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Phoqus Group plc

(formerly Phoqus Group Limited)

Report and Consolidated Financial Statements

31 December 2005

Ernst & Young

Directors and Advisors

Directors

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

Secretary
P G Johnson

Nominated Advisor & Nominated Broker
Nomura Code Securities Limited
1 Carey Lane
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EC2V 8AE

Auditors
Ernst & Young LLP
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SE1 2AF

Bankers
HSBC Bank plc
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Chairman's and Chief Executive's Review

2005 was a transformational year for Phoqus. We have undergone a major transition from being a privately-owned company to a public company quoted on AIM. We have continued to expand our portfolio of collaborations with leading pharmaceutical companies and we have taken our first internal product into a clinical trial in human volunteers. The completion of construction of our commercial scale manufacturing equipment means that we are now well positioned to operate at full commercial scale.

Phoqus uses unique and patented electrostatic coating technology to create a range of novel drug delivery systems for tablets and medical devices. Our highly differentiated technology offers the pharmaceutical industry a wide range of applications enabling product life cycle extensions, brand distinction and greater flexibility in dosing active drugs providing drug release, safety and compliance benefits. We aim to commercialise the products through collaborations with large pharmaceutical companies in return for development, manufacturing and licence fees.

In November 2005, Phoqus was admitted to trading on AIM, raising £10m before expenses. We have used £2m of the proceeds to pay down a trade loan from Cardinal Health. The loan was repaid ahead of the due date resulting in a net saving on interest of approximately £0.1m. We are using the rest of the proceeds to fund our research and development activities, including the initial development of our own improved formulations of selected products, and increase the number of feasibility and development collaborations with pharmaceutical companies.

We have built a portfolio of collaborations for tablet-based drug delivery systems with leading players in the pharmaceutical market – among our clients are three of the top five global pharmaceutical companies. Existing collaborations are making progress on the path to commercialisation and we also continue to be successful in expanding our portfolio of collaborations for tablet coating with new companies. We have signed four new collaborations for feasibility studies since IPO.

Phoqus is also developing the coating technology in other sectors which offer potential for good returns. In December 2005 we announced a collaboration agreement with a world leading healthcare company to evaluate the application of our coating technology to medical devices, as well as a collaboration agreement with Unilever to investigate its use in the consumer detergent sector.

A growing component of our business strategy will be to fund, from our internal resources, the development of improved formulations of certain products which will be taken forward into early stage clinical trials by Phoqus. Our first such product, Chronocort, is a modified release formulation of hydrocortisone to treat adrenal insufficiency, which is being developed in collaboration with Diurnal Limited (a subsidiary of Biofusion plc) and addresses an unsatisfied need in an annual worldwide market worth in excess of £75 million. A first Phase I clinical trial in human volunteers commenced in December 2005 and has now been successfully completed. The trial showed that Chronocort released drug and generated blood levels of hydrocortisone that mimics the natural hormone levels in healthy individuals. Additionally, Chronocort showed a clear in-vitro – in-vivo correlation and no adverse effects were reported. The product has already been granted Orphan Medicinal Product designation in the EU which provides for fast track regulatory approval and a period of 10 years' marketing exclusivity from approval. We are now actively engaged in discussions with potential pharmaceutical partners regarding completion of development and commercialisation. We expect to commence development of a second internal product later in 2006.

The construction and factory acceptance testing of our commercial manufacturing equipment was completed in October 2005. The commercial manufacturing process and equipment have been designed to meet the stringent demands of the pharmaceutical sector for precision and consistency, and at the same time be highly competitive in cost of operation. The manufacturing equipment has now been moved to the Schorndorf (near Stuttgart, Germany) facility of Cardinal Health, our global contract manufacturing partner, and is currently undergoing final installation and validation. The equipment and facility are expected to be ready for commercial operation in the second half of 2006, as scheduled.

Chairman's and Chief Executive's Review

Throughout the year we have recruited experienced new staff in business and product development to ensure we continue to be successful in gaining and delivering new business. We will continue to look for opportunities to develop and strengthen our staff and board to fit the changing needs of the Company.

All this progress would not have been possible without the co-operation of our staff and we thank them for their support and their on-going dedication to Phoqus. Equally important in this period has been the support from our original venture capital and new institutional shareholders.

E Moses
Chairman

A A Jones
Chief Executive Officer

31 March 2006

Financial Review

Results

In the 12 months to 31 December 2005, the Group's turnover was £0.3m (2004: £0.3m) which was derived mainly from fees arising from collaborations with pharmaceutical companies.

The operating loss of £6.0m (2004: £6.8m) included research and development expenses which qualify for additional tax allowances from the Inland Revenue, amounting to £2.5m (2004: £2.6m). Other research and development expenditure amounted to £1.9m (2004: £2.5m).

The £1.2m expenditure associated with the placing has been charged against share premium and is not included in the operating loss.

Interest receivable includes £1.1m, being the reversal of accrued dividends in respect of 'A' preferred ordinary shares classified as financial liabilities in the 2004 accounts. The interest payable in 2004 includes the £1.1m charge accruing dividend payable on the 'A' preferred ordinary shares. The holders of the shares formally waived their dividend rights as part of the share capital restructuring prior to placing on AIM.

Taxation includes a Research and Development tax credit for £0.6m (2004: £0.6m).

The loss per share at 17.3p (2004: 46.7p) was based on the weighted average number of ordinary shares adjusted retrospectively for the restructuring and bonus issues during 2005 in accordance with FRS 22 'Earnings per share'.

Financial position and cashflow

The IPO in November generated £10m before placing expenses through the placing of 7.1m ordinary shares. Prior to that in January 2005, the Company raised £1.5m through a second tranche of venture funding.

During 2005, the Group entered into a sale and leaseback finance agreement for certain plant and machinery assets which raised £1.5m to be paid back over three years.

The Group's net cash outflow before management of liquid resources and financing in the 12 months ended 31 December 2005 was £5.1m (2004: £5.9m), the reduction being due mainly to lower operating costs offset by higher capital expenditure (mainly a laboratory scale version of the commercial manufacturing equipment being commissioned in Stuttgart, Germany).

All surplus cash is kept on deposit in accordance with the Company's policy to maximise returns on low risk cash or cash-equivalent investments that safeguard the principal whilst ensuring that cash resources are available to fund the Group's operations when required.

At 31 December 2005 the Group had cash and short term deposits of £6.5m. This was after repayment of the £2m trade loan from Cardinal Health which was repaid ahead of the due date resulting in a net saving on interest of approximately £0.1m.

International Financial Reporting Standards (IFRS)

The AIM currently intends to mandate international accounting standards for all companies for financial periods commencing on or after 1 January 2007. Therefore Phoqus will prepare interim financial statements under IFRS for the 6 months ending 30 June 2007.

Given that comparative information for the period beginning 1 January 2006 will be required, consideration has begun as to the impact of IFRS so that the procedures are put in place to ensure the necessary data will be available.

Financial Review

The following areas that could have a material impact on the Group's financial statements have been identified (this summary is not intended to be comprehensive and further differences may arise as a result of our ongoing review):

- Capitalisation of Research and Development expenditure compulsory if criteria met;
- Share and share option based payments result in profit and loss account charge; and
- Short-term employee benefits.

Post balance sheet events

Warrants exercised after the year end resulted in the Company receiving a total of approximately £300,000.

P G Johnson
Chief Financial Officer

31 March 2006

Directors

The Directors of the Company are:

E Moses PhD, Non-Executive Chairman (Age 51)

Dr Edwin Moses was appointed to the Group Board in November 2004. Dr Moses has extensive experience as a non-executive director for companies including Evotec OAI AG, BioImage A/S, Inpharmatica Ltd, Ionix Limited, Ablynx nv, Avantium Technologies BV, Paradigm Therapeutics and Clinphone Limited.

A A Jones PhD, Chief Executive Officer (Age 45)

Dr Andy Jones joined the Group as commercial director, responsible for business development in May 2002. He became Chief Executive Officer in May 2003. Dr Jones joined Phoqus from Cap Gemini Ernst and Young where he was a Principal Consultant in the Life Science Practice. Prior to Cap Gemini Ernst and Young, Dr Jones spent over 15 years in senior commercial and international roles at Zeneca and ICI.

