlling party is Phoqus Group plc. Copies of the consolidated financial statements in which the results of the Company have been included can be obtained from 10 Kings Hill Avenue, Kings Hill, West Malling, Kent, ME19 4PQ.