

4402178.

# Phoqus Group plc

## Report and Consolidated Financial Statements

31 December 2006

TUESDAY



\*ASNHPRI4\*

A25

24/07/2007

361

COMPANIES HOUSE

## Directors and Advisors

### Directors

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

### Secretary

S E Smith

### Nominated Advisor & Nominated Broker

Nomura Code Securities Limited  
1 Carey Lane  
London  
EC2V 8AE

### Auditors

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

### Bankers

HSBC Bank plc  
275 Greenwich High Road  
Greenwich  
London  
SE10 8NF

### Solicitors

Olswang  
90 High Holborn  
London  
WC1V 6XX

### Registered office

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

## Chairman's Statement

Phoqus has made good progress during 2006 as our first full year as an AIM-listed public company

Our strategy has two components the Service Business and the Internal Development Business. In the Service Business we develop partnerships with pharmaceutical companies to provide solutions for their drug delivery requirements in return for development fees, milestone payments and eventually royalties on sales. In the Internal Development Business we progress projects ourselves to a later stage of development so that when we out-license we can access much greater deal values.

Under the Service Business, we have built and continue to expand the portfolio of collaborations for tablet-based drug delivery systems with leading players in the pharmaceutical market including three of the top five global pharmaceutical companies.

The second component of the strategy, the Internal Development Business, is to fund, from our internal resources, the development of improved formulations of certain products which will be taken forward into clinical trials by Phoqus. This offers the Group greater control over the rate of progress of the project.

In support of this strategy, in October 2006, Phoqus raised £3m gross by means of a secondary placing to fund the development of Chronocort™ through Phase II clinical trials.

In September 2007 we announced that Staph Bakali had been appointed as a Non-Executive Director. With Staph's track record of transforming businesses, he has the right credentials and experience to help the Company through the next stage of its development.

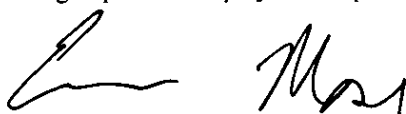
In January 2007 we announced that Andy Jones, Chief Executive, was stepping down from the Board and leaving to pursue interests outside of the Company. Andy Jones had held his position at Phoqus since May 2003, leading the Company through a successful IPO in November 2005. Both Andy and the Board considered it appropriate for a new Chief Executive to take the Company to the next stage of its development.

Peter Johnson, the Chief Financial Officer of Phoqus, took over the role of Chief Executive in an interim capacity while a replacement is found.

We continue to look for opportunities to develop and strengthen our staff and board to fit the changing needs of the Group.

We look forward to what will be an important year for the Group with our lead project, Chronocort™ modified release hydrocortisone tablet for the treatment of congenital adrenal hyperplasia and adrenal insufficiency currently running to plan. This project is expected to herald follow-on projects exploiting the same principle.

E Moses  
*Chairman*



30 March 2007

## Business Review

### *Overview*

Phoqus uses a 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.

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.

While the Group's portfolio of projects with pharmaceutical and other partners continues to grow, the conversion of projects into development programmes has been delayed by slower than anticipated decision making from pharmaceutical partners. Management has nevertheless achieved encouraging progress during the period since IPO and the technology continues to build a following in the industry as evidenced by the growing number of new feasibility projects with pharmaceutical partners.

### *Medical Devices*

In January 2006 Phoqus signed an agreement with a leading international medical devices company to conduct feasibility studies into the use of its coating technology on implantable medical devices with the intention of controlled release of drug from the coating on the device. This deal was mentioned at the time of the IPO as being at the legal negotiation phase.

The electrostatic process has the advantage of covering all surfaces on tablets and devices in a highly controlled manner reducing potential inconsistencies in the coating and wastage of the coating material. Preliminary studies have shown that the coating materials currently used in these applications are compatible with the electrostatic process. The collaboration required 12 months of investigation as anticipated. With these results the applicability is being evaluated and we are exploring other medical device applications for the electrostatic platform technology.

### *Chronocort™*

In February 2006 Phoqus completed the Phase I pharmacokinetic study of Chronocort™, the modified-release hydrocortisone tablet for the treatment of congenital adrenal hyperplasia and adrenal insufficiency. Patients suffering from these diseases are poorly served by existing therapies and Chronocort™ has now received Orphan Drug Designation for both diseases by the EMEA. Discussions with leading Endocrinologists from Europe and the USA have also confirmed that successful development of Chronocort™ will provide an improved treatment for this currently unmet medical need. This product is being developed under license from Diurnal Limited, a subsidiary of Biofusion plc and Phoqus continues to work closely with Professor Richard Ross of Diurnal Limited.

In the Phase I study the product was demonstrated to be safe and well tolerated, and met all the objectives of the study conducted in healthy volunteers in whom natural cortisol production had been suppressed. The data showed that Chronocort™ administration led to hydrocortisone blood levels which mimicked both the timing and levels of naturally produced cortisol.

This was the first clinical experience of any product incorporating Phoqus' modified-release technology, Qtrol™. The clinical data obtained suggested a hydrocortisone release profile in the volunteers consistent with experience of the product in vitro. The Chronocort™ tablet has a multi-layered structure designed to release the active drug in the early hours of the morning following a lag phase of several hours, and in so doing, mirroring the natural production and release into the bloodstream of cortisol from the adrenal glands.

## Business Review

Subsequent studies in patients will be required to obtain regulatory approval of the product. To demonstrate efficacy and, we expect, superiority relative to currently employed oral steroid therapies such studies will seek to demonstrate improved control of symptoms associated with congenital adrenal hyperplasia and adrenal insufficiency in comparison to the existing treatments. Phoqus has confirmed through primary research that successful clinical development of Chronocort™ should enable premium pricing relative to currently available oral steroids. We expect that the product could be launched in 2009.

The controlled-release profile and design falls within the Qtrol™ platform of applications developed by Phoqus. This platform addresses the global modified drug-release market which is estimated to be worth well over \$20bn in annual sales. The success of this Phase I pharmacokinetic trial demonstrated the value of the Group's Qtrol™ technology in man for the first time, and should lead to a raised profile of the technology in the pharma industry.

Phoqus and Diurnal explored out-licensing opportunities for the further development and ultimate marketing and distribution of Chronocort™ but considered that greater shareholder value would be generated by taking the project further through development before out-licensing.