P G Johnson PhD, FCA, Chief Financial Officer (Age 52)

Dr Peter Johnson joined the Group in May 2000 as Chief Financial Officer. Dr Johnson has a PhD in physics and is a Fellow of the Institute of Chartered Accountants having qualified with KPMG. He spent much of his early career in Vickers plc where he was appointed European Finance Director of the medical equipment sales and marketing arm of Vickers Medical and later was appointed Regional General Manager, Benelux. More recently he held senior finance roles in several larger organisations before joining Phoqus where he participated in raising almost £30m in venture capital equity and loans.

J P Cashman, Non-Executive Director (age 65)

Jack Cashman was appointed to the Group Board in September 2002. Mr Cashman is currently non-executive chairman of Vectura Group plc and non-executive chairman of Interface Biologics Inc. He is also a non-executive director of Bespak plc (UK), Amtrol-Alfa (Portugal), Transat AT Inc and various other private companies. Mr Cashman led, as chairman and joint-CEO, the leveraged buyout and privatisation of RP Scherer Corporation and its subsequent successful flotation on the New York Stock Exchange.

A C Playle, Non-Executive Director (Age 61)

Tony Playle was appointed to the Group Board in June 2003. Mr Playle has more than thirty-five years of experience in the pharmaceutical industry, including senior positions in Aventis. Mr Playle is a director of Acpharma Ltd, Labopharm Inc, a Toronto listed drug delivery company and a director and managing director of its wholly owned subsidiary Labopharm of Europe, which is based in Dublin.

J C Benjamin, Non-Executive Director (Age 65)

Jerry Benjamin was appointed to the Group Board in September 2002. Mr Benjamin is a general partner of Advent Venture Partners and has been a non-executive director of public companies that include Dura Pharmaceuticals Inc, Oxford Glycosciences plc, Orthofix International NV, Professional Staff plc and Vanguard Medica Limited, as well as many private health care companies.

With a background in chemical engineering and biotechnology, Mr Benjamin spent the first 20 years of his career in Monsanto's healthcare and petrochemical businesses. Over the last 17 years he has successfully developed Advent's involvement in the healthcare and medical sectors, having supervised investments in over 30 private companies, many of which are now successful publicly-quoted businesses.

D F J Leathers FCA Non-Executive Director (Age 63)

Directors

David Leathers was appointed to the Group Board in September 2002. Mr Leathers is a director of Abingworth Management Limited, having joined in 1987 and his directorships have included GeneMedicine, GenPharm International and Pharming.

Mr Leathers is a Fellow of the Institute of Chartered Accountants. He joined the investment division of N M Rothschild & Sons in 1972 and became a director of Rothschild Asset Management in 1978. Mr Leathers has specialised in investing in biotechnology companies in the UK and the US since 1981 when he was involved in setting up and managing Biotechnology Investments Limited, whose early stage venture portfolio included Amgen, Genzyme and Immunex.

Remuneration Committee's Report

The committee consists of Edwin Moses (Chairman), Jack Cashman and Tony Playle. No member of the Committee has any conflict of interests arising from cross-directorships.

Objectives and Remuneration Policy

The main aim of the Committee is to attract, retain and motivate high quality individuals with a competitive package of remuneration comprising basic salary, incentives and rewards which are linked to the overall performance of the Group but also recognise individual performance and responsibility.

The Board believes that the total remuneration package aligns the Executive Directors' interests with those of the shareholders and gives these individuals keen incentives to perform at the highest levels.

Directors' Remuneration

The Director's remuneration consists of either salary or fees. There are no pension entitlements. The Executive Directors along with all employees of the Group are potential beneficiaries of the Phoqus Employee Benefit Trust (see notes 6 and 7).

	2005 *£000*	*2004* *£000*
Emoluments	331	329

The emoluments of the individual directors who served during the year were as follows:

	Salary *£000*	*Fees* *£000*	*Benefits* *£000*	*Total emoluments 2005* *£000*	*Total emoluments 2004* *£000*
T W D Blaney (1)	–	–	–	–	18
J Benjamin	–	–	–	–	–
G J Blaker (2)	–	–	–	–	20
J P Cashman	–	16	–	16	14
P G Johnson	114	–	1	115	110
A A Jones	148	–	–	148	140
D F Leathers	–	–	–	–	–
E Moses (3)	–	26	2	28	4
A C Playle	–	12	1	13	11
H Seager (4)	–	9	2	11	12
	262	63	6	331	329

(1) Resigned 30th June 2004
(2) Resigned 30th November 2004
(3) Appointed 3rd November 2004
(4) Resigned 31st October 2005

During 2005, the Company operated the Existing Share Option Schemes (which comprised the EMI

Remuneration Committee's Report

Scheme, the Unapproved Scheme and the US Plan) but also adopted the New Share Schemes (which comprise the New EMI Scheme and the Non-Employee Scheme). All of the Share Option Schemes are established for the benefit of employees of the Group, save in the case of the Non-Employee Scheme under which those providing services to the Group may receive options. Each of the Share Option Schemes is administered and supervised by the Remuneration Committee who determines the allocation, vesting period and any performance conditions.

The Company has established the Employee Benefit Trust (EBT) and the Employee Share Ownership Trust (ESOT) for the benefit of a class of individuals linked by their or other's employment with the Group. The Trusts do not currently hold any Ordinary Shares but do hold cash. The operation of these Trusts was supervised by the Remuneration Committee.

This report should be read in conjunction with notes 6 and 7 to the financial statements together with the disclosures made in the Director's Report on pages 12 to 15 inclusive.

By order of the Remuneration Committee

E Moses
Chairman

31 March 2006

Corporate Governance

The Directors recognise the value of the Principles of Good Governance and Code of Best Practice (the 'Combined Code') and, although as an AIM listed company it is not required to comply with the Combined Code, Phoqus is taking appropriate measures to ensure that the Group adopts those principles of the Combined Code that it considers appropriate for a Group of its size.

This statement describes the principles identified in the Combined Code which are being applied.

Board Composition

In addition to the Non-Executive Chairman, Edwin Moses, the Directors consider that two independent Non-executive Directors, namely Jack Cashman and Tony Playle, are, at present, sufficient and appropriate and regard Jack Cashman as the senior independent Non-executive Director. The Board meets at least six times per annum and additionally where necessary. The Board has responsibility for the overseeing of all day to day matters of the Group but it has particular responsibility for reviewing trading performance, resources (including key appointments), standards of conduct, ensuring adequate funding, setting and monitoring strategy and reporting to shareholders. The Non-executive Directors have a particular responsibility to ensure that the strategies proposed by the Executive Directors are fully considered and they wish to bring their independent judgement to bear in this role. To enable the Board to discharge its duties, all Directors receive appropriate information from the management of the Group. However, all Directors are free to make further enquiries where they feel it necessary and to take independent advice as required.

Nomination committee

The Nomination Committee has responsibility for considering the size, structure and composition of the Board, retirements and appointments of additional and replacement directors, and making appropriate recommendations to the Board. The Nomination Committee is chaired by Edwin Moses and also includes Jack Cashman and Tony Playle.

Audit committee

The Audit Committee is chaired by Tony Playle and also includes Edwin Moses and Jack Cashman, all of whom are Non-executive Directors. The Audit Committee meets at least twice a year and has a primary responsibility for monitoring the quality of internal control and ensuring that the financial performance of the Group is properly measured and reported on, and for reviewing reports from the Group's auditors relating to the Group's accounting and internal controls. The Committee has unlimited access to the Group's auditors.

Remuneration committee

The Remuneration Committee is chaired by Edwin Moses and also includes Jack Cashman and Tony Playle and meets formally not less than twice a year. The Remuneration Committee, in accordance with written terms of reference, determines on behalf of the Board the terms and conditions of service of the Executive Directors, including the remuneration and grant of options to Directors. The Committee also considers proposals made by Executive Directors in respect of the remuneration and benefits of certain senior managers in the Group. In formulating its remuneration policy, the Committee gives full consideration to matters set out in Schedule A to the combined code.

Corporate Governance

The Non-executive Directors do not have service contracts but do have letters of appointment with the Company. The Board as a whole determines the level of fees of Non-Executive directors, after taking into account fees payable by comparable companies and independent advice.

Internal Financial Control

The Directors are responsible for the Group's system of internal financial control. Although no system of internal financial control can provide absolute assurance against material misstatement or loss, the Group's system is designed to provide the Directors with reasonable assurance that problems are identified on a timely basis and dealt with appropriately. Key procedures that have been established and are designed to provide effective internal financial control are described below:

Financial Reporting

The budget is approved each year by the Board in the light of the Group's strategic plan. Key risk areas are identified. Performance is monitored and relevant action taken throughout the year through the regular reporting to the Board of any variances from the budget and updated forecasts for the year together with information on the key risk areas.

