Xytis Pharmaceuticals Limited

Report and Financial Statements

31 December 2005

ERNST & YOUNG

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COMPANIES HOUSE 26/10/2006

Registered No: 05116784

Directors
W Tschollar
J Besse
H Guerin

Secretary
Jordan Company Secretaries Limited

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

Registered office
20-22 Bedford Row
London
WC1R 4JS

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Director's report

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

Results and dividends

The loss for the year amounted to €2,139,740. The directors do not recommend the payment of any dividends.

Principal activities and future development

The principal activity of the company continued to be that of research and development activities for the evaluation, testing and approval of new drug candidates.

Two important events have assisted in securing the company's future and allowing it to continue in its mission of assembling a pipeline of novel compounds addressing major unmet needs in the CNS field.

a) In accordance with the terms of a combination agreement dated 29 December 2005, a second round of financing has been finalised for an amount of USD24.5m. The company received funding of USD7m in January 2006 and additional funding of USD17.5m in July 2006 from Sanderling Ventures, Atlas Venture, CDC Enterprises Innovation and Ventech.

b) As part of the second round of financing, a USA Delaware based company, Xytis Inc. was created. Xytis Inc. is the result of the merger of Xytis Pharmaceuticals Ltd and Remergent Inc, a company created in February 2002 to commercialise drug discoveries with seed funding from Sanderling Ventures.

Broadening the investor base, opening access to the American market and including a discovery group are all strategically important actions for the company and this together with the second round of financing of USD24.5m, allow management to be confident that the financing and structure are in place to carry the company forward.

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Directors

The directors who served the company during the year were as follows:

W Tschollar	
J Besse	
R Pearce	(resigned 3 January 2005)
H Guerin	(appointed 13 April 2005)

Directors' interests

The directors' interests in the share capital of the company were as follows:

	Ordinary shares of €0.01 each	
	At 31 December 2005	*At 1 January 2005 or subsequent date of appointment*
W Tschollar	126,000	126,000
J Besse	–	–
R Pearce	–	–
H Guerin	–	–

Director's report

Directors' interests (continued)

	Deferred shares of £1 each	
	At 31 December 2005	*At 1 January 2005 or subsequent date of appointment*
W Tschollar	1	1
J Besse	–	–
R Pearce	–	–
H Guerin	–	–

Auditors

In accordance with section 385 of the Companies Act 1985, a resolution to re-appoint Ernst & Young LLP as the company's auditor will be put to the forthcoming Annual General Meeting.

On behalf of the board

W Tschollar
Director

18 OCT 2006

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Statement of directors' responsibilities in respect of the financial statements

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

Company law requires the directors to prepare financial statements for each financial year which give a true and fair view of the state of affairs of the company and of the profit or loss of the company for that 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; and
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the company will continue in business.

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

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Independent auditors' report

to the members of Xytis Pharmaceuticals Limited

We have audited the company's financial statements for the year ended 31 December 2005 which comprise the Profit and Loss Account, the Balance Sheet and the related notes 1 to 13. These financial statements have been prepared in accordance with the accounting policies set out therein and the requirements of the Financial Reporting Standard for Smaller Entities.

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 statement in accordance with applicable United Kingdom law and Accounting Standards (United Kingdom Generally Accepted Accounting Practice) as set out in the Statement of Directors' Responsibilities.

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

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

We read the directors' report and consider the implications for our report if we become aware of any apparent misstatements within it.

Basis of audit opinion

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements. It also includes an assessment of the significant estimates and judgements 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 Xytis Pharmaceuticals Limited (continued)

Opinion

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

Emphasis of matter - going concern

In forming our opinion, which is not qualified in this respect, we have considered the adequacy of the disclosures made in note 1 to the financial statements concerning the company's ability to continue as a going concern. There is a material uncertainty as to whether the company will be able to complete the development and achieve the successful commercial launch of new medicinal products and therefore as to the company's ability to continue as a going concern. The financial statements do not include any adjustments that would result if the company was unable to continue as a going concern.