In October 2006 Phoqus announced that it had sought and received support from its investors to take Chronocort™ to Phase II. To support Phase II Chronocort™ development, the Group raised an additional £3m (gross) through a placing of 2.8m shares at 107p.

### *External Collaborative Project*

In December 2006, Phoqus announced its first external collaborative project to move into clinical trials. The product being progressed is a modified-release (Qtrol™) version of a currently marketed product from GlaxoSmithKline (GSK). This progression represented the second time a Qtrol™ formulation has moved into clinical trials.

The clinical trials are to be conducted in healthy volunteers. The goal of the study is to assess the bioavailability and pharmacokinetics of the drug released from the Qtrol™ formulation. The final results from the study are expected to be made available during the first half of 2007.

### *Manufacturing*

The Commercial Manufacturing Suite (CMS) was moved to the Schorndorf (near Stuttgart, Germany) facility of Cardinal Health, our global contract manufacturing partner, and is currently undergoing final validation. The equipment and facility are expected to be ready for commercial operation when planned for use in the Chronocort™ project.

### *Principal risks and uncertainties*

The Group considers there are the following principal risks and uncertainties:

- The Chronocort™ project being delayed or Phase II clinical trial results not being positive,
- Development projects with pharmaceutical companies/partners not progressing to manufacturing deals,
- Failure of the manufacturing capability,
- Competing technologies may be developed with more attractive approaches, and
- Adequate cash resources.

The Group manages the first three of these risks by careful planning of the activities, building in contingencies and mitigating actions. The progress of all the activities and how they interrelate with each other is reviewed by the management team every week. The Group also constantly reviews developments

## Business Review

in the industry to identify potential competitive technologies to ensure firstly that there is no infringement of the Group's Intellectual Property rights and second to evaluate the relative merits of the technologies so that customers may be kept fully informed. Finally, cash resources are carefully managed, requirements forecast and actions taken to replenish as necessary.

Throughout the year we have continued to seek to recruit experienced new staff in business and product development to ensure we continue to be successful in gaining and delivering new business.



P G Johnson  
*Chief Financial Officer*

30 March 2007

## Financial Review

### Results

In the 12 months to 31 December 2006, the Group's turnover was £0.2m (2005 £0.3m) which was derived mainly from fees arising from collaborations with pharmaceutical companies

The operating loss of £5.1m (2005 £6.0m) included research and development expenses which qualify for additional tax allowances from the Inland Revenue, amounting to £1.7m (2005 £2.5m). Other research and development expenditure amounted to £1.5m (2005 £1.9m).

The £0.2m expenditure associated with the secondary placing has been charged against share premium and is not included in the operating loss.

The interest receivable in 2005 included £1.1m, being the reversal of accrued dividends in respect of 'A' preferred ordinary shares classified as financial liabilities in the 2004 accounts.

Taxation includes a Research and Development tax credit for £0.4m (2005 £0.6m).

The loss per share at 14.3p (2005 17.3p) 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 Group's net cash outflow before management of liquid resources and financing in the 12 months ended 31 December 2006 was £4.7m (2005 £5.1m).

All surplus cash is kept on deposit in accordance with the Group'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 2006 the Group had cash and short term deposits of £4.4m (2005 £6.5m).

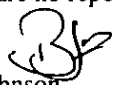
### International Financial Reporting Standards (IFRS)

The London Stock Exchange currently intends to mandate International Financial Reporting Standards for all AIM 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.

### Post balance sheet events

There are no reportable post balance sheet events.

  
P G Johnson  
Chief Financial Officer

30 March 2007

## Directors

The Directors of the Company are

### **E Moses PhD, Non-Executive Chairman (Age 52)**

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.

### **P G Johnson PhD, FCA, Chief Financial Officer and Interim Chief Executive Officer (Age 53)**

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. Dr Johnson is also a director of Obtineo Limited, Acknowledge Resourcing Limited, HRx Limited and Hollybush Enterprises Limited.

### **J P Cashman, Non-Executive Director (age 66)**

Jack Cashman was appointed to the Group Board in September 2002. John P (Jack) Cashman is President of Humphrey Management Limited, a privately owned holding company that also provides consulting services. Since 2001, Mr Cashman has been the Non-Executive Chairman of Vectura Group Plc, a drug delivery company located in the United Kingdom. He is also the Non-Executive Chairman of Interface Biologics Inc, a privately held Canadian therapeutic biomaterials company and Non-Executive Chairman of Inception Biosciences Inc, Canada's largest and most established cord blood bank. Mr Cashman is also a Non-Executive Director of Transat A T (Canada – TSX), and a Non-Executive Director of Amtrol Holdings Inc (USA) and Amtrol-Alfa A A (Portugal). From 2002 to 2006 Mr Cashman was the Non-Executive Chairman of Advanced Surgical Concepts, an Irish based medical devices company and a Non-Executive Director of Bepak Plc, the world's largest supplier of dry powder inhalers.

Mr Cashman is the former Chairman and joint CEO of R P Scherer Corporation and participated in its leveraged buy-out and privatization and subsequent successful public offering flotation on the New York Stock Exchange in October 1991 (R P Scherer was subsequently acquired by Cardinal Health Inc (NYSE)).

### **A C Playle, Non-Executive Director (Age 62)**

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 66)**

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



## Directors

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 64)**

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.

### **M L Bakalı, Non-Executive Director (Age 45)**

Staph Bakalı was appointed to the Group Board in September 2006.

Mr Bakalı has been in the pharmaceutical industry for almost 20 years. He is the former COO of ID Biomedical and played a significant role in transforming the company from an R&D organisation into a fully-integrated biotech company, doubling its market cap within two years. He was also instrumental in the acquisition of Shire Biologics by ID Biomedical (\$120 m) and led the efforts to integrate the newly acquired company. ID Biomedical itself was acquired by GlaxoSmithKline for \$1.4 bn in 2005. Mr Bakalı gained considerable entrepreneurial experience in building and managing successful organisations in the vaccines industry through his previous positions at PowderJect, Chiron and SmithKline Beecham. Mr Bakalı is also a director of Osisko Exploration Limited, Intercell AG, Lumiu Limited and Napo Pharmaceuticals, Inc and a partner of the Data Application Analysis Research Application Service Provider LLP.