Control of Operations

Control of operations is primarily effected by day to day supervision. The integrity and competence of personnel is entrusted through high recruitment standards and appropriate training and professional development. High quality personnel are seen as an essential part of the budgetary process and authorisation levels. For expenditure beyond specified levels, detailed written proposals have to be submitted to the Board.

Going Concern

After making enquiries, the Directors have a reasonable expectation that the Group has adequate resources to continue in operational existence for the foreseeable future. For this reason they continue to adopt the going concern basis in preparing the accounts. This is described in more detail in note 1.

Relations with Shareholders

Communication with shareholders is given a high priority. The Chairman's and Chief Executive's Review and Financial Review on pages 2 to 5 include a detailed review of the business and future prospects. The Company plans to have regular dialogue with institutional shareholders including presentations after the Group's preliminary announcement of the year-end and half-year results. Copies of the Annual Reports and Interim Reports will be available on the Company's website www.phoqus.com. Approved by the Board of Directors and signed on behalf of the Board.

P G Johnson
Secretary

31 March 2006

Directors' report

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

Results and dividends

The loss for the year amounted to £4,505,000 (2004 - £7,562,000). The Directors do not recommend the payment of a dividend for the year.

Principal activities and review of the business

The principal activity of the Group 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); LeQtradose (active dose loading) and UniQ (unique tablet imaging).

The management team of the operating company 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 Group 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' (GMP) 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 2006.

In October 2005, Phoqus Group Limited (the Company) changed its name and re-registered as Phoqus Group plc. There was a reorganisation of the share capital and the new shares were floated on AIM in November. The Company raised £10m before placing expenses at its IPO which was achieved against the background of a difficult market.

Future developments

The Directors believe that there are sufficient funds to execute the business plan presented to investors during the preparation for the AIM placing. Further details are provided in the Chairman's and Chief Executive's Review.

Research and development

The Group 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.

Charitable and political donations

The Group encourages employee involvement in charitable causes. However the Group makes no donations of any kind.

Creditor payments

It is the Group's policy to agree credit terms with all of its suppliers and pay when due provided that the goods or services supplied are satisfactory. The trade creditors' balance at 31 December 2005 represented 33 days of purchases during the year for the Group (2004 – 33), and nil for the Company (2004 – nil).

Directors' report

Risk management of the financial instruments

In relation to the use of financial instruments by the company and by its subsidiary undertakings, the Group's principal financial instruments comprise bank loans, finance leases and hire purchase contracts and cash and these are used to finance the Group's operations. The Group has various other financial instruments, such as trade debtors and trade creditors that arise directly from its operations and are excluded from the disclosures in note 13. The Group's objective in using financial instruments is to maximise the returns on funds held on deposit, to minimise exchange risk where appropriate and to secure and use finance leases and hire purchase contracts where these can be obtained on attractive terms.

The main risk arising from the Group's financial instruments is interest rate risk. The board reviews and agrees policies for managing this risk and it is summarised in note 13. The Group also monitors the foreign currency risk and the market price risk arising from all financial instruments, the magnitude of this risk that has arisen over the respective years/period is also outlined in note 13.

Substantial shareholding

At 22 March 2006, the nearest practical date to the date of this Report, the Group had a total of 87 ordinary shareholders and 32,697,656 shares in issue.

The Directors have been notified of the following substantial holdings in the Company's share capital as at the close of business on 22 March 2006.

	No. of shares '000	%
Advent III	9,742	29.8
BNY (OCS) Nominees Limited	5,150	15.8
Abingworth Bioventures III	4,980	15.2
HSBC Global Custody Nominee (UK) Limited	2,482	7.6
Advent II	2,442	7.5
Vidacos Nominees Limited	2,328	7.1
BBHISL Nominees Limited	2,123	6.5
State Street Nominees Limited	1,098	3.7

Employment policy

The Group aims to provide remuneration packages that attract, retain and motivate staff.

The Group encourages the flow of information by holding whole staff meetings where the Management Team provides Company updates but also in smaller meetings which are designed to promote opportunities for staff feedback.

Applications for employment from disabled persons are fully considered and if staff becomes disabled alternative suitable work would be sought within the Group.

Post balance sheet events

A warrant holder exercised 100,000 shares at £0.54 on 20 January 2006 and 454,635 shares at £0.54 on 13 February 2006. The Company received a total of £300,000.

There were no other reportable post balance sheet events.

Directors' report

Directors and their interests

The Directors at 31 December 2005 and their interests in the share capital of the Company at 31 December 2005 and at 1 January 2005, according to the register of Directors' interests are as follows:

	Class	*At 31 December 2005*	*At 1 January 2005*
J P Cashman	'D' ordinary	–	50,000
J P Cashman	Preferred	–	91,518
J P Cashman	A Preferred	–	105,118
J P Cashman	Ordinary	161,449	–
P G Johnson *	'D' ordinary	–	445,934
P G Johnson *	'F' ordinary	–	11,937
P G Johnson *	Ordinary	478	–
A A Jones *	'D' ordinary	–	487,489
A A Jones *	'F' ordinary	–	14,992
A A Jones *	Ordinary	523	–
E Moses	Ordinary	271	–
A C Playle	Ordinary	104	–

** Held by a trust in which the Director has an interest*

In addition, the following Directors had interests in options over ordinary shares in the Company:-

	Class	*At 1 January 2005*	*Granted*	*Exercised*	*Surrendered*	*At 31 December 2005*
A A Jones	'D' ordinary	328,747	–	–	(328,747)	–
A A Jones	'F' ordinary	2,985	–	–	(2,985)	–
A A Jones*	Ordinary	–	291,070	–	–	291,070
P G Johnson	'D' ordinary	222,562	–	–	(222,562)	–
P G Johnson	'F' ordinary	2,388	–	–	(2,388)	–
P G Johnson*	Ordinary	–	234,449	–	–	234,449
J P Cashman	'D' ordinary	106,020	–	–	(106,020)	–
J P Cashman	'F' ordinary	2,686	–	–	(2,686)	–
J P Cashman	Ordinary	–	90,299	(114)	–	90,185
E Moses	'D' ordinary	–	250,000	–	(250,000)	–
E Moses	'F' ordinary	–	10,000	–	(10,000)	–
E Moses	Ordinary	–	212,265	(271)	–	211,994
A C Playle	'D' ordinary	96,320	–	–	(96,320)	–
A C Playle	'F' ordinary	2,686	–	–	(2,686)	–
A C Playle	Ordinary	–	94,518	(104)	–	94,414

** Includes options held by a trust in which the Director has an interest*

The options surrendered above were replaced by options granted over the new shares in the Company with the same exercise price (see note 17).

In addition to the Directors listed above, the following Director served during the year:
H Seager resigned on 31 October 2005 and retains an interest in 61,580 ordinary shares.

Directors' report

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

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 Group and of the profit or loss of the Group for that period. 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 Group 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 Group and which enable them to ensure that the financial statements comply with the Company Act 1985. They are also responsible for safeguarding the assets of the Group and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

ERNST & YOUNG

Independent auditors' report

to the members of Phoqus Group plc

(formerly Phoqus Group Limited)

We have audited the Group's financial statements for the year ended 31 December 2005 which comprise the Consolidated Profit and Loss Account, the Consolidated Statement of Total Recognised Gains and Losses, the Consolidated Balance Sheet, the Company Balance Sheet, the Consolidated Statement of Cashflows and the related notes 1 to 29. 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 other information in the Annual Report and consider whether it is consistent with the audited financial statements. This other information comprises only the Directors' Report, the Chairman's and Chief Executive's Review, the Financial Review and the Remuneration Committee's 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. 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 Group plc (continued)
(formerly Phoqus Group Limited)

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 and Group's affairs as at 31 December 2005 and of the loss of the Group 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 Group'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 on this respect.

Ernst & Young LLP.