Ernst & Young LLP

Ernst & Young LLP
Registered Auditor
London

25 October 2006

Profit and loss account

for the year ended 31 December 2005

	Notes	*Year ended 31 December 2005* €	*Period from 30 April 2004 to 31 December 2004* €
Administrative expenses		(2,131,380)	(698,620)
Operating loss	3	(2,131,380)	(698,620)
Interest receivable	6(a)	7,494	–
Interest paid	6(b)	(15,854)	–
Loss on ordinary activities before taxation		(2,139,740)	(698,620)
Tax on loss on ordinary activities		–	–
Loss for the year	12	(2,139,740)	(698,620)

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Balance sheet

at 31 December 2005

	Notes	2005 €	2004 €
Fixed assets			
Tangible assets	7	8,400	5,448
Investment	8	13,080	–
		21,480	5,448
Current assets			
Debtors	9	81,817	–
Cash at bank and in hand		177,004	964,336
		258,821	964,336
Creditors: amounts falling due within one year	10	(472,806)	(38,403)
Net current (liabilities)/assets		(213,985)	925,933
Total assets less current liabilities		(192,505)	931,381
Capital and reserves			
Called up share capital	11	26,460	16,301
Share premium account	12	2,619,395	1,613,700
Profit and loss account	12	(2,838,360)	(698,620)
Shareholders' funds - equity		(192,505)	931,381

The financial statements were approved by the board on

W Tschollar
Director

18 OCT 2006

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Notes to the financial statements

at 31 December 2005

1. Fundamental accounting concept - going concern

The accompanying financial statements have been prepared on the going concern basis, which contemplates the realisation of assets and the satisfaction of liabilities in the normal course of business.

The company is in the clinical stages of research and development activities for the evaluation, testing and approval of new medicinal products for the treatment of central nervous system disorders and there is inherent uncertainty with respect to regulatory approval, commercial viability of the developed products and the certainty and timing of future revenue streams. The company has incurred losses of €2,838,360 from incorporation to 31 December 2005 and expects to incur additional losses in trying to bring identified products to market.

Subsequent to the year end, the group received additional funding of USD7m in January 2006 and USD17.5m in July 2006 in accordance with the terms of a combination agreement dated 29 December 2005.

Based on funding received after the balance sheet date, the directors believe that the company has sufficient funds for the next stage of product development and that it is therefore appropriate to prepare the financial statements on a going concern basis. Beyond this stage, there are risk factors inherent to the business and its potential to generate future revenues.

If the funds available to the company are not sufficient to enable completion of further stages of the development phase, or if the medicinal products being developed do not achieve successful commercial launch, thereby generating ongoing funding, the going concern basis of preparation may not be appropriate.

The financial statements do not include any adjustments that would result from a failure to develop a commercial medicinal product and to generate future revenues. In these circumstances, adjustments would have to be made to reduce the carrying value of assets to their realisable amount, to provide for any further liabilities which might arise and to reclassify fixed assets as current assets.

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2. Accounting policies

Accounting convention

The financial statements are prepared under the historical cost convention and in accordance with the Financial Reporting Standard for Smaller Entities (effective January 2005).

Consolidated financial statements and cash flow statement

The company has taken advantage of the exemption granted by section 248 of the Companies Act 1985 and has not prepared group financial statements.

The company has taken advantage of the exemption available for smaller entities under FRS 1 and has not included a cash flow statement in these financial statements.

Functional currency

The financial statements are prepared in euros, which is the company's functional currency.

Tangible fixed assets and depreciation

Tangible fixed assets are stated at cost less depreciation. Depreciation is provided at rates calculated to write off the cost less estimated residual value of each asset over its expected useful life, as follows:

Fixtures, fittings and equipment - over 2 years under reducing balance method

The carrying values of tangible fixed assets are reviewed for impairment in periods if 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)

Investments

Fixed asset investments are stated at cost less provision for diminution in value. The carrying values of fixed asset investments are reviewed for impairment in periods if events or changes in circumstances indicate the carrying value may not be recoverable.