## 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 Committee 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).

	2006 £000	2005 £000
Emoluments	392	331

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

	Salary £000	Fees £000	Benefits £000	Total emoluments 2006 £000	Total emoluments 2005 £000
M L Bakalı (1)	—	7	—	7	—
J Benjamin (4)	—	20	—	20	—
J P Cashman	—	20	4	24	16
P G Johnson (6)	126	—	1	127	115
A A Jones (2) (5)	162	—	—	162	148
D F Leathers	—	—	—	—	—
E Moses	—	30	2	32	28
A C Playle	—	20	—	20	13
H Seager (3)	—	—	—	—	11
	288	97	7	392	331

(1) Appointed 1 September 2006

(2) Resigned 31 January 2007

(3) Resigned 31 October 2005

(4) Fees paid to J Benjamin are paid to Advent Venture Partners

(5) In addition to the above £67,400 (2005 - £90,330) was appointed to a family trust of which A A Jones is a potential beneficiary from the Group's EBT (note 7)

(6) In addition to the above £60,100 (2005 - £87,550) was appointed to a family trust of which P G Johnson is a potential beneficiary from the Group's EBT (note 7)

## Remuneration Committee's Report

During 2006, the Group operated the New Share Schemes (which comprise the New EMI Scheme and the Non-EMI Scheme) All of the Share Option Schemes are established for the benefit of employees of the Group, save in the case of the Non-EMI 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 fees paid to Jerry Benjamin are paid to Advent

On 10 May 2006, the Group granted a total of 668,880 ordinary share options under a Long Term Incentive Plan (LTIP) using New EMI Scheme and the Non-EMI Scheme The options all have a vesting period of three years in which they may not be exercised In addition, the options are subject to performance conditions which state that they cannot be exercised unless the percentage growth in the Phoqus share price is greater than, or equal to, the percentage growth in the FTSE Pharmaceutical and Biotech All-Share Index for the period from 3 November 2005 to 10 May 2009

In addition, the number of options released for exercise will be proportional to a growth target discount curve If Phoqus' share price has increased by 50%, then 25% of the Options will be released If Phoqus' share price has increased by 100%, then 100% of the Options will be released If growth in value is between 50% and 100%, the number of Options released is scaled pro-rata to be between 25% and 100% and the remainder of the Options lapse Also, in the event of cessation of employment prior to vesting the Options lapse

The following Directors had interests in options over ordinary shares in the Company -

	<i>At 1 January 2006</i>	<i>Granted</i>	<i>Exercised</i>	<i>Lapsed</i>	<i>At 31 December 2006</i>
A A Jones*	291,070	116,000	222,202	–	184,868
P G Johnson*	234,449	89,857	183,632	–	140,674
J P Cashman	90,185	–	–	–	90,185
E Moses	211,994	–	–	–	211,994
A C Playle	94,414	–	–	–	94,414

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

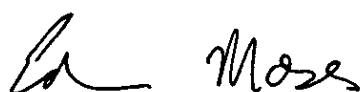
The gains made on exercise of options by AA Jones and PG Johnson was £311,000 and £257,000 respectively

The Group 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 is 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 Directors' Report on pages 14 to 16 inclusive

By order of the Remuneration Committee

E Moses  
Chairman



30 March 2007

## Corporate Governance Statement

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 that it considers appropriate for a Group of its size

This statement describes the principles of Good Governance which are being applied

### Statement of Compliance

The Group has been in compliance with the provisions set out in Section 1 of the Code throughout the year. Certain share options were granted to the Non-Executive Directors, Edwin Moses, Jack Cashman and Tony Playle prior to placing on AIM as set out in the Remuneration Committee's Report. The Board considers it essential that in order to attract and retain Non-Executive Directors with appropriate experience it may be necessary to grant share options. However no share options have been granted to the Non-Executive Directors since the placing on AIM.

### 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 does not consider Jerry Benjamin or David Leathers to be independent since they represent significant share holders and Staph Bakalı is also not considered independent as he acted as a consultant to the Group in addition to his position on the Board.

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, all of whom are Non-Executive Directors.

### 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 responsibility for monitoring the quality of internal control and ensuring that the financial performance of the Group is properly measured and reported on, for agreeing the scope of audits, fees, terms of engagement, and reviewing audit quality and 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.

## Corporate Governance Statement

### 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 and believes that it complies fully

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 achieved by day to day supervision. The integrity and competence of personnel is ensured 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.

#### *Internal Audit Function*

The Directors consider that the Group is too small to support a dedicated internal audit function. The Directors do interact with the external auditors and seek comments on the appropriateness of the control environment for the Group.

### 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 to the Financial Statements.

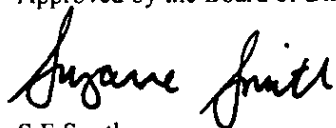
## Corporate Governance Statement

### Relations with Shareholders

Communication with shareholders is given a high priority. The Chairman's Statement, Business Review and Financial Review on pages 2 to 6 include a detailed review of the business and future prospects. The Group 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 Group's website [www.phoqus.com](http://www.phoqus.com)

Separate announcements of all material events are made as necessary by press releases which are also posted on the Group's website

Approved by the Board of Directors and signed on behalf of the Board by



S E Smith  
*Secretary*

30 March 2007

## Directors' report

The Directors present their Annual Report and Financial Statements of the Group for the year ended 31 December 2006

### Results and dividends

The loss for the year amounted to £4,743,000 (2005 - £4,505,000) 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<sup>TM</sup> (fast dissolve), Qtrol<sup>TM</sup> (modified release), LeQtrados<sup>®</sup> (active dose loading) and UniQ<sup>TM</sup> (unique tablet imaging)

During the year the management team of the operating company consisted of Dr Andy Jones, CEO, Dr Peter Johnson, CFO, Dr Marshall Whiteman, VP Technical Development, and Mr Mike Holroyd, VP Engineering In January 2007 the Group agreed to release Andy Jones from his CEO position and Peter Johnson, the CFO, took over on an interim basis while a permanent replacement is found

The Key Performance Indicators of the business are considered to be the size and nature of the sales pipeline, progress on development projects (including in-house projects such as Chronocort<sup>TM</sup>), progress to manufacturing readiness and net cash outflow before management of liquid resources and financing The review of the business is given separately in the Business Review and the Financial 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 is engaged on these activities when not servicing customer projects Further details are given in the Business Review