Ernst & Young LLP
Registered Auditor
London

31 March 2006

Consolidated profit and loss account

for the year ended 31 December 2005

		Notes	2005 £000	2004 £000 (restated)
Turnover		3	274	300
Administrative expenses			(6,293)	(7,141)
Operating loss		4	(6,019)	(6,841)
Interest receivable and similar income		9	1,227	61
Interest payable and similar charges		10	(308)	(1,398)
Loss on ordinary activities before taxation			(5,100)	(8,178)
Tax credit on loss on ordinary activities		11	595	616
Retained loss for the year			(4,505)	(7,562)
Loss per share	– basic	12	17.3p	46.7p
	– diluted	12	17.3p	46.7p

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Consolidated statement of total recognised gains and losses

for the year ended 31 December 2005

	Note	2005 £000	2004 £000 (restated)
Loss for the financial year attributable to members of the parent company	18	(4,505)	(7,562)
Exchange difference on retranslation of net assets of subsidiary undertakings	18	6	(2)
Total losses relating to the year	20	(4,499)	(7,564)

Dividends accrued in 2004 have been reclassified within interest payable and similar charges as a result of the adoption of the presentation requirements of FRS 25 (note 2).

Consolidated balance sheet

at 31 December 2005

	Notes	2005 £000	2004 £000 (restated)
Assets			
Fixed assets			
Tangible assets	14	2,322	2,395
Current assets			
Debtors	16	1,370	1,109
Cash at bank and in hand		6,530	977
		7,900	2,086
		10,222	4,481
Liabilities			
Capital and reserves			
Called up share capital	17	3,260	3
Share premium account	18	19,048	–
Merger reserve	18	18,295	18,295
Other reserve:			
- warrants	18	206	131
Profit and loss account	18	(33,159)	(28,892)
Shareholders' funds/(deficit)	20	7,650	(10,463)
Creditors			
Amounts falling due within one year	21	1,727	13,920
Amounts falling due in more than one year	22	845	1,024
		2,572	14,944
		10,222	4,481

Approved by the Board on 31 March 2006

A A Jones
Chief Executive Officer

P G Johnson
Chief Financial Officer

Company balance sheet

at 31 December 2005

	Notes	2005 £000	2004 £000 (restated)
Assets			
Fixed assets			
Investments	15	24,331	134
Current assets			
Debtors	16	68	13,309
Cash at bank and in hand		1	1
		69	13,310
		24,400	13,444
Liabilities			
Capital and reserves			
Called up share capital	17	3,260	3
Share premium account	18	19,048	–
Other reserve:			
- warrants	18	206	131
Profit and loss account	18	1,403	(826)
Shareholders' funds/(deficit)		23,917	(692)
Creditors			
Amounts falling due within one year	21	483	13,136
Amounts falling due in more than one year	22	–	1,000
		483	14,136
		24,400	13,444

Approved by the Board on 31 March 2006

A A Jones
Chief Executive Officer

P G Johnson
Chief Financial Officer

Consolidated statement of cash flows

for the year ended 31 December 2005

	Notes	2005 £000	2004 £000
Net cash outflow from operating activities	19a	(5,163)	(6,226)
Returns on investment and servicing of finance			
Interest received		103	61
Interest paid		(144)	(233)
Interest element of finance lease rental payments		(164)	(41)
		(205)	(213)
Taxation			
Corporation tax credit received		616	575
Overseas tax paid		(6)	(2)
		610	573
Capital expenditure and financial investment			
Payments to acquire tangible fixed assets		(329)	(46)
		(329)	(46)
Net cash outflow before management of liquid resources and financing		(5,087)	(5,912)
Management of liquid resources			
(Increase)/decrease in short-term deposits		(5,691)	416
Financing			
Issue of ordinary share capital		11,500	5,030
Share issue costs		(1,200)	–
New long-term loans		1,000	1,000
Repayment of long-term loans		(2,000)	(201)
Inception of finance leases		1,576	–
Repayment of capital element of finance leases and hire purchase contracts		(241)	(172)
		10,635	5,657
(Decrease)/increase in cash		(143)	161

Consolidated statement of cash flows

for the year ended 31 December 2005

Reconciliation of net cash flow to movement in net funds/(debt)

	Notes	2005 £000	2004 £000
(Decrease)/increase in cash		(143)	161
Cash inflow from increase in loans		(1,000)	(1,000)
Repayment of long-term loans		2,000	201
Cash inflow from inception of finance leases		(1,576)	–
Repayment of capital element of finance leases and hire purchase contracts		241	172
Cash inflow/(outflow) from short-term deposits		5,691	(416)
Change in net funds/(debt) resulting from cash flows		5,213	(882)
Other non-cash movements		80	–
Movement in net funds/(debt)	19b	5,293	(882)
Net (debt)/funds at 1 January	19b	(83)	799
Net funds/(debt) at 31 December	19b	5,210	(83)

Notes to the financial statements

at 31 December 2005

1. Fundamental accounting concept

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

The Group'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 Group's investment in costs to achieve this strategy. In order to finance the commercialisation phase of the strategy, the Group raised £8.8m of funds (net of costs) through a Placing on the Company's admission to AIM as described in note 17. 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 Group on a medium-term basis and hence the validity of the basis of preparation of these financial statements.

The Directors are of the opinion, and have prepared cash flow forecasts that indicate, that the commercial application of the technology will generate sufficient future revenues and free cash flows in the medium-term. Until such time, the proceeds of the Placing will be sufficient, in the opinion of the Directors, to enable the Group to meet its liabilities as they fall due for the foreseeable future. If the technology being developed by the Group is not developed through to successful commercial launch, thereby generating ongoing funding, the going concern basis of preparation might not be appropriate. The financial statements do not include any adjustments that would result from a failure to develop a commercial product and generate future revenues. The Directors are of the opinion that it is not practical to quantify the adjustments that might be required, but should any adjustments be required they may be significant.

2. Accounting policies

Basis of preparation

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

In preparing the financial statements for the current year, the Group has adopted FRS 22 (IAS 33) 'Earnings per Share'. The Group has also adopted the presentation requirements of FRS 25 (IAS 32) 'Financial Instruments: Disclosure and Presentation' and has applied this retrospectively, as required by the standard, to the financial statements of the previous years. The adoption of these standards has resulted in a change in accounting policy for financial instruments.

The effect of the adoption of this standard is to reclassify the capital and premium elements of 'A' preferred ordinary shares as financial liabilities rather than equity shares and share premium. These shares are, however, only deemed to have been classified as financial liabilities following the change in their terms in 2004 as detailed in note 17. The corresponding cumulative preferred dividends on these shares have also been classified within interest and similar charges as prescribed by the standard from the date the terms of the shares changed. The provision for accumulated preferred dividends has been included within other creditors rather than other reserves as a consequence of the adoption of this standard.

The effect of these changes is to increase the loss on ordinary activities before taxation in 2004 by £1,124,000 but this adjustment has no effect on retained earnings for 2004. No other profit and loss accounts in any other period have been changed as a consequence of the adoption of this standard.

The effect of these changes on the balance sheet was to reduce share capital by £2,000 and share premium by £12,004,000 in 2004; creditors falling due within one year were increased by an equal amount. The share premium and capital amounts of these shares were included within financial instruments in 2004 as a result of this reclassification. No other balance sheet reclassifications were necessary.

Notes to the financial statements

at 31 December 2005

2. Accounting policies (continued)

Financial instruments

Shares are included in shareholder's funds. Other instruments are classified as liabilities if they contain an obligation to transfer economic benefits. The finance cost recognised in the profit and loss account in respect of capital instruments other than equity shares is allocated to periods over the term of the instrument at a constant rate on the carrying amount.

Basis of consolidation

The consolidated financial statements includes the financial information of the Company and its subsidiary undertakings, Phoqus Pharmaceuticals Limited, a company incorporated in the United Kingdom and Phoqus Pharmaceuticals Inc, a company incorporated in the USA.

The merger method of accounting has been adopted in accordance with FRS 6 'Acquisitions and Mergers' as the reorganisation that took place in 2002 met the definition of a Group reconstruction as laid down by the standard. Under this method, the results, assets and cashflows of subsidiary undertakings acquired during 2002 were combined from the beginning of the financial year. No subsequent acquisitions or mergers have taken place.

No profit and loss account is presented for Phoqus Group plc as permitted by section 230 of the Companies Act 1985

Turnover

Turnover arises from the provision of services to client companies in respect of the application of the Group's technology to the client's active materials, stated net of 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 in proportion to the work completed in the period. Revenue is only recognised when the Group has an unconditional right to the consideration and all performance obligations have been met.

Research and development

Research and development expenditure is written off in the period in which it is incurred. Research and development tax credits are accrued during the period in which they are generated.

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.