Research and development

Expenditure on research and development, including the cost of licences granted under patents, is charged to the profit and loss account in the year in which it is incurred.

Deferred taxation

Deferred taxation 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 right to pay less or to receive more tax, with the following exception:

- deferred tax assets are recognised only to the extent that the directors consider that it is more likely than not that there will be suitable taxable profits from which the future reversal of the underlying timing differences can be deducted.

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

Foreign currency translation

Monetary assets and liabilities denominated in foreign currencies are translated into euros at the rates of exchange ruling at the balance sheet date. Transactions in foreign currencies are recorded at the rate ruling at the date of the transaction. All differences are taken to the profit and loss account.

3. Operating loss

This is stated after charging:

	Year ended 31 December 2005	*Period from 30 April 2004 to 31 December 2004*
	€	*€*
Depreciation of tangible fixed assets	4,660	2,724
Auditor's remuneration	40,419	5,000
Foreign exchange loss	77	5
Fees payable to group undertakings	664,100	–
Research and development costs	984,257	392,402

4. Employee information

The company had no employees during the year (period ending 31 December 2004 - nil) other than the directors and no staff costs were incurred except as disclosed in note 5.

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Notes to the financial statements

at 31 December 2005

5. Directors' emoluments

	Year ended 31 December 2005 €	Period from 30 April 2004 to 31 December 2004 €
Value of shares issued as consideration for services to the company	–	126,000
Other emoluments	106,050	97,500
	106,050	223,500

The company pays fees to other group undertakings (note 3) for services which include those of the company's directors. It is not possible to determine the amount of such fees that related to the services of the directors.

6. Interest receivable/paid

	Year ended 31 December 2005 €	Period from 30 April 2004 to 31 December 2004 €
(a) Interest on loan to group company	7,494	–
(b) Interest paid on 12% convertible loan notes	(15,854)	–

7. Tangible fixed assets

	Fixtures, fittings and equipment €
Cost:	
At 1 January 2005	8,172
Additions	7,612
At 31 December 2005	15,784
Depreciation:	
At 1 January 2005	2,724
Charge for the period	4,660
At 31 December 2005	7,384
Net book value:	
At 31 December 2005	8,400
At 1 January 2005	5,448

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Notes to the financial statements

at 31 December 2005

8. Investment

	Investment in subsidiary undertaking
	€
Cost:	
At 1 January 2005	–
Additions	13,080
At 31 December 2005	13,080

The company holds all of the issued share capital of Xytis SARL which is incorporated in Switzerland and conducts research on behalf of the company.

	Capital and reserves 2005	*Profit for the year 2005*
	€	*€*
Xytis SARL	73,313	60,233

9. Debtors

	2005	*2004*
	€	*€*
Amounts owed by group undertakings	63,067	–
Other debtors	18,349	–
Prepayment	401	–
	81,817	–

Included in other debtors is a current account balance of €18,346 due from a director, W Tschollar.

10. **Creditors:** amounts falling due within one year

	2005	*2004*
	€	*€*
Bank overdraft	–	8
Amounts owed to group undertakings	150,365	–
Trade creditors	292,941	11,998
Other creditors	–	1,897
Accrued expenses	29,500	24,500
	472,806	38,403

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Notes to the financial statements

at 31 December 2005

11. Share capital

	Authorised	*Authorised*
	2005	*2004*
	€	*€*
Ordinary shares of €0.01 each	2,000	2,000
Ordinary A shares of €0.01 each	26,000	15,000
Deferred shares of £1	1	1
	28,001	17,001

	Allotted, called up and fully paid	
	2005	*2004*
	€	*€*
130,000 ordinary shares of €0.01 each	1,300	1,300
2,515,854 ordinary A shares of €0.01 each	25,159	15,000
1 deferred share of £1	1	1
	26,460	16,301

During the year, the company issued a total of €1,000,000 of 12% convertible loan notes. Under the terms of the instrument drawn up to constitute the issue, the loan notes were convertible to ordinary A shares of the company.

