

## About Arpida

Arpida is a biopharmaceutical company that focuses on the discovery and development of novel pharmaceutical products for the treatment of bacterial infections.

### Mission

Arpida's mission is to discover and develop innovative drugs and provide caregivers with novel therapies to overcome the "antibiotic crisis".

### Vision

Arpida aims to become a world-leading biopharmaceutical company in the area of antibacterial drugs. The longer term goals are to complement the integrated research and development capabilities with a hospital-focused sales and marketing infrastructure and to co-promote, co-develop or out-license product candidates with major pharmaceutical or biopharmaceutical companies, provided satisfactory terms and conditions can be achieved.

## Highlights & Outlook

### 2005 Highlights

- ▶ Excellent pipeline progress:
  - Lead compound, intravenous iclaprim, received US FDA fast-track product designation and is in global Phase III clinical trials for complicated Skin and Skin Structure Infections
  - Positive results from a Phase I lung study with intravenous iclaprim paving the way for its development in nosocomial pneumonia, a second major indication
  - IND approved by the US FDA for oral iclaprim and initiation of Phase I programme
  - Confirmation of the potential of AR-709 for the treatment of respiratory tract infections in the community based on *in vitro* microbiological studies
- ▶ Cash resources of CHF 122.4 million at 31 December 2005, which provides strategic flexibility to progress clinical product candidates towards commercialisation
- ▶ Initial Public Offering on Main Segment of the SWX Swiss Exchange raising CHF 97.2 million
- ▶ Prof. John G. Bartlett, a leading authority on infectious diseases, appointed to Scientific Advisory Board
- ▶ Dr. Nicholas Coppard appointed as Head of Development

### Post Year-end Events

- ▶ Safety and bioavailability data from Phase I studies with oral iclaprim confirm potential for "intravenous to oral" switch therapy and outpatient treatment
- ▶ Chief Operating Officer and Director Dr. Dieter Gillessen, one of Arpida's founders, to retire

### 2006 Outlook

- ▶ Further pipeline progress expected:
  - Interim report from independent Data and Safety Monitoring Board on Phase III clinical trial for intravenous iclaprim
  - Completion of patient recruitment in first of two Phase III trials for intravenous iclaprim
  - Evaluation of programme of intravenous iclaprim in nosocomial pneumonia
  - Completion of Phase I trial programme for oral iclaprim
  - IND-enabling studies and initiation of "first-in-man" study for AR-709
  - Advancement of preclinical research programmes
- ▶ Continued careful control on costs

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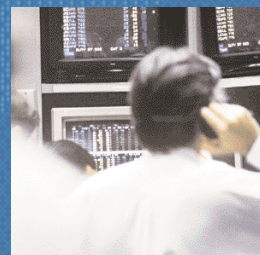
This annual report contains certain forward-looking statements. These forward-looking statements may be identified by words such as "believes", "expects", "anticipates", "projects", "should", "seeks", "estimates", "future" or similar expressions or by discussion of, among other things strategy, goals, plans or intentions. Various factors may cause actual results to differ materially from those reflected in the forward-looking statements contained in this annual report.

This annual report is available in English and German. In case of discrepancies, the English version prevails.

# Clear Lines of Progress

*Arpida progressed very well in 2005. We raised CHF 97.2 million in the stock market and transitioned from a private to a public company. We started the year with intravenous iclaprim in clinical trials and by the end of the year we also initiated the clinical programme with oral iclaprim. Intravenous iclaprim moved from Phase II into Phase III. We intend to keep up the pace in 2006. Ultimately, all efforts are aimed at progressing our compounds towards the market.*

**CHF 250.5 million** market capitalisation at year-end 2005



**Phase III** for intravenous iclaprim



It is great to work at the cutting edge of science, coming up with new compounds that have the potential to progress into development. Ilknur Durand-Oral, Chemistry

**Headcount** 82 people, up from 72 last year, including 36 Ph.D.s



# Letter to Our Shareholders

## Dear shareholder

The year 2005 was a very eventful and successful one for Arpida. We completed the flotation of our shares on the SWX Swiss Exchange, our lead compounds progressed well on their respective development paths and we managed to strengthen our organisation.

Since 4 May 2005 the Arpida share has been listed on the Main Segment of the SWX Swiss Exchange under the symbol ARP.N. Our Initial Public Offering (IPO) was one of the largest in European Biotech in 2005. Despite tough market conditions, we raised the full amount that we were looking for: CHF 97.2 million (before expenses). After a difficult first day of trading, the share recovered and ended the year at CHF 15.30. During the first months of 2006, the share has risen further and at 24 February it stood at CHF 21.85.

Iclaprim and AR-709, our lead compounds, progressed well in 2005. After promising Phase II results, intravenous iclaprim entered the third and final phase of clinical trials for its first indication, the treatment of complicated Skin and Skin Structure Infections (cSSSI). In August 2005, the US Food and Drug Administration (FDA) granted fast track status to this programme, and we expect to be able to report further progress during 2006.

Moreover, good results of a special Phase I trial have paved the way for additional trials of intravenous iclaprim for the treatment of nosocomial pneumonia as a second important indication.

Clinical trials with the oral formulation of iclaprim got under way in 2005 and in early 2006 we announced results of several Phase I trials. These showed that oral formulations of iclaprim can achieve therapeutic doses comparable with intravenous iclaprim. Further Phase I trials are planned during the year, which are expected to provide the foundation for later-stage clinical trials.



*From left: Dr. Khalid Islam, President and CEO, and Dr. André Lamotte, Chairman of the Board of Directors*

We strongly believe that the availability of an oral formulation will be one of the key differentiating features of iclaprim over virtually all of the antibiotics for the treatment of bacterial infections including MRSA. Iclaprim can be offered not only as an intravenous therapy for hospital use in acute situations, but also as an oral formulation, allowing early patient discharge and outpatient treatment. This switch should be a valuable instrument in reducing healthcare costs and enhancing patient comfort.

The Board greatly appreciates the efforts made in 2005 and is confident of continuing good progress in 2006.

Our third product candidate, AR-709, progressed well through preclinical efficacy testing in 2005. The results of *in vitro* studies, completed in the fourth quarter indicated that AR-709 could present a valuable therapeutic against upper and lower respiratory tract infections. We are currently performing IND-enabling studies and plan to start first-in-man studies later this year.

The Arpida organisation continued to develop well in 2005. The Copenhagen centre, acquired late 2004, is by now well-embedded. Moreover, we managed to attract a number of highly qualified staff to strengthen our organisation and to best support the next phases of product development. Overall, the number of staff grew from 72 at year-end 2004 to 82 at the end of the year under review.

In financial terms, the year evolved as expected. We have maintained a diligent watch on the cost base and kept the cash burn low. At year-end 2005 the cash balance was CHF 122.4 million.

As at year-end 2005, Arpida has every reason to look into the future with confidence. With iclaprim, we have a promising compound in the final phase of clinical trials. We believe that iclaprim has the potential to be welcomed by care-givers as an important addition to their armamentarium in the fight against bacterial infections.

Our organisation remains lean, flexible and determined to get our product candidates to market.

Moreover, partly thanks to the IPO of May 2005, our cash position is strong. We are fully funded to complete the ongoing clinical trials for iclaprim and progress AR-709 into the clinic. Of course, partnerships could offer opportunities, but we retain the strategic flexibility to proceed independently.

In 2006 we will be saying goodbye to one of the founders of our company: Dr. Dieter Gillessen. He is now 70 years old and will be enjoying his well-deserved retirement. He has made a crucial contribution to Arpida's development and this company owes a lot to his expertise and dedication.

We are convinced 2006 will be another exciting year for Arpida. We are looking forward to the challenges lying ahead, knowing we have the product, the team and the financial resources to be successful. We delivered on our promises in 2005, and we intend to keep doing this.

The Board of Directors wishes to thank all those who contributed to Arpida's progress in 2005, including employees, shareholders and business partners. Your dedication to Arpida is essential for its success.

Best regards,



Dr. André Lamotte  
Chairman of the  
Board of Directors



Dr. Khalid Islam  
President and CEO

Münchenstein, 24 February 2006

# Arpida's Stock and Financial Review

## Arpida's Stock

Arpida shares have been listed on the Main Segment of the SWX Swiss Exchange on 4 May 2005 under the symbol ARP.N. The Reuters code is ARP.N.S, the Swiss Valoren number is 2121806, and the ISIN code is CH 0021218067. The stock ended the year at CHF 15.30 and rose to a level of CHF 21.85 at 24 February 2006. At year-end 2005 Arpida's market capitalisation amounted to CHF 250.5 million.

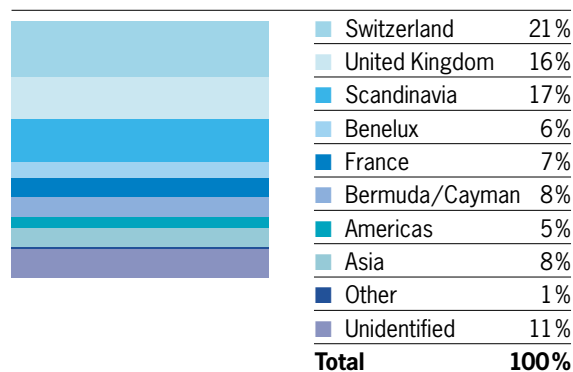
As far as Arpida is aware, the following shareholders had holdings of over 5% as at 31 December 2005.

Shareholder	Location	% of issued share capital
Health Cap Funds*	Sweden	8.5%
HBM Bioventures	Cayman Islands	6.8%
3i Group plc	United Kingdom	6.4%

\*including associated shareholders

The shares of the pre-IPO investors, in total representing 67% of the capital as of 31 December 2005, are subject to a lock-up of a maximum of 12 months starting from the listing date. Furthermore, the members of Arpida's Board of Directors as well as the Chief Financial Officer will observe an additional lock-up of a maximum of six months for two thirds of their shares and options.

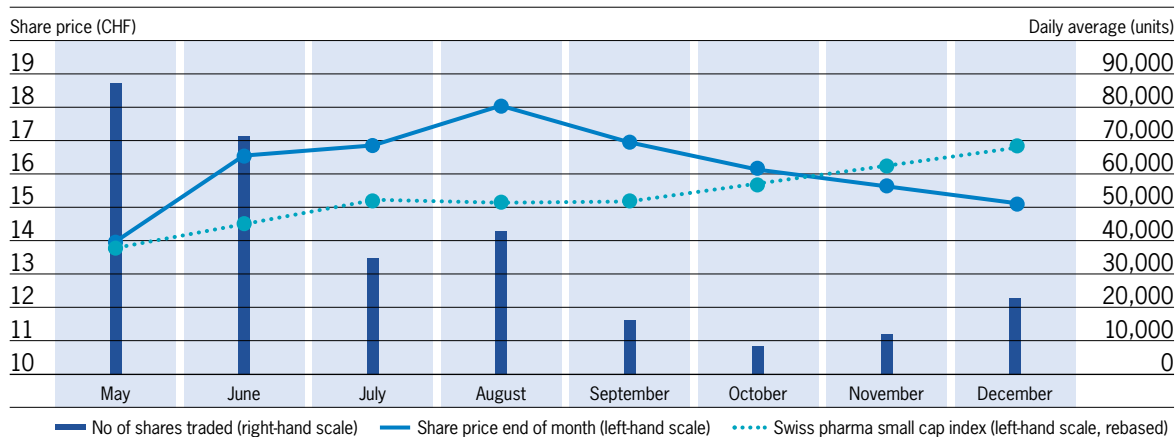
Arpida has only registered shares outstanding. At year-end 2005, 89% of all shares have been traced. Some 90% of the traced shares were held by institutional investors, with the remainder being held by private shareholders. In total, some 850 shareholders are entered in the register. The geographical split was as follows:



Source: Arpida share register December 2005

Apart from the banks which were involved in the IPO (Deutsche Bank, Bank Julius Bär, Lombard Odier Darier Hentsch and swissfirst Bank/Bank am Bellevue), Bank Vontobel initiated equity research coverage of Arpida during 2005. In December 2005, 4 of the 5 research analysts covering the stock had a positive recommendation, with the 5th being neutral on the share.