Notes to the financial statements

at 31 December 2005

2. Accounting policies (continued)

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 exceptions:

- provision is made for deferred tax that would arise on the remittance of the retained earnings of subsidiaries, associates and joint ventures only to the extent that, at the balance sheet date, dividends have been accrued as receivable;
- 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

The financial information of overseas subsidiary undertakings is translated at the rate of exchange ruling at the balance sheet date. The exchange difference arising on the retranslation of opening net assets is taken directly to reserves. All other translation differences are taken to the profit and loss account.

Finance lease agreements

Where the Group 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 at a constant rate applied to a reducing balance, 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.

Sale and leaseback arrangements

Sale and leaseback arrangements using finance leases have, in accordance with SSAP 21 'Accounting for leases and hire purchase contracts' and FRS 5 'Reporting the substance of transactions' been accounted for such that the assets remain in the Group's balance sheet at their previous book value and the sales proceeds are shown as a creditor, representing the Group's finance lease liability under the leaseback. The finance lease payments are treated as outlined in the finance lease agreements accounting policy above.

All of the Group's sale and leaseback transactions throughout the period were in the form of finance leases.

Pension costs

Phoqus Pharmaceuticals Limited, a 100% owned subsidiary undertaking, is a member of a group personal defined contribution pension scheme. Employees contribute at various rates, which are partially matched by Phoqus Pharmaceuticals Limited and charged to the profit and loss account as they become payable in accordance with the rules of the scheme.

Notes to the financial statements

at 31 December 2005

2. Accounting policies (continued)

Finance and warrants

Finance secured with the issue of warrants is accounted for in accordance with FRS 25. The finance proceeds are allocated 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 allocated to accounting periods so that the total finance cost on the debt will have a constant relationship to the outstanding obligation.

Employee Benefit Trust

In accordance with UITF 38, assets and liabilities held by the EBT are consolidated within the assets of the Group. Contribution payments made to the Trust are treated as a Group cash asset until the Trust makes an unconditional agreement to transfer funds for the benefit of specific individuals or incurs administration expenses charged by the Trustees. At this point a charge is made to the profit and loss account.

The Company's access to the assets held by the EBT is subject to the agreement of the Trustees of the Trust.

Provisions for liabilities and charges

Provisions for onerous contracts are recognised immediately once a contract is identified as having no future economic benefit to the Group. The remaining contractual obligations are expensed to the profit and loss account in the period in which the lack of future economic benefit is identified.

Liquid resources

Liquid resources are current asset investments which are readily convertible into cash or traded in an active market and may be disposed of without disrupting the running of the business.

3. Turnover and segmental analysis

An analysis of turnover by geographical destination is given below:

	2005	*2004*
	£000	*£000*
United Kingdom	91	260
USA	166	–
Europe	17	–
Japan	–	40
	274	300

The Directors have assessed that substantially all of the Group's operations and therefore their losses and net assets for all years by geographical destination relate to continuing activities in the United Kingdom.

The Directors also believe that the Group's turnover (by origin), losses and net assets are substantially all related to continuing activities performed in the UK.

The Directors have assessed that substantially all of the Group's operations relate to the principal activity of the development and commercialisation of the electrostatic deposition technology for the manufacture of tablets with tailored appearance and medical properties for the pharmaceutical industry. The Directors therefore believe that all turnover, losses and net assets relate to continuing activities performed in the Group's principal activity as stated above.

Notes to the financial statements

at 31 December 2005

4. Operating loss

Operating loss is stated after charging:

	2005 £000	2004 £000
Auditors' remuneration - audit services	43	12
- non-audit services *	8	15
Research and development	2,501	2,572
Depreciation of owned fixed assets	194	356
Depreciation of assets held under finance lease	175	72
Loss on disposal of fixed assets	34	130
Grant of options	232	–
Operating lease rentals- land and buildings	404	309
- plant and machinery	1	1
Net loss on foreign currency translation	5	4

* In addition to the auditor's remuneration above, £229k non-audit services in 2005 relating to IPO costs has been charged to share premium.

5. Staff costs

	2005 £000	2004 £000
Wages and salaries	1,588	1,754
Social security costs	175	188
Other pension costs	80	88
	1,843	2,030

The average monthly number of employees (including Executive Directors) during the year was:

	2005 No.	2004 No.
Pharmaceutical and technical	21	27
Business development and administration	9	11
	30	38

6. Directors' remuneration

	2005 £000	2004 £000
Emoluments	331	329

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

	2005 £000	2004 £000
Emoluments	148	140

Notes to the financial statements

at 31 December 2005

6. Directors' remuneration (continued)

There were no pension contributions made by the Group in respect of the Directors. In addition to the above amounts, the Group operates an Employee Benefit Trust which awards funds for the benefit of the staff and Executive Directors as detailed in note 7.

7. Employee Benefit Trust

The Group made contributions of £245,000 (2004 - £270,000) to the Employee Benefit Trust (EBT) for the benefit of employees. The Trustees of the EBT appointed £177,880 (2004 - £113,830) to family trusts of which two Directors are potential beneficiaries. In respect of the highest paid Director, £90,330 (2004 - £64,130) was appointed to a family trust of which he is a potential beneficiary.

The Trustees of the EBT also appointed a further £89,300 (2004 - £133,530) for the benefit of other employees. The cash balance in the EBT at the end of the year was net of contributions made by the Group, interest received, appointments made and administration fees charged by the Trustees. The appointed amounts will be chargeable to taxation at the time of distribution.

At 31 December 2005 the EBT had cash of £6,000 (31 December 2004 - £43,000) which was included within the Group's cash at bank and in hand. This balance is subject to the control of the Trustees and, as such, the Group's access to it is restricted.

8. Pensions

The Group contributes to a group personal defined contribution pension scheme operated by Scottish Widows. The employees contribute at various rates which are partially matched by the Group. The cost to the Group for the period was £80,000 (2004 - £88,000) and has been charged to the profit and loss account. Included in accruals and deferred income is £nil (31 December 2004 - £9,000) relating to pension contributions unpaid at the balance sheet date.

9. Interest receivable and similar income

	2005	*2004*
	£000	*£000*
Interest on bank deposits	103	61
Waiver of dividend accrued on preference shares	1,124	–
	1,227	61

10. Interest payable and similar charges

	2005	*2004*
	£000	*£000*
		(restated)
Interest on other loans	144	233
Interest on finance leases	164	41
Dividend accrued on preferred shares:		
- relating to prior year	–	389
- relating to current year	–	735
	308	1,398

Dividends accrued on preferred shares relates to 'A' preferred ordinary shares were waived on conversion of the shares to ordinary shares (notes 9 and 17).

Notes to the financial statements

at 31 December 2005

11. Taxation

(a) Tax on loss on ordinary activities

The tax credit is made up as follows:

	2005	*2004*
	£000	*£000*
UK corporation tax	601	618
Foreign tax	(6)	(2)
	595	616

(b) Factors affecting current tax credit

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

	2005	*2004*
	£000	*£000*
Loss on ordinary activities before tax	(5,100)	(8,178)
Loss on ordinary activities multiplied by the standard rate of corporation tax in the UK of 30%	(1,530)	(2,453)
Preferred dividends not deductible for tax purposes	(337)	337
Other	(3)	–
Decelerated capital allowances	415	141
Other timing differences	70	–
Group relief (difference between UK and overseas tax rates)	–	(1)
Foreign tax	1	–
Losses surrendered to research and development tax credit	149	155
Losses arising in the period not relievable against current tax	640	1,205
	(595)	(616)

(c) Factors that may affect future tax credits

The Group has estimated tax losses arising in the UK of £23,433,000 (2004 - £21,300,000) that are available indefinitely for offset against future taxable profits of those companies in which the losses arose. Deferred tax assets have not been recognised in respect of these losses as the Company in which they were generated, Phoqus Pharmaceuticals Limited – a wholly owned subsidiary, is a start-up company and therefore these losses do not satisfy the recognition criteria for deferred tax assets in FRS 19. These losses may not be used elsewhere in the Group.

Based on current capital investment and research and development plans, the Group expects to continue to be able to claim capital allowances in excess of depreciation and research and development tax credits in future years; however, as capital investment and research and development expenditure is reviewed in future years, the rate at which these credits are claimed may reduce.