### Future developments

The Directors believe that there are sufficient funds to execute the business plan presented to investors at the placing on AIM in November 2005 as modified by the secondary placing in October 2006 Further information is provided in the Business Review and the Financial Review

### Events since the balance sheet date

There are no reportable post balance sheet events

### 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 Concept 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 2006 represented 30 days of purchases during the year for the Group (2005 - 63), and 41 days for the Company (2005 -

## Directors' report

158) The 2005 figures represent the high level of costs incurred in respect of the IPO at the end of the year

### Risk management and financial instruments

The Group's treasury policy is one of conservatism and does not undertake speculative transactions which would increase its currency or interest rate exposure

The Group's principal financial instruments comprise 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 given in note 13

The main risk arising from the Group's financial instruments is interest rate risk. The Board reviews and agrees policies for managing this risk are summarised below. The Group also monitors the magnitude of foreign currency risk and the market price risk arising from all financial instruments as outlined in note 13

#### 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

In relation to the use of financial instruments by the Group and by its subsidiary undertakings, the Group's objective 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

Cash deposits are held on sterling denominated deposit accounts with the Group's bankers and with two other banks. These accounts actively manage the funds to maximise the interest at no additional risk. Deposits are held on call or at most with one month's notice. The Directors consider that the only significant area of credit risk is the cash bank deposits. The credit risk policy is to distribute cash between the three banks

### Substantial shareholding

At 20 March 2007, the nearest practical date to the date of this Report, the Group had a total of 133 shareholders and 35,501,394 ordinary 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 20 March 2007

	No. of shares	
	'000	%
Advent Venture Partners LLP	11,953	33.7
Abingworth Bioventures III	5,066	14.3
3i Group plc	4,920	13.9
Amvescap plc	3,252	9.2
Fidelity	2,921	8.2
HSBC Global Custody Nominee (UK) Limited	2,370	6.7



## Directors' report

### Employment policy

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

The Group encourages effective two-way communication 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. The Company has recently conducted an anonymous employee survey and identified a series of actions the first being with an employee suggestion scheme

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

### Directors and their interests

The Directors at 31 December 2006 and their interests in the share capital of the Company at 31 December 2006 and at 1 January 2006, according to the register of Directors' interests are as follows

		<i>At 31 December</i>	<i>At 1 January</i>
	<i>Class</i>	<i>2006</i>	<i>2006</i>
J P Cashman	Ordinary	169,732	161,449
P G Johnson *	Ordinary	184,109	478
A A Jones *	Ordinary	246,090	523
E Moses	Ordinary	23,636	271
A C Playle	Ordinary	104	104

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

(See Directors interests in options in the Remuneration Committee's report on page 10 )

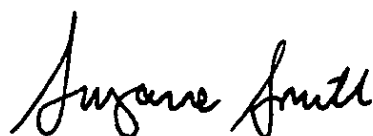
### Disclosure of information to the auditors

So far as each person who was a Director at the date of approving this report is aware, there is no relevant audit information, being information needed by the auditor in connection with preparing its report, of which the auditor is unaware. Having made enquiries of fellow directors and the group's auditor, each Director has taken all the steps that he is obliged to take as a Director in order to make himself aware of any relevant audit information and to establish that the auditor is aware of that information

### Re-appointment of auditors

In accordance with s 385 of the Companies Act 1985, a resolution is to be proposed at the Annual General Meeting to reappoint Ernst & Young LLP as auditor of the Group

By order of the Board



S E Smith  
*Secretary*

30 March 2007

## **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 UK 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 Companies 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.

The Directors are responsible for the maintenance and integrity of the corporate and financial information included on the Group's website. Legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

# **Independent auditors' report**

**to the members of Phoqus Group plc**

We have audited the Group and parent company financial statements ("the financial statements") of Phoqus Group plc for the year ended 31 December 2006 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 30. 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 Statement, the Business Review, the Financial Review, the profile of Directors, the Remuneration Committee's Report and the Corporate Governance Statement. 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.

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 Group's and Company's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or other irregularity or

# Independent auditors' report

## to the members of Phoqus Group plc (continued)

error In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements

### 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 2006 and of the loss of the Group for the year then ended,
- the financial statements have been properly prepared in accordance with the Companies Act 1985, and
- the information given in the Director's Report is consistent with the financial statements

### *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 short and medium – term viability with specific regard to the planned receipt in the short term of significant fees and licensing revenues from current projects, and planned revenues from the commercial application of the technology in the medium term. If the fees and licensing revenues are not forthcoming, the group will need to raise additional funds to continue the development of its products. If the technology being developed by the Group is not developed through to successful commercial launch, through lack of funding or clinical failure, the going concern basis of preparation would not be appropriate. The financial information does not include any adjustments that would result from a failure to generate significant fees and licensing revenue in the short term and failure to develop a commercial product and generate future revenues in the medium term 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  
Registered Auditor  
London

30 March 2007

## Consolidated profit and loss account

for the year ended 31 December 2006

	Notes	2006 £000	2005 £000
<b>Turnover</b>	3	167	274
Administrative expenses		(5,289)	(6,293)
<b>Operating loss</b>	4	(5,122)	(6,019)
Interest receivable and similar income	9	192	1,227
Interest payable and similar charges	10	(209)	(308)
<b>Loss on ordinary activities before taxation</b>		(5,139)	(5,100)
Tax credit on loss on ordinary activities	11	396	595
<b>Retained loss for the year</b>		(4,743)	(4,505)
Loss per share – basic and diluted	12	14 3p	17 3p

## Consolidated statement of total recognised gains and losses

for the year ended 31 December 2006

	<i>Note</i>	<i>2006</i> <i>£000</i>	<i>2005</i> <i>£000</i>
Loss for the financial year attributable to members of the parent company	18	(4,743)	(4,505)
Exchange difference on retranslation of net assets of subsidiary undertakings	18	1	6
<b><i>Total recognised gains and losses relating to the year</i></b>	20	<u>(4,742)</u>	<u>(4,499)</u>