## Development of share price and trading volumes in 2005



Source: SWX, Arpida

## Financial Review

### Key financial indicators

CHF mn	2005	2004
Research and development expenses	(29.2)	(17.6)
Management and general expenses	(7.3)	(5.0)
Net result	(35.1)	(23.1)
Cash at year-end	122.4	68.2
Equity at year-end	130.9	75.6

### Results

In 2005, Arpida did not generate any revenues while in 2004 revenues of CHF 58,360 were recorded from a fee-for-service transaction. Arpida A/S was acquired on 14 October 2004, and its costs in 2004 were only reflected for the remaining 2½ months until 31 December 2004. For 2005, the costs for the full year are included in the consolidated result, leading to higher research and development expenses as well as higher general and management expenses in 2005.

Research expenses relate to the costs of discovery efforts, including but not limited to costs for research staff, consumables and rent for laboratory space used. Furthermore, research expenses include other direct costs such as purchases of compound libraries or costs incurred on external screening of Arpida's compounds. Development expenses primarily relate to costs incurred in conjunction with pre-clinical and clinical trials.

Research and development expenses increased from CHF 17.6 million in 2004 to CHF 29.2 million in 2005, primarily due to (i) the increased spending for pre-clinical and clinical trials (in particular for the Phase III clinical trials with intravenous iclaprim), (ii) the hiring of additional staff, largely in the clinical development team and (iii) the effects of the full-year consolidation in 2005 of Arpida A/S.

Management and general expenses increased from CHF 5.0 million in 2004 to CHF 7.3 million in 2005, due again in part to the full-year consolidation of Arpida A/S and partly to the fact that additional administrative, corporate and senior management functions were filled in conjunction with the ongoing clinical trials and the listing of Arpida AG.

As a result, the operating loss for the year 2005 amounts to CHF 36.5 million (2004: CHF 22.5 million). Taking into consideration the positive effect of the financial result of CHF 1.4 million in 2005, the net loss for 2005 amounts to CHF 35.1 million (2004: CHF 23.1 million).

### Balance sheet and cash flow

On a net basis, cash and cash equivalents at hand increased from CHF 68.2 million as of 31 December 2004, to CHF 122.4 million as of 31 December 2005. On the one hand, the cash position increased by the CHF 97.2 million (CHF 89.3 million after capital increase

At year-end 2005, Arpida had a market capitalisation of CHF 250.5 mn. The shareholder base is well-diversified. In financial terms the year 2005 evolved as expected.

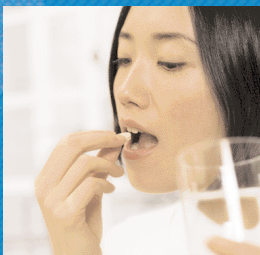
related expenses) raised in the Initial Public Offering of 4 May 2005. On the other hand, operating activities required cash resources of CHF 33.4 million, up from CHF 21.1 million in 2004.

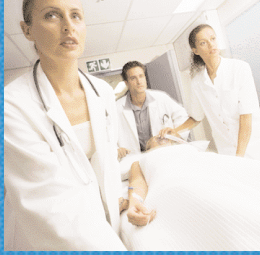
The increase in the equity position in 2005 by CHF 55.3 million to CHF 130.9 million at year-end was largely due to the two factors described above.

# Infectious Diseases Do Not Respect Boundaries

*Bacterial resistance against the antibiotics that were introduced into the market during past decades is rising rapidly, posing a huge threat to public health worldwide. According to Robert Rapp, Professor of Pharmacy, Lexington, Kentucky: "By the year 2010, many antibiotics used today won't be worth the plastic they're bottled in."*

**+ 25%** Expected growth rate of branded anti-MRSA antibiotics 2002–2008 (Source: Goldman Sachs)





2 million Nosocomial infections in the US (Source: CDC)



USD 26 billion Global antibiotics market 2005 (Source: Wood Mackenzie)

There is a large unmet medical need for new antibiotics. This knowledge instills us all with a clear sense of urgency and responsibility. Chouaib Tahtaoui, Ph.D., Chemistry



# The Antibiotics Market: Crisis and Opportunity

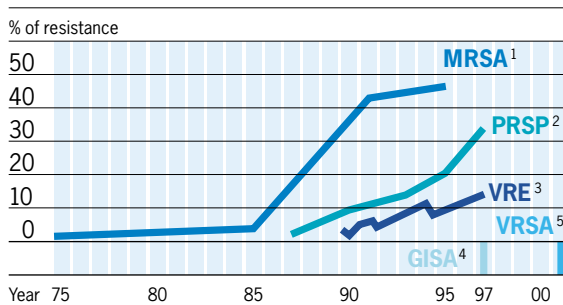
## The antibiotics crisis

Antibiotics were considered miracle drugs when they first became available more than 60 years ago. Penicillin, the first antibiotic, quickly became the drug of choice to cure “every infection”, saving the lives of millions of people.

However, bacteria increasingly developed resistance to the most commonly used antibiotics, leading to a situation in which, according to the US National Institute of Allergy and Infectious Diseases (NIAID), hospitals worldwide are facing an unprecedented crisis from the rapid emergence and dissemination of microbes resistant to one or more anti-infectives. It has been shown that around 70% of infections acquired in US hospitals are caused by bacteria resistant to at least one antibiotic.

Nowadays, it is estimated that bacterial infections lead to around 17 million deaths worldwide. Furthermore, geographical borders provide no barriers to infections and in today’s global village, outbreaks in one part of the world can rapidly transmit to another, as demonstrated by SARS, bird flu and tuberculosis.

## Resistance rate in Gram-positive pathogens in the US



- 1 MRSA = methicillin-resistant *Staphylococcus aureus*  
Source: Smith TL et al. N Engl J Med. 1999;340:493–501
- 2 PRSP = penicillin-resistant *Streptococcus pneumoniae*  
Source: Paladino JA. Am J Health Syst Pharm 2000; 57 suppl 2: s10–2
- 3 VRE = vancomycin-resistant *Enterococci*  
Source: Martone WJ. Infect Control Hosp Epidemiol. 1998;19:539–545
- 4 GISA = glycopeptide intermediate-resistant *Staphylococcus aureus*  
Source: Hiramatsu K et al. J Antimicrob Chemother. 1997;40:135–136
- 5 VRSA = vancomycin high-level resistant *Staphylococcus aureus*  
Source: CDC. MMWR Morb Mortal Wkly Rep. 2002;51:565–567

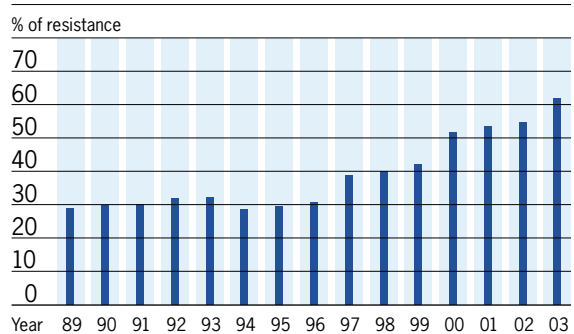
## The “superbug” MRSA

Of all resistant bacteria, methicillin-resistant *Staphylococcus aureus* (MRSA) is a particularly challenging one. Often, a patient with an unidentified bacterial infection is treated initially with a penicillin (first line). If this antibiotic does not have the desired effect, methicillin is available as a second line of defence. If the bacteria prove to be resistant to this drug as well, vancomycin is used as a last resort treatment.

However, with resistance rates of 70%, the likelihood of success of the first and second line therapeutics is low, blurring the traditional dividing lines between first, second and last resort treatment. This is perhaps best highlighted by the fact that some 26 million doses of vancomycin per year are used.

If bacteria develop resistance to vancomycin, the first signs of which have already surfaced, even the traditional treatment of last resort will lose its value against MRSA. This would present clinicians with a very serious problem.

## Resistance rates to the “superbug” MRSA in the USA



Proportion of *Staphylococcus aureus* resistant to Oxacillin (MRSA) among intensive care unit patients, 1989–2003 (Source: NNIS System, data for 2003 are incomplete)

### Global anti-infectives market

The global market for anti-infectives represents the third-largest worldwide pharmaceutical drug segment, with sales of over USD 45 billion in 2004 according to Wood Mackenzie. Of this total, some USD 26 billion constituted sales of antibacterial products. Bacterial infections remain a major cause of death worldwide.

According to data of the US Center for Disease Control and Prevention (CDC), more than two million people in the US alone contract serious hospital-acquired infections each year, resulting in approximately 90,000 deaths.

The number of community-acquired infections in the US is estimated at 10 million per year, with more than half being respiratory tract infections.

During the 1970s and 1980s, pharmaceutical companies developed many antibiotics from existing antibacterial classes and introduced them on to the market. As many of these therapeutics proved to be highly effective in treating infectious diseases, pharmaceutical companies shifted their discovery and development focus and resources to other therapeutic areas.

As a consequence, until recently, no antibacterial agents from a new chemical class had been introduced in over 25 years. Since 2000 only three new antibiotics with activity against MRSA have entered the market (Pfizer's Zyvox<sup>®</sup>, Cubist's Cubicin<sup>®</sup> and Wyeth's Tygacil<sup>®</sup>).

Many large pharmaceutical groups have reduced their research efforts in antibiotics, creating an attractive opportunity for smaller, financially nimble companies like Arpida.

### Arpida's opportunity

For a company like Arpida, the antibiotics market is very attractive. The withdrawal of large pharma companies from research in this area has meant that focused, innovative and financially nimble companies have been able to acquire promising programmes and experienced R&D personnel.

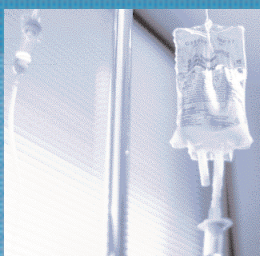
The attraction of the antibiotics market is not only driven by its size and the increasing unmet medical need; there are also several features of anti-infectives research that lower the risk profile compared with other therapeutic areas:

- Preclinical outcomes are more predictive; preclinical infectious disease models use the same organism that causes disease in humans.
- Clinical trials endpoints are well-defined and unambiguous (i.e. clinical cure and microbiological eradication).
- Anti-infectives have the greatest success rate from investigational new drugs (IND) to market among the four largest therapeutic areas (anti-infective, anaesthetic/analgesic, CNS and cardiovascular).