Notes to the financial statements

at 31 December 2005

11. Taxation (continued)

(d) Deferred tax

The unrecognised deferred tax assets are as follows:

	2005	*2004*
	£000	*£000*
Tax losses available	7,030	6,390
Capital allowances in advance of depreciation	(143)	(661)
Other timing differences	70	3
	6,957	5,732

12. Loss per share

The calculation of basic earnings per ordinary share is based on losses of £4,505,000 (2004 - £7,562,000) and on 26,049,034 (2004 – 16,177,132) ordinary shares, being the weighted number of shares adjusted retrospectively for restructuring and bonus issues during 2005. In accordance with FRS 22 (IAS 33) 'Earnings per share' the Group has applied retrospective adjustments to the loss per share calculation as a result of the share capital reorganisation as detailed in note 17.

The Share Options and Warrants are not dilutive since if they were exercised they would reduce the loss per share as the Group is loss making.

13. Financial instruments

The Group's principal financial instruments comprise bank loans, finance leases and hire purchase contracts and cash and these are used to finance the Group's operations. The Group has various other financial instruments, such as trade debtors and trade creditors that arise directly from its operations and are excluded from the disclosures below.

The main risk arising from the Group's financial instruments is interest rate risk. The board reviews and agrees policies for managing this risk and it is summarised below. The Group also monitors the foreign currency risk and the market price risk arising from all financial instruments, the magnitude of this risk that has arisen over the respective years/period is also outlined below.

Interest rate risk

The Group borrows at fixed rates of interest from a number of sources to ensure the desired interest profile and to mitigate the Group's risk to interest fluctuations.

All of the financial liabilities of the Group are fixed rate financial liabilities, the amounts outstanding at the respective year ends are as follows:

	2005	*2004*
	£000	*£000*
Sterling loans	2	1,002
Sterling finance leases	1,318	58
Sterling 'A' preferred ordinary shares	–	12,005
Total	1,320	13,065

Notes to the financial statements

at 31 December 2005

13. Financial instruments (continued)

Fixed rate financial liabilities

	Weighted average interest rate %	*Weighted average period for which rate is fixed months*
2004	11.0	28
2005	23.8	30

The interest rate profile of the financial assets of the Group as at the respective year ends is as follows (all amounts are denominated in sterling):

	2005 £000	*2004 £000*
Floating rate financial assets	6,530	977
Financial assets on which no interest is earned	174	130
Total	6,704	1,107

Financial assets bearing interest comprise cash deposits on money market at call, 7 day and monthly rates all in sterling. These assets bear interest at rates which fluctuate with LIBOR.

The financial assets on which no interest is earned represent rental deposits.

Currency exposures

All of the Group's monetary assets and liabilities are denominated in sterling at 31 December 2004 and 2005 therefore minimising the Group's currency exposures; in other words those transactional (or non-structural) exposures that give rise to the net currency gains and losses recognised in the profit and loss account.

Maturity of financial liabilities

The maturity of the Group's financial liabilities* as at the following dates is as follows:

	2005 £000	*2004 £000*
In one year or less, or on demand	475	12,041
In more than one year but not more than two	845	1,024
	1,320	13,065

* Included within financial liabilities in 2004 are 'A' preferred ordinary shares which were convertible on demand as detailed in note 17.

Notes to the financial statements

at 31 December 2005

13. Financial instruments (continued)

Borrowing facilities

The Group had various borrowing facilities available to it. The undrawn committed facilities available at the respective year/period ends of which all precedent conditions had been met at that date are as follows:

	2005	*2004*
	£000	*£000*
In more than one year but not more than two	–	1,000

The additional £1,000,000 loan was drawn down in 2005 and repaid early. All facilities have now been terminated.

Preference shares

At 31 December 2004, the Company had in issue both preferred ordinary and 'A' preferred ordinary shares. 'A' preferred ordinary shares were included within financial liabilities in 2004 in accordance with FRS 25. Preferred ordinary shares were not deemed to be financial liabilities in accordance with FRS 25 and were therefore classified as equity.

At 31 December 2005 there were no 'A' preferred ordinary shares in existence following the share conversion in preparation for the placing on AIM, (note 17).

Fair values of financial assets and financial liabilities

The Directors have performed a comparison of book values and fair values of the Group's financial assets and liabilities which is shown below. The fair value is defined as the amount at which a financial instrument could be exchanged in an arm's length transaction between informed and willing parties, other than a forced or liquidation sale. Market values have been used to determine the fair value of all financial assets and liabilities with the exception of 'A' preferred shares which were valued by discounting expected future cash flows at prevailing interest rates.

		2005		*2004*
	Fair value	*Book value*	*Fair value*	*Book value*
	£000	*£000*	*£000*	*£000*
Cash	6,530	6,530	977	977
Rental deposits	174	174	130	130
Loans	2	2	1,002	1,002
Finance lease	1,318	1,318	58	58
'A' Preferred shares	–	–	12,005	12,005

Notes to the financial statements

at 31 December 2005

14. Tangible fixed assets

	Leasehold improvements £000	Assets in the course of construction £000	Plant and machinery £000	Office furniture and fittings £000	Total £000
Cost:					
At 1 January 2005	902	–	2,312	490	3,704
Additions	–	22	292	15	329
Disposals	–	–	(44)	–	(44)
Exchange differences	–	–	–	1	1
At 31 December 2005	902	22	2,560	506	3,990
Accumulated depreciation:					
At 1 January 2005	154	–	826	329	1,309
Charge for the year	63	–	246	60	369
Disposals	–	–	(10)	–	(10)
At 31 December 2005	217	–	1,062	389	1,668
Net book value:					
At 31 December 2005	685	22	1,498	117	2,322
At 1 January 2005	748	–	1,486	161	2,395

Included in the total net book value of assets above are the following amounts relating to assets held under finance leases.

	Leasehold improvements £000	Plant and machinery £000	Office furniture and fittings £000	Total £000
2005	685	1,069	90	1,844
2004	–	177	–	177

During 2005, the Group entered into a finance sale and leaseback agreement to sell and leaseback assets with a book value of £1,996,000. These are accounted for in accordance with the accounting policies described in note 2.

Notes to the financial statements

at 31 December 2005

15. Investments

Company	*Subsidiary undertakings*
	£000
Cost at 1 January 2004	134
Additions	24,197
	24,331

Investments include long term loans of £24,122,000 (2004 - £nil) which represent the company's long term investment in the trading subsidiary.

Subsidiary undertakings

The Company's subsidiary undertakings, both of which are wholly owned and engaged in the development and marketing of Phoqus technology, are as follows:

	Country of incorporation if not Great Britain	*Class of shares held in company*
Phoqus Pharmaceuticals Limited		100% of issued ordinary share capital
Phoqus Pharmaceuticals Inc.	USA	100% of issued common stock

16. Debtors

		Group		*Company*
	2005	*2004*	*2005*	*2004*
	£000	*£000*	*£000*	*£000*
				(restated)
Trade debtors	157	20	–	–
Amounts owed by Group undertakings	–	–	–	13,306
Other debtors and deposits	407	212	68	3
Prepayments and accrued income	205	261	–	–
Research and development tax credit	601	616	–	–
	1,370	1,109	68	13,309

Included within other debtors and deposits is £174,000 (31 December 2004 - £130,000) relating to deposits that are repayable in more than one year.

The amount owed by Group undertakings of £24,122,000 which represents the company's long term investment in the trading subsidiary has been shown in investments (note 15).

Notes to the financial statements

at 31 December 2005

17. Share capital

Authorised share capital:

	2005	*2004*
	£000	*£000*
Amounts classified as equity		
'A' ordinary shares of £0.0001 each	–	4,075
'B' ordinary shares of £0.0001 each	–	710
'C' ordinary shares of £0.0001 each	–	150
'D' ordinary shares of £0.0001 each	–	496
'E' ordinary shares of £0.0001 each	–	100
'F' ordinary shares of £0.0001 each	–	10
Preferred ordinary shares of £0.0001 each	–	1,750
Ordinary shares of £0.1 each	8,055	–
Deferred shares of £1,046 each	46	–
Amounts classified as financial liabilities		
'A' preferred ordinary shares of £0.0001 each	–	1,910
	8,101	9,201

	2005	*2004*
	No.	*No.*
Amounts classified as equity		
'A' ordinary shares of £0.0001 each	–	40,750,000
'B' ordinary shares of £0.0001 each	–	7,100,000
'C' ordinary shares of £0.0001 each	–	1,500,000
'D' ordinary shares of £0.0001 each	–	4,960,000
'E' ordinary shares of £0.0001 each	–	1,000,000
'F' ordinary shares of £0.0001 each	–	100,000
Preferred ordinary shares of £0.0001 each	–	17,500,000
Ordinary shares of £0.1 each	80,552,250	–
Deferred shares of £1,046 each	44	–
Amounts classified as financial liabilities		
'A' preferred ordinary shares of £0.0001 each	–	19,100,000
	80,552,294	92,010,000