## Consolidated balance sheet

at 31 December 2006

	Notes	2006 £000	2005 £000
<b>Assets</b>			
<b>Fixed assets</b>			
Tangible assets	14	2,119	2,322
<b>Current assets</b>			
Debtors	16	1,007	1,370
Cash at bank and in hand		4,395	6,530
		5,402	7,900
		7,521	10,222
<b>Capital and reserves</b>			
Called up share capital	17	3,596	3,260
Share premium account	18	21,839	19,048
Merger reserve	18	18,295	18,295
Other reserve			
- warrants	18	206	206
Profit and loss account	18	(37,856)	(33,159)
<b>Shareholders' funds</b>			
	20	6,080	7,650
<b>Creditors</b>			
Amounts falling due within one year	21	1,097	1,727
Amounts falling due in more than one year	22	344	845
		1,441	2,572
		7,521	10,222

Approved by the Board on 30 March 2007



P G Johnson  
Chief Financial Officer

# Company balance sheet

at 31 December 2006

	Notes	2006 £000	2005 £000
<b>Assets</b>			
<b>Fixed assets</b>			
Investments	15	28,694	24,331
<b>Current assets</b>			
Debtors	16	7	68
Cash at bank and in hand		3	1
		10	69
		28,704	24,400
<b>Capital and reserves</b>			
Called up share capital	17	3,596	3,260
Share premium account	18	21,839	19,048
Other reserve			
- warrants	18	206	206
Profit and loss account	18	3,037	1,403
		28,678	23,917
<b>Shareholders' funds</b>			
<b>Creditors</b>			
Amounts falling due within one year	21	26	483
Amounts falling due in more than one year	22	-	-
		26	483
		28,704	24,400

Approved by the Board on 30 March 2007



P G Johnson  
Chief Financial Officer



## Consolidated statement of cash flows

for the year ended 31 December 2006

	Notes	2006 £000	2005 £000
<b>Net cash outflow from operating activities</b>	19a	(5,180)	(5,163)
<b>Returns on investment and servicing of finance</b>			
Interest received		192	103
Interest paid		(36)	(144)
Interest element of finance lease rental payments		(140)	(164)
		16	(205)
<b>Taxation</b>			
Corporation tax credit received		601	616
Overseas tax paid		(6)	(6)
		595	610
<b>Capital expenditure and financial investment</b>			
Payments to acquire tangible fixed assets		(164)	(329)
		(164)	(329)
<b>Net cash outflow before management of liquid resources and financing</b>		(4,733)	(5,087)
<b>Management of liquid resources</b>			
Decrease /(increase) in short-term deposits		2,134	(5,691)
<b>Financing</b>			
Issue of ordinary share capital		3,300	11,500
Share issue costs		(140)	(1,200)
New long-term loans		–	1,000
Repayment of long-term loans		–	(2,000)
Inception of finance leases		–	1,576
Repayment of capital element of finance leases and hire purchase contracts		(496)	(241)
		2,631	10,635
<b>Increase/(Decrease) in cash</b>		32	(143)

## Consolidated statement of cash flows

for the year ended 31 December 2006

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

	Notes	2006 £000	2005 £000
Increase/(Decrease) in cash		32	(143)
Cash inflow from increase in loans		–	(1,000)
Repayment of long-term loans		–	2,000
Cash inflow from inception of finance leases (sale and lease back)		–	(1,576)
Repayment of capital element of finance leases and hire purchase contracts		496	241
Cash inflow/ (outflow) from short-term deposits		(2,134)	5,691
Change in net funds/(debt) resulting from cash flows	19b	(1,606)	5,213
Inception of finance leases		(87)	–
Other non-cash movements		(33)	80
<b>Movement in net funds/(debt)</b>		<b>(1,726)</b>	<b>5,293</b>
<b>Net funds/ (debt) at 1 January</b>	19b	<b>5,210</b>	<b>(83)</b>
<b>Net funds/ (debt) at 31 December</b>	19b	<b>3,484</b>	<b>5,210</b>

## Notes to the financial statements

at 31 December 2006

### 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 level of retained losses as at the date of these financial statements represents the Group's costs incurred to pursue this strategy. In order to finance the next phase of the strategy, the Group raised £8.8m of funds (net of costs) through a Placing on the Company's admission to AIM in November 2005 and £2.8m of funds (net of costs) through a Secondary Placing in October 2006 as described in note 17.

The Group has agreed to enter into a £2.5m loan agreement expected to be completed on 2 April 2007 the terms of which will be an immediate drawdown of £1.25m, with the drawdown of the balance being subject to certain conditions. The loan is repayable over 36 monthly instalments, with an initial interest only period of 6 months, at an interest rate of 13.3%. The Group will grant the lender a warrant to subscribe for shares equal to 6% of the drawn down loan with an exercise price equal to the average closing price per share in the 30 days preceding the closing of documentation.

As set out in the business review there are risk factors inherent in the business and its potential to generate future revenues. 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 going concern basis adopted in the preparation of these financial statements.

The Directors have prepared and approved cash flow projections that indicate that the company will be able to meet its liabilities as they fall due for the foreseeable future. These projections include the planned receipt in the short term of significant fees and licensing revenues from current projects, and planned revenues from the commercial application of the technology in the medium term. If the fees and licensing revenues are not forthcoming, the group will need to raise additional funds to continue the development of its products. If the technology being developed by the Group is not developed through to successful commercial launch, through lack of funding or clinical failure, the going concern basis of preparation would 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 20 'share based payment'. The adoption of FRS 20 has resulted in a change in accounting policy for share-based payment transactions. FRS 20 requires the fair value of options and share awards which ultimately vest to be charged to the profit and loss account over the vesting or performance period. For equity settled transactions the fair value is determined at the date of the grant using an appropriate pricing model. If an award fails to vest as the result of certain types of performance condition not being satisfied, the charge to the income statement will be adjusted to reflect this.

There is no impact for prior years due to all options being in existence having vested prior to 1 January 2006. Under FRS 20 a charge of £45,000 was recognised in the profit and loss account in the current year with a corresponding entry taken to equity. The impact in the year by applying FRS 20 as opposed to UITF 17 is to reduce the profit and loss account charge by £168,000.

## Notes to the financial statements

at 31 December 2006

### 2. Accounting policies (continued)

#### *Financial instruments*

Shares are included in shareholders' 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 England 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. The profit for the year was £1,634,000 (2005: £1,997,000).