Arpida believes it has the product and pipeline, the team and the financial resources, strategy and flexibility to successfully bring new and effective antibacterial products to patients.

# Innovative Products toward Market

*Arpida focuses on the discovery and development of novel pharmaceutical products for the treatment of bacterial infections. The current portfolio of research compounds and product candidates can be considered to be one of the strongest in its field. Lead product candidate iclaprim is well on track in Phase III.*



**Intravenous iclaprim** is well on track in Phase III

**Oral iclaprim** successfully completes several Phase I trials

**AR-709** initiates IND-enabling package





These minute bacteria are tough adversaries. Finding new ways to attack them and bypass their defence mechanisms is a constant challenge. Muriel Bühr, Biology

# Research and Development

## iclaprim

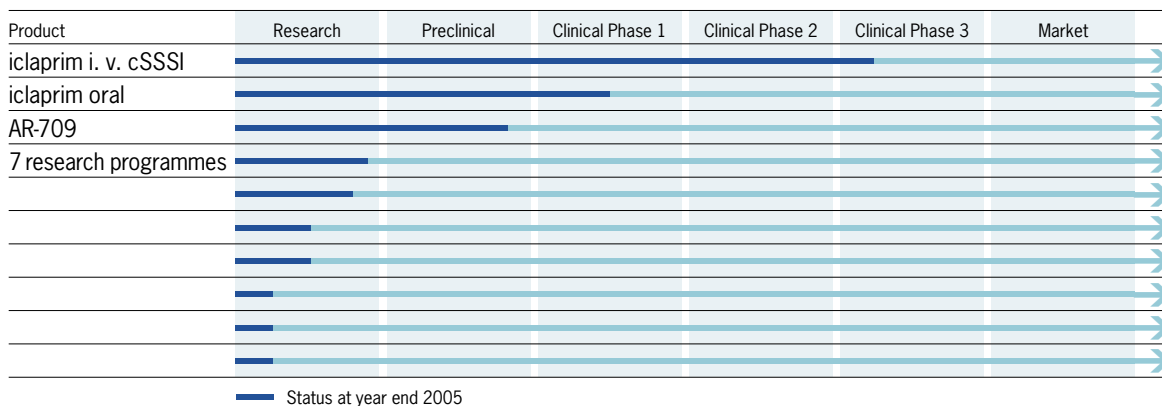
Arpida's lead development compound is currently known by its compound name "iclaprim". It is a potent antibiotic that is active against many multidrug-resistant bacteria, including methicillin-resistant *Staphylococcus aureus* (MRSA). Arpida obtained exclusive unencumbered ownership rights of iclaprim from Roche in 2001 in exchange for a one-time payment and additional future royalty payments which are fixed as a single-digit percentage of net sales. The intellectual property status is strong. Two development programmes are underway: one for an intravenous and one for an oral formulation.

Iclaprim is a member of the diaminopyrimidines class of antibiotics. Iclaprim targets dihydrofolate reductase (DHFR), an enzyme in the bacterium fulfilling an essential step in bacterial DNA synthesis. DHFR is a well-studied, but commercially under-exploited target.

Based on the results of tests conducted so far, iclaprim is expected to have several important characteristics, which should enable it to secure a good position upon market entry. These include:

- broad spectrum of activity
- potent activity against Gram-positive pathogens, including MRSA
- rapidly bactericidal, "killing" action on bacteria
- low propensity for development of resistance
- good distribution in tissues and organs
- safe and well-tolerated
- ease of administration
  - twice daily
  - possibility to switch from intravenous to oral formulation

## Pipeline



### First indication: complicated Skin and Skin Structure Infections

After successful completion of Phase II clinical trials, Arpida received clearance in March 2005 from the FDA to include US centres in the Phase III clinical trials for intravenous iclaprim for its first indication: complicated Skin and Skin Structure Infections (cSSSI).

The global Phase III ASSIST studies (Arpida's Skin and skin Structure Infection STudies) are designed to compare the efficacy and safety of iclaprim with that of market leader linezolid (marketed by Pfizer as Zyvox®).

In August 2005, the FDA granted fast-track status to intravenous iclaprim for the treatment of cSSSI, citing the following rationale:

- ▶ Iclaprim is being developed to treat potentially life-threatening conditions, including infections attributed to MRSA.
- ▶ Iclaprim offers the potential for alternative treatment for those patients who may not be able to tolerate currently existing therapies.
- ▶ Iclaprim may offer potential benefit in the treatment of community-acquired MRSA infections.

Selection of clinics and patient enrolment is progressing as planned and Arpida expects to report the findings of an independent Data and Safety Monitoring Board (DSMB) based on an interim safety data analysis during the first half of 2006. A positive report would permit the ASSIST clinical programme to continue as planned.

In addition, results from several Phase I trials, studying special populations and drug-drug interactions, are expected over the next months. The first of the two ASSIST trials is due to complete by late 2006.

### **Nosocomial pneumonia – a second important indication**

In June 2005, the results of a special Phase I clinical trial determining iclaprim concentrations in the lung were announced, confirming that iclaprim achieves

high concentrations in the specific compartments of the lung where clinically relevant pathogens, including MRSA, are most commonly found. These results pave the way for additional trials of iclaprim for the treatment of nosocomial pneumonia as a second important indication. A programme for this indication is currently under evaluation.

### **Oral iclaprim**

In July 2005, the US FDA approved an Investigational New Drug application (IND), allowing Arpida to file clinical studies of oral iclaprim with the FDA.

Iclaprim targets multiple indications. The potential switch from intravenous to oral is one of the key differentiating features for iclaprim.

In 2005, clinical trials were initiated in Europe. Early in 2006, Arpida announced results of several trials within this Phase I programme, which showed that oral administration (solution and capsule) of iclaprim can easily achieve blood levels comparable with those of therapeutic doses of intravenous iclaprim. A further trial to determine the maximum tolerated dose is currently ongoing. Additional Phase I trials are planned during the year which are expected to provide the foundation for later-stage clinical trials.

Arpida strongly believes that the availability of an oral formulation will be one of the key differentiating features of iclaprim over virtually all of the antibiotics for the treatment of bacterial infections including MRSA.

Iclaprim can be offered not only as an intravenous therapy for hospital use in acute situations, but also as an oral formulation, allowing earlier discharge from hospital and out-patient treatment. This switch should be a valuable instrument in reducing healthcare costs and enhancing patient comfort.

## AR-709

AR-709 originates directly from Arpida's own drug discovery efforts. It is a bactericidal antibiotic against pathogens that cause infections of the upper and lower respiratory tract. In particular it shows potent activity against pan-resistant *Streptococcus pneumoniae* which is becoming a real threat to the community.

Unlike iclaprim which targets infections in hospitalised patients, AR-709 is aimed at the community market. Sales in this market total some USD 18 billion p.a.

An international patent on the structure, synthesis and use was filed in July 2001. In 2003, a patent on the specific synthesis, composition of matter and use of the compound followed.

In preclinical tests, AR-709 effectively sterilised the lung tissue. Moreover, preclinical testing has shown that the compound could have characteristics that would make it a valuable addition to the general practitioner's armamentarium for the treatment of streptococcal infections. They include:

- ▶ potent against multidrug-resistant pathogens
- ▶ bactericidal
- ▶ low propensity for development of resistance
- ▶ potential for once-daily dosage

In October 2005, a preclinical study conducted by Prof. Michael R. Jacobs of the University of Cleveland was completed. AR-709 demonstrated a potent ability to eradicate pathogens such as *Streptococcus pneumoniae*, which were resistant to commonly used antibiotics such as penicillins, macrolides and cotrimoxazole.

Arpida is currently undertaking IND-enabling studies and expects to start first-in-man studies during 2006.

AR-709 addresses the community market, sales in this market total some USD 18 billion per annum.

## Research

Arpida's discovery platform consists of an integrated multidisciplinary approach to identify novel classes of antibiotics. In particular, Arpida seeks to identify antibiotics acting via novel mechanisms of action, focusing on the secretion pathway, gene regulation, protein synthesis (non-ribosomal), sugar transport and response cascade of bacteria, as well as on novel cell wall targets. Such drugs should be able to overcome the resistance problems associated with current clinical therapies and be active on new emerging pathogens while showing good safety in disease-compromised patients.

The platform benefits from Arpida's strong knowledge base in antibiotic research and development, hands-on experience and access to state-of-the-art technologies. The highly integrated discovery process that has been developed exploits the combined expertise of Arpida's scientific staff in exploratory research, assay development, screening and lead generation, and lead optimisation and development.

Benefiting from this highly integrated discovery platform, 12 discovery targets have already been screened. Several new chemical hits and leads have been identified against many of these targets. Biological

profiling has indicated that these leads act on bacteria via selective inhibition of specific target proteins and constitute novel classes of antibiotics.

Arpida's research efforts are focussed on finding new chemical entities to address current and future needs. For example, in recent years topical antibiotics used in preventive medicine have seen a large increase in resistance and represent an important emerging need. Similarly, recent reports have raised serious concerns on gastrointestinal infections, particularly those caused by *Clostridium difficile*. The main programmes, aimed at these needs, are the following.

#### Topical programme

Arpida is investigating the activity of new molecular classes against novel targets. Result of this research effort has been the identification of a new series possessing good *in vitro* activity against Gram-positive and anaerobic pathogens. The compounds of this series appear to have the appropriate characteristics for development for several topical indications (e.g. prevention and treatment of MRSA skin infections). Currently, early studies are in progress to establish proof of concept, which if successful, have the potential to lead onto preclinical development later in 2006.

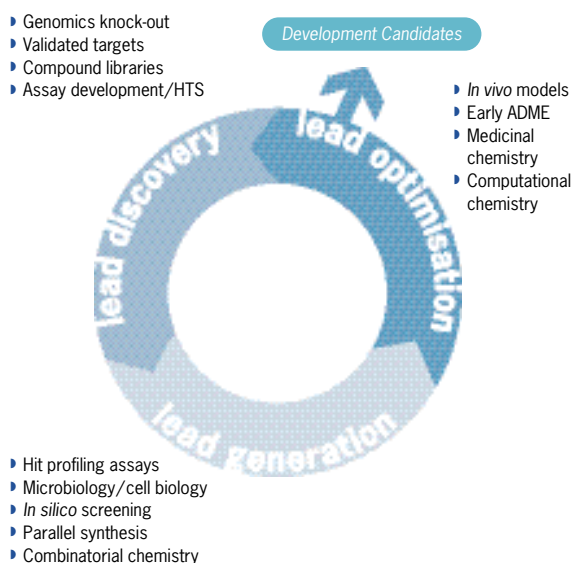
#### Gastrointestinal programme

Arpida's research team has identified molecules of different series possessing very good *in vitro* activity against *Clostridium difficile*. The molecules of these series have potential in the treatment and prevention of serious gastrointestinal infections including those caused by the emerging and difficult-to-treat multidrug-resistant *Clostridium difficile*. As above, if proof of concept is established for these molecules during 2006, preclinical development could potentially begin by late 2006 or early 2007.