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Notes to the financial statements

at 31 December 2005

17. Share capital (continued)

Allotted, called up and fully paid share capital:

	2005 £	*2004* £
Amounts classified as equity		
'A' ordinary shares of £0.0001 each	–	625
'B' ordinary shares of £0.0001 each	–	160
'C' ordinary shares of £0.0001 each	–	150
'D' ordinary shares of £0.0001 each	–	250
'F' ordinary shares of £0.0001 each	–	5
Preferred ordinary shares of £0.0001 each	–	1,610
Ordinary shares of £0.1 each	3,214,310	–
Deferred shares of £1,046 each	46,024	–
Amounts classified as financial liabilities		
'A' preferred ordinary shares of £0.0001 each	–	1,601
	3,260,334	4,401

	2005 *No.*	*2004* *No.*
Amounts classified as equity		
'A' ordinary shares of £0.0001 each	–	6,250,000
'B' ordinary shares of £0.0001 each	–	1,600,000
'C' ordinary shares of £0.0001 each	–	1,500,000
'D' ordinary shares of £0.0001 each	–	2,501,988
'F' ordinary shares of £0.0001 each	–	51,868
Preferred ordinary shares of £0.0001 each	–	16,095,048
Ordinary shares of £0.1 each	32,143,095	–
Deferred shares of £1,046 each	44	–
Amounts classified as financial liabilities		
'A' preferred ordinary shares of £0.0001 each	–	16,006,968
	32,143,139	44,005,872

In accordance with FRS 25, 'A' preferred ordinary shares and the premium thereon were reclassified as financial liabilities to reflect the substance of the rights and obligations of this class of shares.

On 11 January 2005, the Company issued 1,999,998 'A' preferred ordinary shares each of 0.01p nominal value at 75 pence per share resulting in consideration received of £1,499,999.

In November 2005, the 'A' preferred ordinary shares were converted and all rights to dividends waived and accordingly these shares were reclassified as ordinary shares.

Share conversion

In November 2005, in preparation for the placing on AIM all classes of shares namely A to F ordinary, preferred ordinary and 'A' preferred ordinary were converted into a single class of ordinary shares in Phoqus group plc. This was applied to shares in issue, options and warrants.

The basis of conversion was agreed by shareholders and followed the intent set out in the articles in respect of the particular class rights of 'A' preferred ordinary shares. A resolution was passed and articles

Notes to the financial statements

at 31 December 2005

17. Share capital (continued)

adopted to eliminate all classes of shares and replace with a single class of ordinary share of nominal value 10p and all accrued dividend entitlements were waived.

A total of 23,942,395,853 bonus shares of nominal value 0.01p were issued to holders of 'A' preferred ordinary shares in proportion to their shareholding. The cost of this issue was charged to share premium and increased the total number of shares to 23,988,569,122.

The shares were then combined by dividing the number by 959.635 to reduce the total number of shares to 24,997,598 with each new share having a nominal value of 9.59635p. There was then a further bonus issue of 24,997,598 shares with nominal value of 0.40365p on a one for one basis. Then these two shares were combined to give 24,997,598 shares with a nominal value of 10p. The cost of the further bonus issue was also charged to share premium.

An identical procedure was followed in respect of the share options and warrants.

On 3 November 2005 the company was admitted to trading on AIM and issued 7,142,858 new ordinary shares of 10p at a market value of £1.40 giving a share premium of £1.30 per share and resulting in consideration received of £10,000,001.

All ordinary shares rank pari passu with regards to voting rights. Certain shareholders have entered into formal agreements that they will not sell their shares for one year from the date of placing and will be subject to 'orderly market' rules for a further 12 months.

In addition, the issued share capital includes 44 deferred shares of nominal value £1,046 each which were issued to all shareholders on the share register prior to placing on AIM. The deferred shares rank pari passu in all respects with all other shares except as follows: deferred shares do not confer any right to dividends or other distributions; on a return of capital on liquidation or otherwise the holders of deferred shares are entitled only to the repayment of the amounts paid up or credited as paid up on such shares after payment in respect of each other class of share in the capital of the Company of £10,000,000; the deferred shares do not carry any right to participate in the profits or assets of the Company; the deferred shares do carry the right to receive notice of and attend general meetings of the Company but have no right to vote; the deferred shares are treated as though they were ordinary shares except that the price per share at which each share is transferred shall not exceed the amount paid up or credited as paid up on that share; and finally the Directors have irrevocable authority at any time to appoint any person to execute on behalf of the holders of the deferred shares a transfer thereof and/or an agreement to transfer the same, without making any payment to the holders thereof, to such person as the Directors may determine as custodian thereof and to cancel and/or purchase the same (in accordance with the provisions of statute) without making any payment to or obtaining the sanction of the holders thereof and pending the transfer and/or cancellation and/or purchase to retain the certificate for such shares.

Warrants to subscribe for shares

During 2004, the warrants were re-negotiated with all of the lenders resulting in the issue of warrants for the issue of shares exercisable at a price of £0.75 each, exercisable on the following classes of shares in the following periods which were still outstanding at 31 December 2004 of:

2004 *Exercisable in period ending on:*	*Class*	*Number*	*Exercise price*
Later of 29 September 2010 and 5 years from Initial Public Offering	'A'	300,000	£0.75
Later of 19 September 2012 and 5 years from Initial Public Offering	'Preferred'	150,000	£0.75
Earlier of 7 November 2009 and 4 years from Initial Public Offering	'A'	266,667	£0.75

During 2005, the Group issued 400,000 warrants to European Venture Partners, to subscribe for 'A' ordinary shares of £0.0001 at £0.75 each. The Directors assessed the value of these warrants at £0.1875

Notes to the financial statements

at 31 December 2005

17. Share capital (continued)

each, resulting in a £75,000 increase in the warrant reserve. These warrants were adjusted in accordance with the terms of the warrant agreements as part of the share conversion arrangements described above. This resulted in the following warrants on the following classes of shares remaining outstanding at 31 December 2005.

2005 *Exercisable in period ending on:*	*Class*	*Number*	*Exercise price*
Later of 29 September 2010 and 5 years from Initial Public Offering	Ordinary	160,284	£1.41
Later of 19 September 2012 and 5 years from Initial Public Offering	Ordinary	77,785	£1.41
Earlier of 7 November 2009 and 4 years from Initial Public Offering	Ordinary	139,914	£1.43
Earlier of 22 June 2015 and 4 years from Initial Public Offering	Ordinary	554,635	£0.54

Options

The Company has granted options over 'D' and 'F' ordinary shares as shown in the table below, all of which were exercisable at the nominal value of the shares of £0.0001 per share and except as indicated vested with the option holder in four equal annual instalments commencing on the anniversary of the date of grant or at a placing if that occurred earlier.

All the options over 'D' and 'F' ordinary shares in Phoqus Group Limited were surrendered and replaced by options over ordinary shares in Phoqus Group plc under the terms of the share conversion (see above). In place of the surrendered options a total of 2,641 new options were granted over the new shares. Under the terms of an agreement in place when the original F share options were granted, a grant of 1,141,046 options over shares held by the investors was made.

In addition a grant of 488,299 options over shares held by the investors was made. All the options were granted with an exercise price of 0.01p and vest immediately.

Finally, a grant of 178,570 options was made at an exercise price of 10p and vest immediately. A charge of £232,141 to profit and loss has been made to reflect the grant of these options at less than fair value.

Exercisable in ten year period commencing	*Class*	*At 1 January 2005*	*Granted*	*Exercised*	*Surrendered/ Lapsed*	*At 31 December 2005*
May 2002	'D'	150,000	–	–	(150,000)	–
June 2002	'D'	150,000	–	–	(150,000)	–
August 2002	'D'	195,000	–	–	(195,000)	–
October 2002	'D'	275,000	–	–	(275,000)	–
November 2002	'D'	17,750	–	(1,750)	(16,000)	–
April 2003	'D'*	1,815	–	(170)	(1,645)	–
May 2003	'D'	401,169	–	(5,820)	(395,349)	–
June 2003	'D'	50,000	–	–	(50,000)	–
July 2003	'D'	250	–	–	(250)	–
March 2004	'D'*	1,859	–	(160)	(1,699)	–
March 2004	'D'	1,000	–	–	(1,000)	–
September 2004	'D'	973,035	–	(56,075)	(916,960)	–
September 2004	'F'	38,132	–	(2,984)	(35,148)	–
May 2005	'D'	–	50,750	–	(50,750)	–
**	'D'	–	250,000	–	(250,000)	–
**	'F'	–	10,000	–	(10,000)	–
November 2005	Ordinary	–	1,810,556	–	–	1,810,556
		2,255,010	2,121,306	(66,959)	(2,498,801)	1,810,556

Notes to the financial statements

at 31 December 2005

17. Share capital (continued)

* These options vested in full on grant.