#### *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.

#### *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:

## Notes to the financial statements

at 31 December 2006

### 2. Accounting policies (continued)

#### *Deferred taxation*

- provision is made for tax on gains arising from the revaluation (and similar fair value adjustments) of fixed assets, and gains on disposal of fixed assets that have been rolled over into replacement assets, only to the extent that, at the balance sheet date, there is a binding agreement to dispose of the assets concerned. However, no provision is made where, on the basis of all available evidence at the balance sheet date, it is more likely than not that the taxable gain will be rolled over into replacement assets and charged to tax only where the replacement assets are sold,
- 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, and
- 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*

##### *Company*

Transactions in foreign currencies are recorded at the rate ruling at the date of the transaction or at the contracted rate if the transaction is covered by a forward foreign currency contract. Monetary assets and liabilities denominated in foreign currencies are retranslated at the rate of exchange ruling at the balance sheet date or if appropriate at the forward contract rate. All differences are taken to the profit and loss account with the exception of differences on foreign currency borrowings, to the extent that they are used to finance or provide a hedge against foreign equity investments, which are taken directly to reserves together with the exchange difference on the carrying amount of the related investments. Tax charges and credits attributable to exchange differences on those borrowings are also dealt with in reserves.

##### *Group*

The financial statements of overseas subsidiary undertakings are 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 with the exception of differences on foreign currency borrowings to the extent that they are used to finance or provide a hedge against group equity investments in foreign enterprises, which are taken directly to reserves together with the exchange difference on the net investment in these enterprises. Tax charges and credits attributable to exchange differences on those borrowings are also dealt with in reserves.

#### *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.

## Notes to the financial statements

at 31 December 2006

### 2. Accounting policies (continued)

#### *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. Lease incentives are recognised over the shorter of the lease term and the date of the next rent review.

#### *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 have been 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.

#### *Share-based payments*

##### *Equity settled transactions*

The cost of equity-settled transactions with employees is measured by reference to the fair value at the date at which they are granted and is recognised as an expense over the vesting period, which ends on the date on which the relevant employees become fully entitled to the award. Fair value is determined by an external valuer using an appropriate pricing model. In valuing equity-settled transactions, no account is taken of any vesting conditions, other than conditions linked to the price of the shares of the Company (market conditions).

No expense is recognised for awards that do not ultimately vest, except for awards where vesting is conditional upon the a market condition, which are treated as vesting irrespective of whether or not the market condition is satisfied, provided that all other performance conditions are satisfied.

At each balance sheet date before vesting, the cumulative expense is calculated, representing the extent to which the vesting period has expired and management's best estimate of the achievement or otherwise of non-market conditions number of equity instruments that will ultimately vest or in the case of an instrument subject to a market condition, be treated as vesting as described above. The movement in cumulative expense since the previous balance sheet date is recognised in the income statement, with a corresponding entry in equity.

Where the terms of an equity-settled award are modified or a new award is designated as replacing a cancelled or settled award, the cost based on the original award terms continues to be recognised over the original vesting period. In addition, an expense is recognised over the remainder of the new vesting period for the incremental fair value of any modification, based on the difference between the fair value of the original award and the fair value of the modified award, both as measured on the date of the modification. No reduction is recognised if this difference is negative.

Where an equity-settled award is cancelled, it is treated as if it had vested on the date of cancellation, and any cost not yet recognised in the income statement for the award is expensed immediately. Any compensation paid up to the fair value of the award at the cancellation or settlement date is deducted from equity, with any excess over fair value being treated as an expense in the income statement.

## Notes to the financial statements

at 31 December 2006

### 2. Accounting policies (continued)

#### *Share-based payments*

##### *Equity settled transactions*

The Group has taken advantage of the transitional provisions of FRS 20 in respect of equity-settled awards so as to apply FRS 20 only to those equity-settled awards granted after 7 November 2002 that had not vested before 1 January 2006

For awards granted before 7 November 2002, the Group recognises only the intrinsic value or cost of these potential awards as an expense. This is accrued over the performance period of each plan based on the intrinsic value of the equity settled awards

#### *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 32, 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*

A provision is recognised when the Group has a legal or constructive obligation as a result of a past event and it is probable that an outflow of economic benefits will be required to settle the obligation

#### *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

	2006 £000	2005 £000
United Kingdom	72	91
USA	76	166
Europe	19	17
	<u>167</u>	<u>274</u>

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 Group's turnover (by origin), losses and net assets are substantially all related to continuing activities performed in the United Kingdom

## Notes to the financial statements

at 31 December 2006

### 3. Turnover and segmental analysis (continued)

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.

### 4. Operating loss

Operating loss is stated after charging

	2006 £000	2005 £000
Auditors' remuneration - audit services - parent	29	18
- audit services - subsidiary	25	25
- taxation services *	32	8
Research and development - qualify for additional tax allowances	1,674	2,501
- not qualifying for additional tax allowances	1,462	1,900
Depreciation of owned fixed assets	70	194
Depreciation of assets held under finance lease	286	175
Loss on disposal of fixed assets	98	34
Share based payments	45	232
Operating lease rentals- land and buildings	192	404
- plant and machinery	2	1
Net loss on foreign currency translation	14	5

\* In addition to the auditors' remuneration above, £8,000 taxation services in 2006 relating to secondary placing costs has been charged to share premium (2005 - £175,000 corporate finance, £32,000 audit related services and £22,000 taxation services)

The £45,000 charge in respect of the grant of options in 2006 is under FRS 20. The £232,141 charge in 2005 relates to share options accounted for under UITF 17, as we have taken advantage of the transitional exemptions under FRS 20. See note 17.

### 5. Staff costs

	2006 £000	2005 £000
Wages and salaries	1,851	1,588
Social security costs	195	175
Other pension costs	92	80
	2,138	1,843

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

	2006 No	2005 No
Pharmaceutical and technical	27	21
Business development and administration	10	9
	37	30



## Notes to the financial statements

at 31 December 2006

### 6. Directors' remuneration

	2006 £000	2005 £000
Emoluments	392	331

### 6. Directors' remuneration (continued)

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

	2006 £000	2005 £000
Emoluments	162	148

There were no pension contributions made by the Group in respect of the Directors. Gains made by the Directors on the exercise of share options are disclosed in the Remuneration Committee's Report. 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 £360,000 (2005 - £245,000) to the Employee Benefit Trust (EBT) for the benefit of employees. The Trustees of the EBT appointed £127,500 (2005 - £177,880) to family trusts of which two Directors are potential beneficiaries. In respect of the highest paid Director, £67,400 (2005 - £90,330) was appointed to a family trust of which he is a potential beneficiary.