Arpida's research team is working on 7 programmes with potential to enter preclinical development.

#### A fully integrated multidisciplinary R&D engine

- Genomics knock-out
- Validated targets
- Compound libraries
- Assay development/HTS

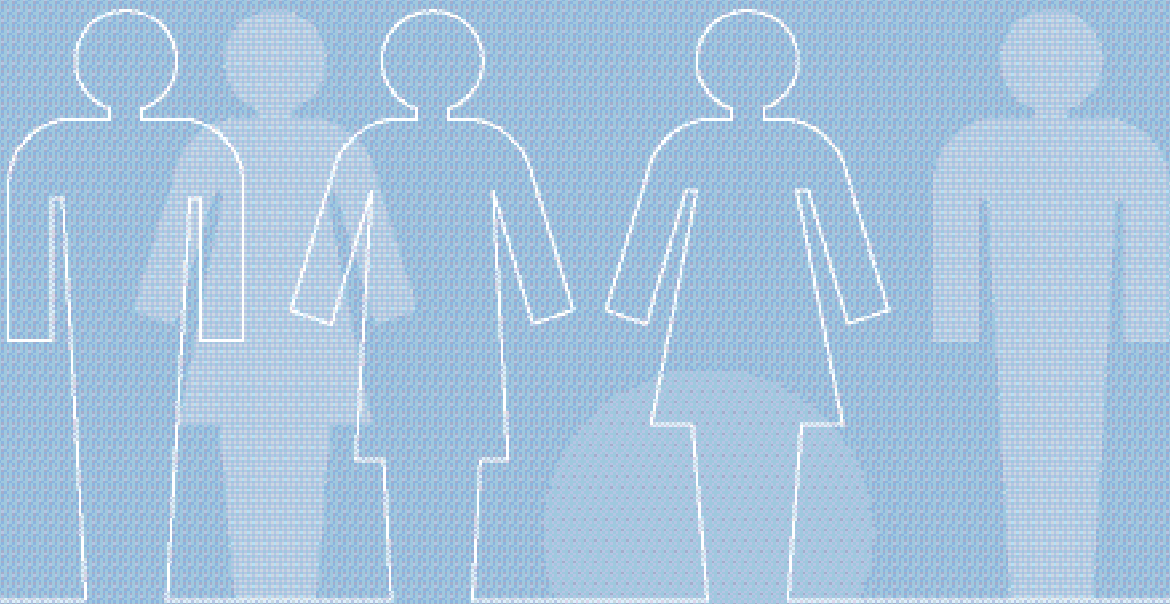


#### Five early-stage research programmes

In addition, Arpida's search for low molecular weight series acting on novel targets not exploited by any of the currently commercialised antibiotics, has led to the selection of several high affinity ligands with good inhibitory activity on their respective targets. Structural studies of ligand-target complexes are currently underway or planned to start in early 2006. These should support optimisation efforts for the series in order to improve *in vitro* and *in vivo* activities.

# Steady and Successful Growth through Teamwork

*At year-end 2005, 82 people were working for Arpida at the locations in Münchenstein and Copenhagen. Their average age is 36. Fourteen nationalities are represented. These facts, combined with short lines of communication and regular scientific interaction with colleagues, ensure a stimulating working environment.*

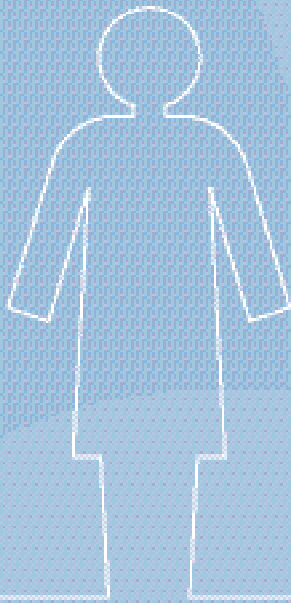


Headcount up 10 to 82 in 2005

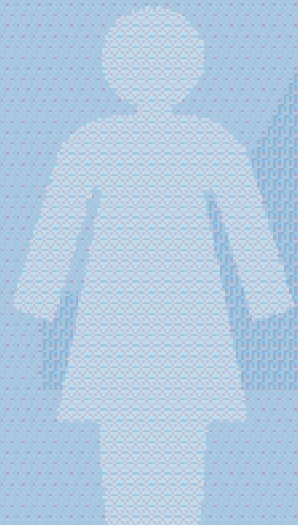




36 is the average age of Arpida's employees



36 Ph.D.s form a good scientific basis



I've seen Arpida grow from 6 to 82 people and I continue to enjoy the team spirit and international flavour of our company. *Andreas Haldimann, Ph.D., Biology*



# The Arpida Team

At year-end 2005, Arpida employed 82 people, up from 72 at the end of 2004. The growth mainly stems from the expansion of the clinical development department. This is driven by compounds moving from the laboratory into clinical trials, requiring a different set of skills.

## Number of staff

Department	Münchenstein	Copenhagen	Total
Biology	19	7	26
Chemistry	19	16	35
Clinical development	7	–	7
General and administrative	11	3	14
<b>Total</b>	<b>56</b>	<b>26</b>	<b>82</b>

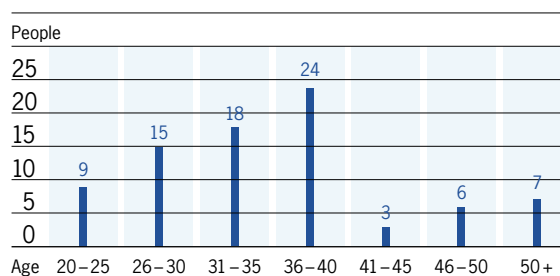
At the end of 2005, Arpida employed 36 Ph.D.s, 44% of the total headcount. In order to create a stimulating environment for them and for the laboratory staff, weekly colloquia are organised. These meetings are used to deepen and broaden the knowledge base by high level interaction with colleagues. Moreover, they offer a good platform for informing staff on progress in certain areas.

## Arpida's Scientific Advisory Board

Prof. John Bartlett	John Hopkins University, USA
Prof. Gunther Fischer	Max Planck Institute, Halle, Germany
Prof. Jörg Hacker	University Würzburg, Germany
Prof. David Hangauer	SUNY at Buffalo, USA
Prof. Günther Jung	University of Tübingen, Germany
Prof. Roberto Kolter	Harvard Medical School, USA
Prof. Edmund Lin	Harvard Medical School, USA
Prof. Henry Paulus	Boston Biomedical Institute, USA
Prof. Thomas Silhavy	Princeton University, USA
Prof. Andreas Widmer	State Hospital Basel, Switzerland
Prof. Peter Wipf	University of Pittsburgh, USA
Prof. Wolf D. Woggon	University of Basel, Switzerland

These internal meetings are supplemented by regular interaction with universities and Arpida's Scientific Advisory Board (SAB). The SAB is a group of leading experts, supplying Arpida with valuable input for the activities in research and development. Moreover, Arpida was represented at several conferences in 2005, the most important being the Interscience Conference on Antimicrobial Agents and Chemotherapy (ICAAC) in Washington D.C. At this conference, three papers (so-called "posters") were presented to the scientific community.

## Age structure Arpida at year-end 2005



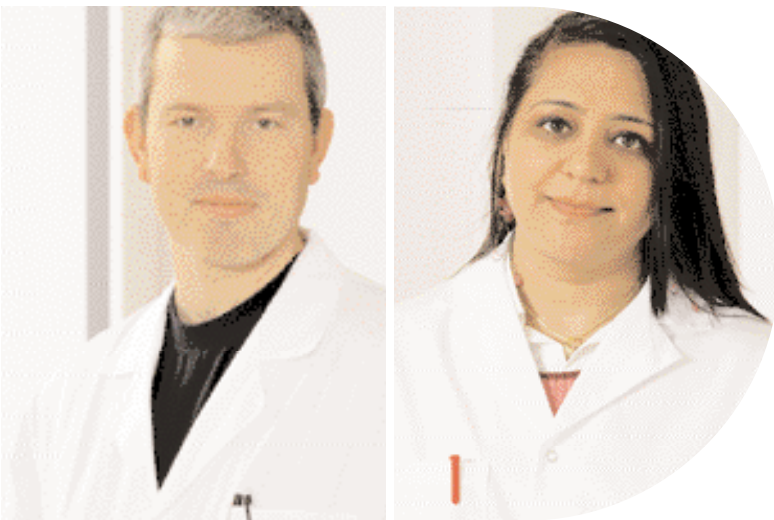
The dedication, expertise and team spirit of Arpida's people are key to the company's success.

The average age of Arpida's employees is 36 at year-end 2005, with some 80% of all staff being younger than 41.

Despite the relatively low average age of Arpida's employees, the company boasts a wealth of experience from academia, large pharmaceutical companies as well as biotechnology. The 5 Senior Executive Officers combined have some 88 years of pharma industry experience.

In total, 14 nationalities are represented, ranging from Italy to India and from the Netherlands to Morocco. The cultural mix of the staff forms a stimulating part of Arpida's corporate identity. A large part of communication takes place in English.

The relatively limited size of the company has the benefit of short lines of communication. Moreover it requires a high degree of entrepreneurship and flexibility.



# Corporate Governance

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## Group Structure and Shareholders

### Group structure

Arpida is a corporation established under the laws of Switzerland with registered office in Münchenstein (Canton of Basel-Landschaft, Switzerland).

The Arpida group consists of parent company Arpida Ltd and two wholly-owned, non-listed subsidiaries:

Name	Based	Issued share capital
Arpida UK Ltd	London, UK	£ 1,000
Arpida A/S (formerly Combio A/S)	Copenhagen, DK	DKK 4,311,583

Arpida's business purpose is to engage in the research, development and marketing of medical drugs as well as in all activities connected therewith.

The business operations are organised along the lines of the main activities: research (biology and chemistry) and development. As yet, there are no marketing operations. Arpida has 5 Senior Executive Officers, the "President", two "Senior Vice Presidents", the "Head of Research" and the "Head of Development".

### Significant shareholders

The Arpida shares have been listed on the Main Segment of the SWX Swiss Exchange since 4 May 2005, under the symbol "ARPN". As far as Arpida is aware, the following shareholders had holdings of over 5% as at 31 December 2005.

Shareholder	Location	% of issued share capital
Health Cap Funds*	Sweden	8.5%
HBM Bioventures	Cayman Islands	6.8%
3i Group plc	England	6.4%

\* including associated shareholders

The shares of the pre-IPO investors, in total representing 67% of the capital as of 31 Dec. 2005, are subject to a lock-up of a maximum of 12 months, starting at the listing date. Furthermore, the members of Arpida's Board of Directors as well as the Chief Financial Officer will observe an additional lock-up of a maximum of 6 months for two thirds of their shares.

### Cross-shareholdings

As of 31 December 2005, no cross-shareholdings existed.

## Capital Structure

### Capital

As of 31 December 2005, 16,371,959 registered common shares were issued, with a nominal value of CHF 0.20 each. At the balance sheet date, the share capital amounted to CHF 3,274,391.80. All shares are fully paid-up. As of 31 December 2005, Arpida does not hold any shares in treasury.