** These options were granted in March 2005 and vested with the option holder in the proportion of 75% on the date of issue and 25% on 1 June 2005.

18. Reserves

Group	*Share premium £000*	*Merger reserve £000*	*Warrant reserve £000*	*Profit and loss account £000*
At 31 December 2004 (restated)*	–	18,295	131	(28,892)
Exchange differences on retranslation of net assets of subsidiary undertakings	–	–	–	6
Reclassification of financial liabilities as equity	12,004	–	–	–
Arising on share issues	10,785	–	–	–
Bonus issues	(2,541)	–	–	–
Share issue costs	(1,200)	–	–	–
Issue of warrants	–	–	75	–
Grant of options	–	–	–	232
Retained loss for the year	–	–	–	(4,505)
At 31 December 2005	19,048	18,295	206	(33,159)

* At 31 December 2004 the statutory share premium of £12,004,000 was included within financial liabilities. At 31 December 2005 the statutory share premium was £19,048,000.

Company	*Share premium £000*	*Warrant reserve £000*	*Profit and loss account £000*
At 31 December 2004 (restated) *	–	131	(826)
Reclassification of financial liabilities as equity	12,004	–	–
Arising on share issues	10,785	–	–
Bonus issues	(2,541)	–	–
Share issue costs	(1,200)	–	–
Issue of warrants	–	75	–
Grant of options	–	–	232
Retained profit for the year	–	–	1,997
At 31 December 2005	19,048	206	1,403

* At 31 December 2004 the statutory share premium of £12,004,000 was included within financial liabilities. At 31 December 2005 the statutory share premium was £19,048,000.

Share premium was reclassified as financial liabilities in 2004 as a result of the change in terms of the shares as detailed in note 17 and in accordance with FRS 25 as outlined in note 2.

Following conversion of the 'A' preferred ordinary shares and the waiving of any rights thereon the 'A' preferred shares were reclassified as ordinary shares.

Notes to the financial statements

at 31 December 2005

19. Notes to the statement of cash flow

(a) Reconciliation of operating loss to net cash outflow from operating activities

	2005	*2004*
	£000	*£000*
Cash flows from operating activities		
Operating loss	(6,019)	(6,841)
Adjustments for:		
Depreciation of fixed assets	369	428
Loss on disposal of fixed assets	34	130
Grant of options	232	–
Increase in debtors	(276)	(2)
Increase in creditors	497	59
Net cash outflows from operating activities	(5,163)	(6,226)

(b) Analysis of net (debt)/funds

	At 1 January 2005	*Cash flow*	*Non-cash changes*	*At 31 December 2005*
	£000	*£000*	*£000*	*£000*
Cash*	202	(143)	5	64
Short-term deposits*	775	5,691	–	6,466
Loans	(1,002)	1,000	–	(2)
Finance leases	(58)	(1,335)	75	(1,318)
	(83)	5,213	80	5,210

* Included within cash at bank and in hand in the balance sheet.

(c) Major non-cash transactions

As part of the sale and leaseback transaction in 2005, warrants were issued with a fair value of £75,000 as detailed in note 17; these have been offset against the balance of the finance lease liability.

20. Reconciliation of movement in shareholders' funds/(deficit)

	2005	*2004*
	£000	*£000*
Total recognised losses	(4,499)	(7,564)
New share issues	11,500	–
Reclassification of equity as financial liabilities	–	(6,974)
Reclassification of financial liabilities as equity	12,005	–
Share issue costs	(1,200)	–
Issue of warrants	75	–
Grant of options	232	–
Net addition to/(reduction in) funds	18,113	(14,538)
Shareholders' (deficit)/funds at start of period	(10,463)	4,075
Shareholders' funds/(deficit) at end of period	7,650	(10,463)

Notes to the financial statements

at 31 December 2005

21. Creditors: amounts falling due within one year

		Group		*Company*
	2005	*2004*	*2005*	*2004*
	£000	*£000*	*£000*	*£000*
'A' preferred ordinary shares	–	12,005	–	12,005
Other loans (note 23)	2	2	–	–
Amounts payable under finance leases (note 24)	473	34	–	–
Trade creditors	938	514	483	7
Other taxation and social security	54	49	–	–
Accruals and deferred income	260	192	–	–
Accrued cumulative preferred dividends	–	1,124	–	1,124
	1,727	13,920	483	13,136

Creditors include 'A' preferred ordinary shares from 2004 onwards following the reclassification of 'A' preferred ordinary shares as financial liabilities in accordance with FRS 25 as outlined in note 2.

The 'A' preferred ordinary shares were convertible on demand and accrued dividends at a fixed rate of 8% per annum as outlined in note 17.

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

		Group		*Company*
	2005	*2004*	*2005*	*2004*
	£000	*£000*	*£000*	*£000*
Other loans (note 23)	–	1,000	–	1,000
Amounts payable under finance leases (note 24)	845	24	–	–
	845	1,024	–	1,000

The other loans were secured by a floating charge over the assets of Phoqus Pharmaceuticals Limited and the finance leases over specific assets.

Details of warrants issued in conjunction with these loans are described in more detail in note 17.

23. Loans

Creditors include finance capital which is due for repayment as follows:

	2005	*2004*
	£000	*£000*
Amounts repayable:		
in one year or less, or on demand	2	2
in more than one year but not more than two years	–	1,000
	2	1,002

The £1m loan was increased to £1.5m in September 2005 and to £2m in October 2005 by further draw downs. The loan was repayable in full with accrued interest, charged at 8% per annum, no later than 30 June 2006. This loan was repaid with accrued interest in November 2005 (see note 10).

Notes to the financial statements

at 31 December 2005

24. Obligations under finance leases

The maturity of these amounts is as follows:

	2005 £000	2004 £000
Within one year	506	34
In two to five years	865	24
	1,371	58
Warrants	(53)	–
	1,318	58

All finance leases are repayable in 36 monthly instalments; the average interest rate on each loan is detailed in note 13.

The warrants issued in 2005 as detailed in note 17 have been offset against the finance lease in 2005. The fair value of these warrants is spread over the life of the finance lease in order to accrete the liability back up to the final amount payable.

25. Commitments under operating leases

Annual commitments under non-cancellable operating leases are as follows:

	Land and buildings 2005 £000	Land and buildings 2004 £000	Other 2005 £000	Other 2004 £000
Operating leases which expire:				
In two to five years	107	232	1	1
In over five years	83	80	–	–
	190	312	1	1

26. Capital commitments

	2005 £000	2004 £000
Contracted but not provided for in the financial statements	88	–

27. Employee Share Ownership Trust

The Group set up an Employee Share Ownership Trust in order to grant share options to employees. A contribution of £100 was made to the Trust to enable it to purchase shares from the Company. The Group has also set up an Enterprise Management Incentive Scheme and other un-approved Share Option Schemes through which employee share options are issued. These schemes work through the Employee Share Ownership Trust.

Set up and administration costs of all share option schemes are expensed to the profit and loss account in the years that they were set up. At 31 December 2005 and 31 December 2004 the Trust had not purchased any shares.

Notes to the financial statements

at 31 December 2005

28. Related party transactions

During the year the following directors were paid for consultancy services and/or other expenses to the Company over and above their duties as directors:

	2005 £000	2004 £000
TWD Blaney	–	1
H Seager	–	1
GJ Blaker	–	1
J Cashman	–	7

There were no outstanding balances at either of the year ends.

E Moses, a Director of the Company, is also a director of Biofusion plc, a company that has a substantial interest in a joint development agreement recently signed by the wholly owned subsidiary, Phoqus Pharmaceuticals Limited. In the future there may be royalty payments due to the Group but to date no transactions have occurred and there are £nil balances between the two companies (2004 - £nil).

29. Post balance sheet events

A warrant holder exercised 100,000 shares at £0.54 on 20 January 2006 and 454,635 shares at £0.54 on 13 February 2006. The Company received a total of £300,000.