The Trustees of the EBT also appointed a further £104,110 (2005 - £89,300) 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 2006 the EBT had cash of £122,000 (31 December 2005 - £6,000) 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 £92,000 (2005 - £80,000) and has been charged to the profit and loss account. There are no outstanding contributions at the year end (2005 - £nil).

### 9. Interest receivable and similar income

	2006 £000	2005 £000
Interest on bank deposits	192	103
Waiver of dividend accrued on preference shares (note 30)	–	1,124
	192	1,227

## Notes to the financial statements

at 31 December 2006

### 10. Interest payable and similar charges

	2006 £000	2005 £000
Interest on other loans	36	144
Interest on finance leases	173	164
	<u>209</u>	<u>308</u>

### 11. Taxation

#### (a) Tax on loss on ordinary activities

The tax credit is made up as follows

	2006 £000	2005 £000
UK corporation tax	402	601
Foreign tax	(6)	(6)
Current tax credit (note 11b)	<u>396</u>	<u>595</u>

#### (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% (2005 - 30%) The differences are reconciled below

	2006 £000	2005 £000
Loss on ordinary activities before tax	<u>(5,139)</u>	<u>(5,100)</u>
Loss on ordinary activities multiplied by the standard rate of corporation tax in the UK of 30% (2005 - 30%)	(1,542)	(1,530)
Waiver of accrued preference dividends not taxable (note 30)	-	(337)
Decelerated capital allowances	-	415
Other timing differences	-	70
Differences in effective rates of overseas taxation	3	1
Losses surrendered to research and development tax credit	477	750
Research and development tax credit claimed	(402)	(601)
Losses arising in the period not relieviable against current tax	1,054	640
Other	14	(3)
Current tax credit (note 11a)	<u>(396)</u>	<u>(595)</u>

#### (c) Factors that may affect future tax credits

The Group has estimated tax losses arising in the UK of approximately £26m (2005 - £23m) that are available indefinitely for offset against future taxable profits of those companies in which the losses arose

## Notes to the financial statements

at 31 December 2006

### 11. Taxation (continued)

Deferred tax assets have not been recognised in respect of these losses as the Group cannot reliably predict suitable taxable profits

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

#### (d) Deferred tax

The recognised and unrecognised deferred tax assets are as follows

	<i>Recognised</i>		<i>Unrecognised</i>	
	<i>2006</i>	<i>2005</i>	<i>2006</i>	<i>2005</i>
	<i>£000</i>	<i>£000</i>	<i>£000</i>	<i>£000</i>
Tax losses available	60	73	7,941	6,957
Capital allowances in advance of depreciation	(143)	(143)	–	–
Other timing differences	83	70	–	–
	<u>–</u>	<u>–</u>	<u>7,941</u>	<u>6,957</u>

### 12. Loss per share

The calculation of basic earnings per ordinary share is based on losses of £4,743,000 (2005 - £4,505,000) and on 33,144,349 (2005 – 26,049,034) ordinary shares, being the weighted number of shares adjusted retrospectively for restructuring and bonus issues during 2005 (note 30). 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

An explanation of the Group's objectives, policies and strategies for the role of derivatives and other financial instruments in creating and changing the risks of the group in its activities can be found on the risk management and financial instruments section of the Directors' report. The Group's trade debtors and trade creditors that arise directly from its operations are not included within the disclosures

#### Interest rate risk profile of financial liabilities

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

	<i>2006</i>	<i>2005</i>
	<i>£000</i>	<i>£000</i>
Sterling loans	2	2
Sterling finance leases	909	1,318
Total	<u>911</u>	<u>1,320</u>

## Notes to the financial statements

at 31 December 2006

### 13. Financial instruments (continued)

#### Fixed rate financial liabilities

	<i>Weighted average interest rate %</i>	<i>Weighted average period for which rate is fixed months</i>
2006	15.3	22
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)

	<i>2006 £000</i>	<i>2005 £000</i>
Floating rate financial assets	4,525	6,704

Financial assets comprise cash deposits on call and on monthly notice periods and bear interest at rates which fluctuate with LIBOR. The financial assets also include £130,000 rental deposits (2005 - £174,000) which accrue interest at rates which fluctuate with LIBOR and are paid from time to time by the landlord. All other financial assets and liabilities not included in the above tables are not interest bearing.

#### Currency exposures

All of the Group's monetary assets and liabilities are denominated in sterling at 31 December 2005 and 2006 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

	<i>2006 £000</i>	<i>2005 £000</i>
In one year or less, or on demand	567	475
In more than one year but not more than two	344	845
	<u>911</u>	<u>1,320</u>

#### 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. 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.

## Notes to the financial statements

at 31 December 2006

### 13. Financial instruments (continued)

sale The fair value has been calculated by discounting the expected future cash flows at prevailing interest rates There is no significant difference between book value and fair values

### 14. Tangible fixed assets

<i>Group</i>	<i>Leasehold improvements £000</i>	<i>Assets in the course of construction £000</i>	<i>Plant and machinery £000</i>	<i>Office furniture and fittings £000</i>	<i>Total £000</i>
Cost					
At 1 January 2006	902	22	2,560	506	3,990
Additions	24	–	216	11	251
Transfers	–	(22)	22	–	–
Disposals	–	–	(164)	(9)	(173)
Exchange differences	–	–	–	(2)	(2)
At 31 December 2006	926	–	2,634	506	4,066
Accumulated depreciation					
At 1 January 2006	217	–	1,062	389	1,668
Charge for the year	64	–	258	34	356
Disposals	–	–	(66)	(9)	(75)
Exchange differences	–	–	–	(2)	(2)
At 31 December 2006	281	–	1,254	412	1,947
Net book value					
At 31 December 2006	645	–	1,380	94	2,119
At 31 December 2005	685	22	1,498	117	2,322