On 8 April 2005, an ordinary shareholders' meeting approved an increase of the authorised share capital of CHF 1,080,000, authorising the Board of Directors to issue up to 5,400,000 registered shares with a nominal value of CHF 0.20 each. All of these were placed in the IPO of 3 May 2005.

Shareholders have approved a conditional capital of CHF 387,000 by issuance of 1,935,000 shares for the company's stock option plans. For further information about these plans, reference is made to the Notes to the Accounts on page 54 and 55.

### Changes in capital

Arpida was founded on 23 July 1997, and registered in the Commercial Register of the Canton of Basel-Landschaft on 18 August 1997, with a share capital of CHF 100,000, divided into 10,000 registered common shares with a nominal value of CHF 10.00 each.

The first financing round took place during 1998/1999 and involved a total of 36,335 preference shares with a nominal value of CHF 10.00 each.

In the second financing round, which was completed in September 2000, 55,557 preference shares and 325 common shares, each with a nominal value of CHF 10.00 were placed.

On 7 May 2004, the third financing round was initiated, involving a total of 62,947 preference shares with a nominal value of CHF 10.00 each.

On 12 August 2004, Arpida made a share split exchanging each old share with a nominal value of CHF 10.00 into 50 new shares with a nominal value of CHF 0.20.

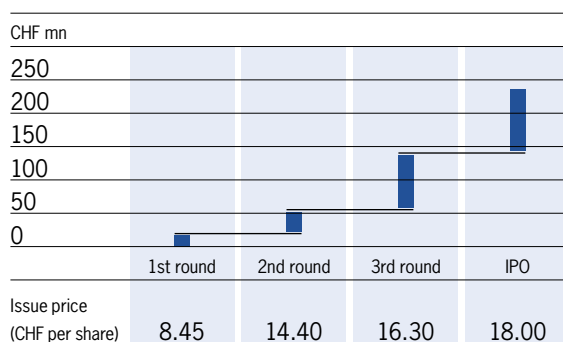
On 23 September 2004, the company continued its third financing round and issued 787,379 preference shares with a nominal value of CHF 0.20 each.

On 14 October 2004, the company issued a total of 1,865,030 preference shares to the shareholders of Combio against the contribution in kind of all shares in Combio. For this transaction, the shares were valued at the subscription price applicable in the previous two capital increases of 23 September and 7 May 2004.

On 14 October 2004, Arpida also issued 61,350 common shares with a nominal value of CHF 0.20 each to holders of warrants, issued in connection with a convertible bond which has been settled in the framework of the third financing round.

The company's share capital (prior to the introduction of a single share class structure) amounted to CHF 2,194,391.80, divided into 577,600 common shares and 10,394,359 preference shares.

### Gross proceeds of fundraising



On 3 May 2005, the Company converted all preferred A, B and C shares one for one into common shares and issued 5,400,000 common shares in the Initial Public Offering at the SWX Swiss Exchange.

### Description of the shares

As of 31 December 2005, only registered shares were outstanding. No bearer shares or participation certificates were in issue. All registered shares have a nominal value of CHF 0.20. Each share carries one vote at the shareholders' meetings of the Company – subject to limitations as described below. The shareholders' meeting may at any time convert registered shares into bearer shares and bearer shares into registered shares through an amendment of the Articles of Association.

### Limitations on transferability and nominee registration

A transfer of shares is effected by a corresponding entry in the books of a bank or depository institution following an assignment in writing by the selling shareholder and notification of such assignment to Arpida by the bank or the depository institution. A transfer of shares further requires that a shareholder file a share registration form in order to be registered in the share register of the company with voting rights. Failing such registration, a shareholder may not vote at or participate in a shareholder's meeting.

A purchaser of shares will be recorded in the company's share register as a shareholder with voting rights if the purchaser discloses its name, citizenship or registered office and address and gives a declaration that it has acquired the shares in its own name and for its own account.

The Articles of Association provide that a person or entity not explicitly stating in its registration request that it will hold the shares for its own account ("Nominee") may be entered as a shareholder in the share register with voting rights for shares up to a maximum of 5% of the outstanding nominal share capital.

Shares held by a Nominee that exceed this limit are only registered in the share register with voting rights if such Nominee declares in writing to disclose name, address and shareholding of any person or legal entity for whose account it is holding 1% or more of the outstanding nominal share capital. The limit of 5% shall apply correspondingly to Nominees who are related to one another through capital ownership or voting rights

or have a common management or are otherwise inter-related. A share being indivisible, the company will only recognise one representative for each share. Furthermore, shares may only be pledged to the bank that administers the bank entries of such shares for the account of the pledging shareholders; in such case, the company must be notified.

### Convertible bonds, warrants and options

As of 31 December 2005, the company did not have any convertible bonds or warrants outstanding.

#### Stock option plans

*Conditional Share Capital:* The company has a conditional share capital for the potential issuance of 1,935,000 registered shares of CHF 0.20 each (share capital of CHF 387,000) under the stock option plans for employees, Board members and persons in comparable positions.

*Stock Option Plans and Plan Administration:* Arpida has established several stock option plans to provide incentives to directors, executives, employees and consultants. Under the plans, such persons have an opportunity to receive non-transferable options to acquire shares of the company.

For further information about these option plans, reference is made to the Notes to the Accounts.

## Board of Directors

### Responsibilities and organisation

According to the Articles of Association, the Board of Directors of the company (the "Board of Directors") shall consist of 5 to 11 members and shall be elected by the general shareholders' meeting for a term of three years, re-election being allowed. Each year one third of the Board is up for re-election. The Board of Directors is entrusted with the ultimate direction of the company and the supervision of management.

The Board of Directors' duties include the duty to:

- ultimately manage the company and issue the necessary directives;
- determine the organisational structure of the company;
- organise the accounting system, the financial controls as well as the financial planning and
- appoint, recall and ultimately supervise the persons entrusted with the management and representation of the company.
- The duties also comprise the responsibility for the preparation of the annual report and the shareholders' meeting, carrying out of shareholders' resolutions and the notification of the judge in case of over-indebtedness of the company.

According to Arpida's organisational regulations, the adoption of resolutions and elections by the Board of

### Members of the Board of Directors

Name	Function	Born	First elected	End of current period	Compensation Committee	Finance & Audit Committee	Nomination Committee
André Lamotte, Ph.D.	Chairman of the Board	1948	1997	2008	●	●	●
Hans Fünfschilling, Ph.D.	Vice-chairman of the Board	1940	2002	2008		●	
Khalid Islam, Ph.D.	Board Member, President, Chief Executive Officer	1955	2002	2007			
Dieter Gillessen, Ph.D.	Board Member, Senior Vice President, Chief Operating Officer	1935	1997	2006			
Axel Kleemann, Prof., Ph.D.	Board Member	1940	2003	2006		●	
Matthias Staehelin, Ph.D., MAES	Board Member	1965	2005	2008			
Magnus Persson, Ph.D., M.D.	Board Member	1960	2002	2007	●		
Søren Carlsen, Ph.D.	Board Member	1952	2004	2007	●		●
Nam-Hai Chua, Prof., Ph.D.	Board Member	1944	2004	2006			●

Directors require a majority of the votes cast. To validly pass a resolution, more than half of the members of the Board of Directors must be present at the meeting.

In accordance with the Articles of Association and the current organisational by-laws (*Organisationsreglement*) enacted by the Board of Directors, the Board of Directors has delegated the operational management of the company to the executive officers of the company. In addition, the Board of Directors has established a Compensation Committee, a Finance & Audit Committee and a Nomination Committee.

Dr. Islam and Dr. Gillessen are executive members of the Board, the other members are non-executives. None of the non-executive Board members were in Arpida's management in the preceding three years, nor do they have any significant business connections with Arpida or its subsidiaries with the following exception: In the year 2005, the law firm Vischer, in which Dr. Matthias Staehelin is a partner, charged fees in the amount of CHF 248,973.65 for its legal and notary services mainly rendered in connection with Arpida's IPO.

Furthermore, there are no interests of any shareholder or members of the Board of Directors or the management in transactions effected by the company which are or were unusual in their nature or conditions.

The Board of Directors includes the following individuals:

*Dr. André Lamotte*, Chairman of Arpida's Board of Directors, is one of the founders of the company. He is an entrepreneur, who founded, co-founded, or seed-financed 18 pharmaceutical and biotech companies (Acambis-Oravax, Axovan, BAGTech, Creagen-Neurex, de Code genetics, Diatide, ICAgen, Inspire Pharmaceuticals, Paion, Vernalis), medtech companies (Cryocath) and medical service companies (Laser Vision, Worldcare). He was Partner of NMT/HBM and the Harvard Medical School Venture Fund, General Manager of Pasteur Merieux US operations and Marketing manager at Sandoz. He has a Ph.D. from MIT, an MBA from Harvard, and is a graduate from Ecole Centrale Paris. Dr. Lamotte is member of the Board of Direc-

tors of the following firms: ICAgen, URRMA and Spine Vision. Dr. Lamotte is a Swiss national.

*Dr. Hans Fünfschilling*, Vice-chairman of Arpida's Board of Directors, is the sole Representative of the Canton of Baselland in the Swiss Senate (Ständerat). Prior to his political career, he worked for almost 21 years in senior executive positions at Roche. Dr. Fünfschilling graduated from the University of Basel and holds a Ph.D. in astronomy. Dr. Fünfschilling also serves on the Board of Directors of the Swiss national broadcasting association ("SRG SSR ideesuisse"), of the association of the Swiss cantonal re-insurance companies ("Interkantonaler Rückversicherungsverband IRV") and of the Endress + Hauser Group, Switzerland. Dr. Fünfschilling is a Swiss national.

*Dr. Khalid Islam* is President and Chief Executive Officer of Arpida. He has a B.Sc. from Chelsea College and a Ph.D. from Imperial College, University of London. After an academic career, he worked for Marion Merrell Dow and Hoechst Marion Roussel (Aventis). In 1999 he joined Arpida where he successfully managed the transition from an early-stage start-up into a well-structured biopharmaceutical company. He has raised over CHF 220 million in private financing and in the IPO. He is a member of the Editorial Board of Current Drug Discovery Technologies, the International Advisory Board of the Network of Excellence in EuroPathoGenomics and President of the Art Foundation Casaperlarte-Foundation Paolo Minoli. Dr. Islam acts as an advisor to several international journals. He holds several patents and has published over 75 articles in leading journals. He also serves as a member of the Board of Directors of Arpida A/S. Dr. Islam has dual British and Italian nationality.

*Prof. Axel Kleemann* was member of the Management Board of ASTA Medica AG with responsibility for Research & Development, Production and Engineering. He holds the position of Honorary Professor of Chemistry at the Johann Wolfgang Goethe University in Frankfurt am Main. Furthermore, Prof. Kleemann is co-author of the standard reference book "Pharmaceutical Substances". He is co-founder of Act. On GmbH Pharma Consultants in Germany and member of the Board of Directors of the following companies: Girindus AG, Germany (chairman until 30 September 2005); Biofrontera

AG, Germany (chairman until 30 June 2005); Combinature Biopharm AG, Germany (chairman), Protagen AG, Germany (chairman) and KeyNeurotek AG, Germany (member). Prof. Kleemann is German.