On 15 July 2005, the authorised share capital of the company was increased, by ordinary resolution of the company, by €11,000 by the creation of 1,100,000 ordinary A shares of €0.01 each.

On 7 October 2005, 1,015,854 ordinary A shares of €0.01 each were issued and fully paid at a price per share of €1.00 through the conversion of the €1,000,000 loan notes plus accrued interest on the notes up to that date of €15,854.

The ordinary A shares and the ordinary shares rank pari passu, with the exception that at any meeting of the company to wind the company up, the ordinary A shareholders shall have, as a class, 75% of the voting rights. On written notice, the ordinary A shares can be converted and re-designated as ordinary shares.

The deferred share shall have no rights to vote or receive a dividend. On a winding up, the deferred shareholder shall be entitled to the amount paid up in respect of the share after the other shareholders in the capital of the company have received 1,000 times the amount subscribed by them.

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Notes to the financial statements

at 31 December 2005

12. Statement of movements on reserves and reconciliation of shareholders' funds

	Share capital	*Share premium account*	*Profit and loss account*	*Total*
	€	€	€	€
On incorporation	–	–	–	–
Retained loss for the period	–	–	(698,620)	(698,620)
Shares issued during the period	16,301	1,613,700	–	1,630,001
At 31 December 2004	16,301	1,613,700	(698,620)	931,381
Loss for the year	–	–	(2,139,740)	(2,139,740)
Shares issued during the year	10,159	1,005,695	–	1,015,854
At 31 December 2005	26,460	2,619,395	(2,838,360)	(192,505)

13. Controlling party

The company's ultimate controlling party is Atlas Venture Associates VI, LP, a venture capital group incorporated in the United States. On 29 December 2005, the company's shareholders entered into a combination agreement with Xytis Inc. a United States Delaware incorporated company. Under the terms of the agreement, the company's shareholders agreed to transfer all their shares in the company to Xytis Inc. in exchange for shares in Xytis Inc. With effect from 29 December 2005, the company's immediate controlling party is Xytis Inc.

During the year, the company was recharged €192,405 (2004 - €43,900) by Atlas Venture Associates VI, LP for development costs. The balance owned to that company at the year end was €13,240 (2004 - €17,500).

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Schedule of expenses

for the year ended 31 December 2005

	Year ended 31 December 2005 €	Period from 30 April 2004 to 31 December 2004 €
Research and development costs		
Business development costs	282,564	83,318
Clinical development costs	259,617	9,084
Preclinical development costs	88,530	–
Chemistry, manufacturing costs	69,875	–
Licences granted under patents	250,000	300,000
Other costs	33,671	–
	984,257	392,402
Premises costs		
Rent	–	7,948
Administration costs		
Subsidiary management and service costs	664,100	–
Repairs and maintenance	3,876	1,028
Motor running expenses	223	32
Legal and professional fee	88,764	4,806
Printing, postage and stationery	3,015	111
Telephone and communication	8,495	602
Subscription and newspapers	704	177
Accountancy	16,512	2,000
Audit fees	40,419	5,000
Directors emoluments	106,050	223,500
Registration costs	–	22,420
Computer costs	29,465	3,411
Congress costs	5,000	2,477
Depreciation	4,660	2,724
Travel expenses	165,143	29,202
Temporary staff	9,542	–
Bank charges	878	775
Foreign exchange charges	77	5
Membership fees	200	–
	1,147,123	297,490
Financial charges		
Loan interest from fellow group companies	(7,494)	–
Interest paid on 12% convertible loan notes	15,854	–
	(8,360)	–
	2,139,740	698,620

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