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

	<i>Leasehold improvements £000</i>	<i>Plant and machinery £000</i>	<i>Office furniture and fittings £000</i>	<i>Total £000</i>
2006	623	946	73	1,642
2005	685	1,069	90	1,844

### Company

The Company has no fixed assets except investments which are detailed in note 15

## Notes to the financial statements

at 31 December 2006

### 15. Investments

<i>Company</i>	<i>Subsidiary undertakings</i>		
	<i>Shares £000</i>	<i>Loans £000</i>	<i>Total £000</i>
Cost at 1 January 2006	209	24,122	24,331
Additions	–	4,363	4,363
Cost at 31 December 2006	209	28,485	28,694

Investments include long term loans 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

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

### 16. Debtors

	<i>2006 £000</i>	<i>Group 2005 £000</i>	<i>2006 £000</i>	<i>Company 2005 £000</i>
Trade debtors	107	157	–	–
Other debtors and deposits	313	407	7	68
Prepayments and accrued income	185	205	–	–
Research and development tax credit	402	601	–	–
	1,007	1,370	7	68

Included within other debtors and deposits is £130,000 (31 December 2005 - £174,000) relating to deposits that are repayable in more than one year

## Notes to the financial statements

at 31 December 2006

### 17. Share capital

#### Authorised share capital

	2006 £000	2005 £000
Ordinary shares of £0.1 each	8,055	8,055
Deferred shares of £1,046 each	46	46
	<u>8,101</u>	<u>8,101</u>

	2006 No	2005 No
Ordinary shares of £0.1 each	80,552,250	80,552,250
Deferred shares of £1,046 each	44	44
	<u>80,552,294</u>	<u>80,552,294</u>

#### Allotted, called up and fully paid share capital:

	2006 £	2005 £
Ordinary shares of £0.1 each	3,550,139	3,214,310
Deferred shares of £1,046 each	46,024	46,024
	<u>3,596,163</u>	<u>3,260,334</u>

	2006 No	2005 No
Ordinary shares of £0.1 each	35,501,394	32,143,021
Deferred shares of £1,046 each	44	44
	<u>35,501,438</u>	<u>32,143,065</u>

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.

## Notes to the financial statements

at 31 December 2006

### 17. Share capital (continued)

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 over 554,635 ordinary shares exercisable on the earlier of 22 June 2015 and 4 years from Initial Public Offering at a price of £0.54 were exercised in January and February 2006.

On 26 October 2006 the Company completed a secondary placing on AIM and issued 2,803,738 new ordinary shares of 10p at a price of £1.07 giving a share premium of £0.97 per share and resulting in consideration received of £3,000,000. The ordinary shares rank *pari passu* in all respects with the existing ordinary shares of the Company in issue.

#### Warrants to subscribe for shares

2006			<i>Exercise</i>
<i>Exercisable in period ending on</i>	<i>Class</i>	<i>Number</i>	<i>price</i>
Later of 29 September 2010 and 5 years from 3 November 2005	Ordinary	160,284	£1.41
Later of 19 September 2012 and 5 years from 3 November 2005	Ordinary	77,785	£1.41
Earlier of 7 November 2009 and 4 years from 3 November 2005	Ordinary	139,914	£1.43
2005			<i>Exercise</i>
<i>Exercisable in period ending on</i>	<i>Class</i>	<i>Number</i>	<i>price</i>
Later of 29 September 2010 and 5 years from 3 November 2005	Ordinary	160,284	£1.41
Later of 19 September 2012 and 5 years from 3 November 2005	Ordinary	77,785	£1.41
Earlier of 7 November 2009 and 4 years from 3 November 2005	Ordinary	139,914	£1.43
Earlier of 22 June 2015 and 4 years from 3 November 2005	Ordinary	554,635	£0.54

These warrants were granted in connection with loan and finance lease arrangements. The warrants over 554,635 shares relates to an existing finance lease and the other warrants relate to loans and finance leases that have been fully repaid.

#### Share based payments

In connection with the Initial Public Offering in November 2005 (see above), certain options over series 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 agreement approved by the shareholders. 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 series F share options were granted, a



## Notes to the financial statements

at 31 December 2006

### 17. Share capital (continued)

#### Share based payments(continued)

grant of 1,141,046 options over shares held by the investors was made with an exercise price of 0.01p and vested immediately

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 vested immediately

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

On 10 May 2006, the Company granted a total of 668,880 ordinary share options under a Long Term Incentive Plan (LTIP) using New EMI Scheme and the Non-EMI Scheme. These were granted at an exercise price of 10p per share and may be exercised at any point from the date of release at the end of the three year holding period until the tenth anniversary of the date of grant. See the Remuneration Report

Exercisable in ten year period commencing	Class	At 1 January 2006	Granted	At 31 December 2006	
		Exercised		Surrendered/ Lapsed	
November 2005	Ordinary	1,810,556	–	(882,320)	–
May 2006	Ordinary	–	668,880	–	(106,690)
		<u>1,810,556</u>	<u>668,880</u>	<u>(882,320)</u>	<u>(106,690)</u>
					<u>1,490,426</u>

The following table illustrates the number and weighted average exercise prices (WAEP) of, and movements in, share options during the year

	2006 No	2006 WAEP pence	2005 No	2005 WAEP pence
Outstanding as at 1 January	1,810,556	1.0	–	–
Granted during the year	668,880	10.0	1,810,556	1.0
Forfeited during the year	(106,690)	10.0	–	–
Exercised	(882,320)	1.0 <sup>1</sup>	–	–
Outstanding at 31 December	<u>1,490,426</u>	<u>5.0</u>	<u>1,810,556</u>	<u>1.0</u>

<sup>1</sup>The weighted average share price at the date of exercise was £1.40

The weighted average remaining life of all options outstanding at the end of the year was 4 years (2005: 2 years). The range of exercise prices is 0.01 pence to 10 pence. The weighted average fair value of the options granted in May 2006 under the Company's LTIP scheme was determined using a Monte Carlo model to be 70p. The share-based compensation charge for the year ended 31 December 2006 is £45,000 (2005: £232,000).

The key inputs of the Monte Carlo model are as follows

Life of Option	10 years
Expected volatility	36%
Expected dividends	nil
Risk free interest rate	4.69%
Weighted average share price at grant	£1.59