*Dr. Matthias Staehelin* is a partner in the law firm Vischer with offices in Basel and Zurich. He is the lead partner of the firm's life sciences group. He studied law at University of Basel where he obtained his Ph.D. and at the

College of Europe, Bruges/Belgium where he obtained a Master of Advanced European Studies (MAES) and a Diplôme des Hautes Etudes Européennes (DHEE). He is admitted to the bar in Basel/Switzerland and is qualified as Public Notary in the Canton Basel-Stadt and Baselland. He serves on the Board of Directors of Swiss subsidiaries of publicly traded companies and privately-held companies incl. Hesperion AG and MEV Schweiz AG. Dr. Matthias Staehelin is a Swiss national.

### Dr. Dieter Gillessen

In view of Dr. Dieter Gillessen's forthcoming retirement in 2006, combined with his important role in the company, some extra attention to his person is well-deserved.

Together with three others, Dr. Gillessen founded Arpida in July of 1997, despite the fact that he was already at an age where most others would start to consider retirement. As Board member, Senior Vice President and Chief Operating Officer, Dr. Gillessen made vital contributions both on the scientific and organisational front.

Before joining Arpida, Dr. Gillessen had already gathered a wealth of experience in the pharma industry. At F. Hoffmann-La Roche in Basel he was Head of Peptide, Protein and Nucleic Acid Research and Deputy Head of the Molecular Biology Department. He was also a member of staff of the pre-clinical research directorate and he served as liaison with the patent department. While with F. Hoffmann-La Roche, Dr. Gillessen also was responsible for the construction of a new Biological Research Building with 48 laboratories. He has been a key player in developing two marketed products (Thyrotropin-Releasing Factor (TRF) and Luteinizing Hormone-Releasing Hormone (LRH), both of Roche Diagnostics). He has also been a part-time Technology Sourcing Officer of the venture capital company New Medical Technologies. He holds several patents and has published over 60 articles in leading journals.

Dr. Gillessen received his Ph.D. from the Technische Hochschule Aachen and spent three years as a post-

doctoral fellow in the Biochemistry Department at Cornell University Medical College in the group of the Nobel laureate Vincent du Vigneaud.

Dr. André Lamotte, Chairman of the Board of Arpida Ltd, commented: "As Board member, Senior Vice president and Chief Operating Officer, Dr. Dieter Gillessen has played an essential role in the development of Arpida,



both on the scientific and the organisational front. Dr. Gillessen has now reached the age of 70 and we fully understand his decision to enjoy his well-deserved retirement. We are very pleased that Dr. Gillessen has agreed to stay on board as an advisor to the company. But, first and foremost, we thank him for his contribution to the well-being of Arpida and we wish him all the best."

*Dr. Magnus Persson* is a partner of HealthCap – a family of venture capital funds managed by the Odlander Fredrikson Group, with committed capital exceeding EUR 650 million. Prior to joining HealthCap, Dr. Persson worked as Clinical Research Physician with Sanofi Winthrop. In 1991 he received a Ph.D. degree in Physiology. He received his medical education at the Karolinska Institute and at Harvard Medical School and is a licensed doctor. He is also a member of the Board of Directors of Alba Therapeutics (US), Trigen plc (Germany and United Kingdom), Creative Peptides A/B (Sweden) and SpineVision S.A. (France). Furthermore, he is an observer to the Board of Directors of Chemocentryx Inc. (US), Nucleonics Inc. (US), FivePrime Inc. (US), and Apoxis S.A (Switzerland). Dr. Persson is Swedish.

*Dr. Søren Carlsen* is Managing Partner of Novo Ventures, a venture capital fund managed by the Danish Novo Group. Before moving to his current position in 2000, Dr. Carlsen was in the executive management of Novo Nordisk's Enzyme Business as Corporate Vice President and Chief Science Officer. Next to Arpida, he serves on the Board of 7TM Pharma A/S (Denmark), Santaris Pharma A/S (Denmark) and PTC Therapeutics, Inc. (USA). Dr. Carlsen is chairman of DanishBiotech – the Association of Biotechnology Industries in Denmark. He is a Danish national.

*Prof. Nam-Hai Chua* holds the position of the Andrew W. Mellon Professor and Head of Laboratory of Plant Molecular Biology at the Rockefeller University, New York City. Prof. Chua has a B.Sc. in Botany and Biochemistry from the University of Singapore and a Ph.D. in Biology from Harvard University. He serves on editorial boards of many scientific journals, such as the Journal of Cell Science and the Journal of Molecular Biology. He is also a member of the Board of Directors of the Delta and Pine Land Company (listed in New York). Furthermore, he is corporate advisor to Temasek Holdings, Inc. (Singapore). Prof. Chua is a citizen of Singapore.

#### **Announced changes**

At the shareholders' meeting of April 2006, Dr. Gillessen will retire from the Board of Directors. He will not stand for re-election. In June 2006 he will also retire in his capacity as Senior Vice President and Chief Operating Officer.

The terms of Prof. Kleeman and Dr. Nam-Hai Chua will expire in the shareholders' meeting. Both will stand for re-election. Dr. Persson will step down in the shareholders' meeting, he will not stand for re-election.

#### **Board Committees**

In 2003 the Board of Directors established a Finance & Audit Committee and a Compensation Committee and, in 2005, a Nomination Committee.

The *Finance & Audit Committee* currently consists of André Lamotte, Hans Fünfschilling and Axel Kleemann. The Committee assists the Board of Directors in fulfilling its duties of supervision of the management. It is responsible for the guidelines for the company's risk management and internal control system, the review of the compliance system, the review of the auditors' audit plans, the review of annual and interim financial statements, the monitoring of the performance and independence of external auditors (including the authorising of non-audit services by the auditors and their compliance with applicable rules), the review of the audit results and the monitoring of the implementation of the findings by management. After examination by the Finance & Audit Committee, the (interim) accounts are approved and recommended for approval by the Board of Directors. The committee met twice in 2005, the CFO and the external auditors were present at both meetings. In one meeting the 2004 accounts were discussed and approved. In the other meeting the accounts for the first half of 2005 and the audit plan for 2006 were the main agenda items.

The *Compensation Committee* currently consists of the following members: André Lamotte, Magnus Persson and Søren Carlsen. The Compensation Committee assists the Board of Directors in compensation related matters. It provides the Board of Directors with recommendations on the compensation of the members of the Board of Directors and the Senior Executive Officers, the policies for the compensation of the Senior Executive Officers and the basic principles for the establishment, amendment and implementation of the company's stock option plans. The committee met twice in 2005, discussing the remuneration system as well as the remuneration levels for the Board of Directors and Senior Executive Officers.

The *Nomination Committee* currently consists of André Lamotte, Søren Carlsen and Nam-Hai Chua. The Nomination Committee enacts guidelines for selecting candidates for election or re-election to the Board of Directors and for appointment of senior management and makes arrangements to select such candidates. The Nomination Committee supplied important input in 2005 in the selection of candidates for key functions.



From left: Dr. Khalid Islam, Dr. Dieter Gillessen

### Information and control instruments

In general, the Board of Directors convenes every two months. The agenda for the meetings is prepared by the Chairman of the Board in close consultation with the President. In general, the main agenda items are the progress of the research and development pipeline, the financial situation, the risks and the company's strategic opportunities. The Board is supplied with an extensive reporting set ahead of each meeting. The Board can ask for additional information and can consult external experts if deemed necessary.

The performance of the auditors is monitored in close consultation with the CFO. If necessary, external experts can be consulted.

## Senior Executive Officers

### Members

Arpida has 5 Senior Executive Officers (the "President", two "Senior Vice Presidents", the "Head of Research" and the "Head of Development", collectively, the "Senior Executive Officers"). The Senior Executive Officers, under the responsibility of the Chief Executive Officer and the control of the Board of Directors, conduct the operational management of the Company pursuant to the company's organisational by-laws and report to the Board of Directors on a regular basis. During 2005, Arpida had no management contracts with external persons or companies.

The following table sets forth the names, dates of appointment and positions of the current Senior Executive Officers (for Dr. Islam and Dr. Gillessen who are also members of the Board of Directors, reference is made to the corresponding descriptions in "Board of Directors"):

Name	Born	Appointed	Position
Khalid Islam, Ph.D.	1955	2002	President, CEO, Board Member
Dieter Gillessen, Ph.D.	1935	1997	Senior Vice President and Chief Operating Officer, Board Member
Harry Welten, MBA	1965	2001	Senior Vice President and Chief Financial Officer
Sergio Lociuero, Ph.D.	1956	2003	Head of Research
Nicholas Coppard, Ph.D.	1959	2005	Head of Development

As described under "Board of Directors" Dr. Gillessen will retire in his capacity of Senior Vice President and Chief Operating Officer in June 2006.

*Harry Welten* has more than 18 years of international experience in finance. He joined Arpida in August 2001 as Chief Financial Officer. He also serves as a member of the Board of Directors of Arpida A/S. He successfully managed Arpida's third financing round (raising CHF 85.6 mn) and the IPO (raising CHF 97.2 mn). Prior to joining Arpida, he was a director at UBS Warburg in New York following various senior positions within the UBS Group. Before joining UBS, he was with ABB and DaimlerChrysler. Mr. Welten holds a degree in Banking and Finance, a degree in Economics and Business Administration and an MBA (Hons.) from Columbia University, New York. Mr. Welten is a Swiss national.

*Dr. Sergio Lociuoro* has held several senior management positions in major pharmaceutical companies such as Marion Merrell Dow and GlaxoSmithKline. Dr. Lociuoro received his Laurea in Chemistry at the University of Rome. He obtained his Ph.D. in Chemistry from the University of New Brunswick (Canada). Dr. Lociuoro is author of numerous publications and holds several patents in the field of pharmaceuticals. He is an Italian national.

*Dr. Nicholas Coppard* has held several senior management positions both in large pharmaceutical and in biotech companies. Overall, he has more than 20 years

## Compensation, Shareholdings and Loans

### Remuneration system

Arpida employs a remuneration system which is based on industry norms. The Compensation Committee regularly reviews the competitiveness of the package. If necessary, changes are recommended. The Board of Directors has the final say in compensation matters. The compensation of the non-executive members of the Board of Directors consists of a monetary amount and a fixed number of options per annum. The compensation of the five Senior Executive Officers con-



*From left: Harry Welten, Dr. Sergio Lociuoro, Dr. Nicholas Coppard*

of experience in pharmaceutical drug research, development and strategic marketing. At Roche Products Ltd (Welwyn, UK), he successfully led teams responsible for the development and life cycle management of Cytovene<sup>®</sup>, Valcyte<sup>®</sup>, Invirase<sup>®</sup>/Fortovase<sup>®</sup> and MabThera<sup>®</sup>. Most recently Dr. Coppard was Director of Applied Research and Development at Adprotech Ltd (Cambridge, UK). Dr. Coppard joined Arpida in September 2005 as Head of Development. He has a B.Sc. (Hons.) in Biochemistry from the University of Manchester and a Ph.D. in Chemistry from the University of Aarhus in Denmark. Dr. Coppard is a British national.

sists of a fixed monetary amount plus potentially a variable cash bonus and number of options. The Compensation Committee makes recommendations to the Board of Directors concerning the yearly awarding of variable remuneration.

### Amounts for the year under review

#### 1. Senior Executive Officers

Total remuneration for the five Senior Executive Officers (4 members in 2004) amounted to CHF 1,965,668 in 2005 (CHF 1,555,368 in 2004).

## 2. Board of Directors

In 2005, the 7 non-executive members of the Board of Directors (2004: 7 members) received compensation in an aggregate amount of CHF 217,009 (2004: CHF 167,938). The remuneration package of the two members of the Board of Directors who are also Senior Executive Officers is included in the senior executive figures.

## 3. Former members of governing bodies

In 2005, one former member of the Board of Directors received a payment of CHF 12,372 in respect of the period that he was on the Board.

## Shares and options

In the year under review, no shares were allotted. For a detailed description of the option plans, reference is made to the Notes on page 54 and 55.

## Highest total compensation

The member of the Board of Directors with the highest compensation received a total amount of CHF 682,077 and 88,086 options in 2005.

## Share ownership

As at year-end 2005, non-executive directors owned a total of 15,900 Arpida shares. Senior Executive Officers owned a total of 46,000 Arpida shares.

## Loans and additional items

In the year under review, the company did not issue or assume any guarantees for any shareholder or member of the Board of Directors or the management. No shareholder and no member of the Board of Directors or the management have received any loans from the company.

In 2005, no fees were paid to members of the Board of Directors or senior management for consultancy or other services delivered to Arpida, except for the fees paid to the law firm Vischer, in which Dr. Matthias Staehelin is a partner (see page 27).

## Shareholders' Participation

### Voting rights

In principle, each share carries one vote. The only limitation to this rule is the one described under "Limitations on transferability and nominee registration".

Each shareholder may authorise in writing another shareholder, a company representative, a specially designated independent shareholder representative or a depositary representative to represent him or her at the shareholders' meeting.

A shareholder wanting to vote at a shareholders' meeting has to be entered in the register no later than 7 days before the meeting takes place.

### Quorum

The Articles of Association do not prescribe a quorum for shareholders' meetings. Unless the law requires otherwise, the general meeting of shareholders passes resolutions and elections with a simple majority of the votes represented at the shareholders meeting.

Swiss law requires a two-thirds majority of the votes represented for resolutions concerning:

- ▶ changes to the company's business purpose;
- ▶ the creation of shares with privileged voting rights;
- ▶ restrictions on the transferability of registered shares;
- ▶ an authorised or conditional increase in the share capital;
- ▶ an increase in the share capital by way of capitalisation of reserves, against contribution in kind for the acquisition of assets or involving the grant of special privileges;
- ▶ the restriction or elimination of pre-emptive rights of shareholders;
- ▶ a relocation of the registered office; or
- ▶ the dissolution of the Company other than by liquidation (for example, by way of merger).

The introduction or abolition of any provision in the Articles introducing a majority greater than that required by law must be resolved in accordance with such greater majority.

### **Convocation**

Under Swiss law, an annual ordinary shareholders' meeting must be held within 6 months after the end of the company's financial year. Shareholders' meetings may be convened by the Board of Directors or, if necessary, by the company's statutory auditors. The Board of Directors is further required to convene an extraordinary shareholders' meeting if so resolved by a shareholders' meeting or if so requested by holders of shares holding in aggregate at least 10% of the nominal share capital.

A shareholders' meeting is convened by publishing a notice in the Swiss Official Gazette of Commerce (Schweizerisches Handelsamtsblatt) at least 20 days prior to such meeting. In addition, holders of registered shares may be informed by a letter sent to the address indicated in the share register.

### **Agenda**

Shareholders, holding shares representing the lower of 10% of the share capital or a nominal value of CHF 1 million have the right to request that a specific proposal be discussed and voted upon at the next shareholders' meeting, setting forth the item and proposal.

According to the Articles of Association, the request to put an item on the agenda has to be made at least 45 days prior to the meeting.

## **Changes of Control and Defence Measures**

### **Duty to make an offer**

A shareholder that, either directly, indirectly or acting in concert with third parties, controls 33⅓% of the voting rights (whether exercisable or not), is obliged to make an offer to acquire all listed shares. Swiss law allows a corporation to deviate from this rule in its Articles of Association. Arpida has opted not to use this possibility.

### **Clauses on changes of control**

Arpida has no special arrangements taking effect in the event of a change of control, other than the customary clauses concerning the exercise of stock options.

## **Auditors**

PricewaterhouseCoopers AG (PwC), Basel, Switzerland is group auditor and statutory auditor since 1997. The lead auditor for Arpida is Mr. Th. Brüderlin, since 2001. In the year under review PwC charged Arpida CHF 85,117 in audit fees and CHF 365,296 for additional services.

## **Information Policy**

Arpida puts much weight on keeping its stakeholders informed. Without proper communication, our achievements in research and development will not be fairly reflected in the public perception or in the share price. Many different channels are used, including the twice-yearly financial results releases, ad-hoc statements, the annual report, the website, shareholders' meetings, roadshows, conferences, and press contacts. The website ([www.arpida.com](http://www.arpida.com)) offers interested parties the possibility to subscribe to the company's news releases. The Corporate Communications department is at the stakeholders' service to respond to questions or requests.

### **Arpida Corporate Communications**

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# 2005 Accounts

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# Consolidated Balance Sheets

CHF	Note	31 Dec. 2005	31 Dec. 2004
<b>Assets</b>			
<b>Non-current assets</b>			
Goodwill	10	6,000,378	5,968,265
Other intangible assets	10	122,115	340,382
Plant and equipment	9	3,103,925	2,594,274
Other non-current receivables		–	49,377
Prepaid pension	16	114,613	3,335
<b>Total non-current assets</b>		<b>9,341,031</b>	<b>8,955,633</b>
<b>Current assets</b>			
Inventories	11	–	490,566
Prepayments		3,004,153	354,608
Other receivables		887,583	407,267
Cash and cash equivalents	12	122,420,409	68,199,187
<b>Total current assets</b>		<b>126,312,145</b>	<b>69,451,628</b>
<b>Total assets</b>		<b>135,653,176</b>	<b>78,407,261</b>
<b>Equity and liabilities</b>			
<b>Equity</b>			
Share capital	13	3,274,392	2,194,392
Share premium		231,831,941	143,652,980
Other reserves (share-based compensation)		1,905,427	990,367
Cumulative translation differences		79,393	(70,289)
Accumulated loss		(106,212,682)	(71,171,022)
<b>Total equity</b>		<b>130,878,471</b>	<b>75,596,428</b>
<b>Current liabilities</b>			
Trade accounts payable		1,564,627	800,639
Accrued and other current liabilities	14	3,210,078	2,010,194
<b>Total current liabilities</b>		<b>4,774,705</b>	<b>2,810,833</b>
<b>Total equity and liabilities</b>		<b>135,653,176</b>	<b>78,407,261</b>

The accompanying notes form an integral part of these consolidated financial statements.

CHF	Note	Period from 1 Jan. to 31 Dec. 2005	Period from 1 Jan. to 31 Dec. 2004
<b>Income from services</b>		–	<b>58,360</b>
Research and development		(29,199,620)	(17,590,455)
Management and general expenses		(7,270,920)	(4,999,447)
<b>Total operating expenses</b>		<b>(36,470,540)</b>	<b>(22,589,902)</b>
<b>Operating loss</b>		<b>(36,470,540)</b>	<b>(22,531,542)</b>
Financial income	6	1,438,288	191,284
Financial expenses	6	(9,408)	(811,818)
<b>Net loss before tax</b>		<b>(35,041,660)</b>	<b>(23,152,076)</b>
Income tax expense/benefit	7	–	–
<b>Net loss for the period</b>		<b>(35,041,660)</b>	<b>(23,152,076)</b>
<b>Basic and diluted loss per share</b>	8	<b>(2.41)</b>	<b>(2.96)</b>

The accompanying notes form an integral part of these consolidated financial statements.

## Consolidated State- ments of Operations

CHF	Note	Period from 1 Jan. to 31 Dec. 2005	Period from 1 Jan. to 31 Dec. 2004
<b>Operating activities</b>			
Net loss for the period		(35,041,660)	(23,152,076)
Reversal of non-cash items			
– Depreciation on tangible assets	9	1,279,137	655,934
– Amortisation on other intangible assets	10	154,448	32,757
– Interest on subordinated convertible loans	15	–	86,263
– Share-based compensation charges	17	915,060	990,367
– Changes in the composition of net working capital			
– Change in inventories		490,372	486,243
– Change in other current and long-term receivables		(429,792)	10,582
– Change in prepayments		(2,648,994)	(16,086)
– Change in accounts payable and accrued liabilities		1,959,784	(90,632)
– Change in prepaid pension	16	(111,278)	(101,059)
<b>Net cash used in operating activities</b>		<b>(33,432,923)</b>	<b>(21,097,707)</b>
<b>Investing activities</b>			
Cash in-flow from acquisition of Arpida A/S	3	–	21,579,727
Plant and equipment purchases	9	(1,777,586)	(323,376)
Proceeds from the sale of intangible assets		64,330	–
<b>Net cash provided by/(used in) investing activities</b>		<b>(1,713,256)</b>	<b>21,256,351</b>
<b>Financing activities</b>			
Issuance of common/preferred shares		97,200,000	60,967,014
Capital increase expenses		(7,941,039)	(3,031,137)
Capital increase expenses for the acquisition of Arpida A/S		–	(165,707)
<b>Total cash provided by financing activities</b>		<b>89,258,961</b>	<b>57,770,170</b>
<b>Net change in cash position</b>		<b>54,112,782</b>	<b>57,928,814</b>
<b>Net increase/(decrease) in cash and cash equivalents</b>		<b>54,112,782</b>	<b>57,928,814</b>
Exchange gains/(losses) on cash and cash equivalents		108,440	(36,420)
Cash and cash equivalents, beginning of period	12	68,199,187	10,306,793
<b>Cash and cash equivalents, end of period</b>	12	<b>122,420,409</b>	<b>68,199,187</b>
Interest payments received as part of net cash used in operating activities		973,328	172,860

The accompanying notes form an integral part of these consolidated financial statements.

## Consolidated State- ments of Cash Flow

# Consolidated Statements of Equity

## Number of shares

	Common shares	Preferred shares	Total
<b>At 31 December 2003</b>	<b>516,250</b>	<b>4,594,600</b>	<b>5,110,850</b>
Issuance of shares (note 13)	61,350	5,605,440	<b>5,666,790</b>
Equity funding costs	-	-	-
Acquisition costs	-	-	-
Conversion subordinated loans (note 15)	-	194,319	<b>194,319</b>
Share-based compensation	-	-	-
Translation differences	-	-	-
Net loss for the period	-	-	-
<b>At 31 December 2004</b>	<b>577,600</b>	<b>10,394,359</b>	<b>10,971,959</b>
Conversion-preferred shares	10,394,359	(10,394,359)	-
Capital increase IPO (note 13)	5,400,000	-	<b>5,400,000</b>
Equity funding costs	-	-	-
Share-based compensation	-	-	-
Translation differences	-	-	-
Net loss for the period	-	-	-
<b>At 31 December 2005</b>	<b>16,371,959</b>	<b>-</b>	<b>16,371,959</b>

## CHF

	Share capital	Share Premium	Total capital paid in	Other reserves	Cumulative translation difference	Accumulated loss	Total equity
<b>At 31 December 2003</b>	<b>1,022,170</b>	<b>53,524,817</b>	<b>54,546,987</b>	-	-	<b>(48,018,946)</b>	<b>6,528,041</b>
Issuance of shares (note 13)	1,133,358	90,247,585	91,380,943	-	-	-	<b>91,380,943</b>
Equity funding costs	-	(3,031,137)	(3,031,137)	-	-	-	<b>(3,031,137)</b>
Acquisition costs	-	(165,707)	(165,707)	-	-	-	<b>(165,707)</b>
Conversion subordinated loans (note 15)	38,864	3,077,422	3,116,286	-	-	-	<b>3,116,286</b>
Share-based compensation	-	-	-	990,367	-	-	<b>990,367</b>
Translation differences	-	-	-	-	(70,289)	-	<b>(70,289)</b>
Net loss for the period	-	-	-	-	-	(23,152,076)	<b>(23,152,076)</b>
<b>At 31 December 2004</b>	<b>2,194,392</b>	<b>143,652,980</b>	<b>145,847,372</b>	<b>990,367</b>	<b>(70,289)</b>	<b>(71,171,022)</b>	<b>75,596,428</b>
Conversion-preferred shares	-	-	-	-	-	-	-
Capital increase IPO (note 13)	1,080,000	96,120,000	97,200,000	-	-	-	<b>97,200,000</b>
Equity funding costs	-	(7,941,039)	(7,941,039)	-	-	-	<b>(7,941,039)</b>
Share-based compensation	-	-	-	915,060	-	-	<b>915,060</b>
Translation differences	-	-	-	-	149,682	-	<b>149,682</b>
Net loss for the period	-	-	-	-	-	(35,041,660)	<b>(35,041,660)</b>
<b>At 31 December 2005</b>	<b>3,274,392</b>	<b>231,831,941</b>	<b>235,106,333</b>	<b>1,905,427</b>	<b>79,393</b>	<b>(106,212,682)</b>	<b>130,878,471</b>

On 12 August 2004, the shares were split 1 to 50. All references to shares in 2004 have been restated to reflect this change. The accompanying notes form an integral part of these consolidated financial statements.

## Notes to Consolidated Financial Statements

### 1. The Company

Arpida Ltd (the "Company") together with its subsidiaries (collectively "Arpida") is a therapeutically focused biopharmaceutical Company focusing on the discovery and development of new, safer and more efficacious anti-microbial drugs for the treatment of infectious diseases.

To date, Arpida has financed its cash requirements primarily from share issuances and debt financings. Arpida is a development stage enterprise as of 31 December 2005 and is exposed to all the risks inherent in establishing a business: Inherent in Arpida's business are various risks and uncertain-

ties, including the substantial uncertainty that current projects will succeed. Arpida's success may depend in part upon its ability to (i) establish and maintain a strong patent position and protection, (ii) enter into collaborations with partners in the pharmaceutical industry, (iii) acquire and keep key personnel employed, and (iv) acquire additional capital to support its operations.

The Company was registered in the register of commerce on 18 August 1997, and has its domicile and registered office at Dammstrasse 36, CH-4142 Münchenstein, Switzerland. Since 4 May 2005, the Company is a public company whose shares are traded at the SWX Swiss Exchange.

### 2. Summary of Significant Accounting Policies

#### Basis of accounting

The financial statements of Arpida are prepared in accordance with the historical cost convention except for the revaluation to market value of certain financial assets and liabilities and comply with the International Financial Reporting Standards (IFRS) formulated by the International Accounting Standards Board (IASB) and with International Accounting Standards (IAS) and interpretations formulated by its predecessor organisation the International Accounting Standards Committee (IASC), as well as with the following significant accounting policies.

#### Critical accounting estimates

The preparation of the financial statement requires management to use certain critical accounting estimates. It also requires management to exercise its judgment in the process of applying the Company's accounting policies. Such estimates and assumptions affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of expenses during the reporting period. Actual outcomes could differ from those estimates.

#### Principles of consolidation

Subsidiaries in which the Company has a controlling interest directly or indirectly are consolidated. Control is defined as the power to govern the financial and operating policies of an enterprise so as to obtain benefits from its activities. Control is normally evidenced when the Company owns, either directly or indirectly, more than 50% of the voting rights or potential voting rights of a company's share capital that are currently exercisable.

The consolidation commences from the date on which control is transferred to the Company and subsidiaries are no longer consolidated from the date that control ceases. Intercompany balances and transactions between group companies are eliminated. Intercompany transactions solely result from providing services to other group companies.

The consolidated financial statements include the accounts of Arpida Ltd and its wholly owned subsidiaries Arpida UK Ltd, a Company located in UK and Arpida A/S, a Company located in Denmark. Arpida UK Ltd was founded in 2003. Combio A/S was acquired in October 2004 and renamed Arpida A/S on 1 March 2005 (refer to Note 3).

#### Foreign currency translation

Group companies use their local currency as their measurement currency reflecting the economic environment they operate in. Transactions in other currencies are initially reported using the exchange rate at the date of the transaction. Gains and losses from such transactions as well as gains and losses on translation of monetary assets and liabilities denominated in other currencies are included in income.

Upon consolidation, assets and liabilities of group companies using measurement currencies other than Swiss francs (foreign entities) are translated into Swiss francs using year-end rates of exchange. Revenues, expenses, net income and cash flows are translated at the average rates of exchange for the year. Translation differences due to the changes in exchange rates between the beginning and the end of the year

and the difference between net loss translated at the average and year-end exchange rates are taken directly to equity.

### Revenue recognition

Revenue from rendering of services is based on the stage of completion determined by reference to services performed to date as a percentage of total services to be performed. Dividends are recognised when the right to receive payment is established.

### Cash and cash equivalents

Cash and cash equivalents comprise cash on hand, deposits held at call with banks and other short-term highly liquid investments which are readily convertible to known amounts of cash (and which are subject to insignificant risk of changes in value) and have a maturity of three months or less from the date of acquisition. This definition is also used for the cash flow statement.

### Financial instruments

Financial instruments carried on the balance sheet include cash and cash equivalents, other receivables, trade accounts payable, accrued and other current liabilities and subordinated convertible loans. The fair value is defined as the amount for which a financial asset, liability or instrument could be exchanged between knowledgeable and willing parties in an arm's length transaction.

The fair value is determined by reference to quoted market prices adjusted for estimated transaction costs that would be incurred in an actual transaction, or by the use of valuation techniques. The fair values at the balance sheet date approximate with their reported book values unless specifically mentioned in the notes to the financial statements.

### Inventories

All supplies acquired by Arpida are related to its research and development activities. Generally these supplies are not considered inventoriable costs, as such they were recorded as a research and development expense when acquired. However, auxiliary materials and semi-finished goods acquired in business combinations are recorded as inventories and expensed subsequently based on the consumption.

### Plant and equipment

Plant and equipment are recorded at cost and are stated at historical cost less accumulated depreciation. Depreciation expense is recorded utilising the straight-line method over the estimated useful life of the assets. Assets are written down to their estimated residual value which usually is determined as zero. The useful lives are summarised as follows:

Group of assets	Useful life
Laboratory furniture and equipment	5 years
Office furniture and fixtures	5 years
Office installations	4 years
Office equipment	3 years
Data processing equipment and software	3 years

The costs of repairs and maintenance are capitalised only if they improve the related asset or extend its useful life.

### Intangible assets

Intangible assets (other than goodwill) are initially recorded at fair value. If assets have been acquired through a business combination, their fair value will be allocated in the acquisition accounting. If such assets have been acquired other than through a business combination, the initial fair value will be cost. Generally, intangible assets are amortised over their useful lives on a straight-line basis.

### Impairment of long-lived assets

Plant and equipment and intangible assets (other than goodwill) are reviewed for impairment whenever events or changes in circumstance indicate that the balance sheet carrying amount of the asset may not be recoverable. When events or changes in circumstance indicate the asset may not be recoverable, Arpida estimates its value in use based on the future cash flows expected to result from the use of the asset and its eventual disposition. If the balance sheet carrying amount of the asset is more than the higher of its value in use to Arpida or its anticipated net selling price, an impairment loss for the difference is recognised. For purposes of assessing impairment, assets are grouped at the lowest level for which there are separately identifiable cash flows. Considerable management judgment is necessary to estimate discounted future cash flows. Accordingly, actual outcomes could vary significantly from such estimates.

### Business combinations and goodwill

Business combinations are accounted for using the purchase method in accordance with IFRS 3. The cost of a business combination is the aggregate of the fair values at the date of exchange of any assets given and equity instruments issued by the acquirer, given in exchange for control over the net assets of the acquired company. The cost of acquisition also includes directly attributable incidental costs. Arpida allocates the cost of a business combination by recognising the acquiree's identifiable assets, liabilities and contingent liabilities that satisfy the recognition criterion at their fair value. In-process research development projects of the acquiree are recognised by Arpida as an intangible asset separately from

goodwill if at the acquisition date the project meets the definition of an intangible asset and its fair value can be measured reliably. Goodwill is recognised as an asset from the acquisition date and is measured as the excess of the cost of the business acquisition over Arpida's interest in the net fair value of the identifiable net assets acquired.

#### **Impairment of goodwill**

An impairment assessment of goodwill is carried out annually. Goodwill is allocated to cash-generating units. When the recoverable amount of the cash-generating unit, being the higher of its fair value less costs to sell or its value in use, is less than its carrying amount, then an impairment in the carrying amount is recorded. The methodology used in the impairment testing for cash-generating units is further described in Note 10.

#### **Subordinated convertible loans**

When subordinated convertible loans are issued, the fair value of the liability component is determined using a market interest rate for an equivalent non-convertible loan; this component is recorded as a non-current liability on the amortised cost basis until extinguished on conversion or maturity of the loans. Therefore, any difference between proceeds (net of transaction costs) and the redemption value is recognised in the income statement until extinguishments.

The remainder of the proceeds is allocated to the conversion option, which is recognised as equity component; the value of the conversion option is not changed in subsequent periods.

#### **Leases**

Leases where a significant portion of the risks and rewards of ownership are retained by the lessor are classified as operating leases. Payments made under operating leases (net of any incentives received from the lessor) are charged to the income statement on a straight-line basis over the period of the lease.

Leases of tangible fixed assets where Arpida has substantially all the risks and rewards of ownership are classified as finance lease.

#### **Provisions**

Arpida recognises provisions when it has a present legal or constructive obligation to transfer economic benefits as a result of past events and a reasonable estimate of the obligation can be made. Employee entitlements to annual leave are recognised when they accrue to employees. An accrual is made for annual leave as a result of services rendered by employees up to the balance sheet date.

#### **Share-based compensation**

Non-executive members of the Board of Directors and certain employees of Arpida participate in stock options plans. The fair value of these equity compensation awards granted to employees is estimated at the grant date and recorded as an expense over the vesting period. The expense is charged to the appropriate income statement heading within the operating expenses and a corresponding increase is recorded in equity. Any subsequent cash flows from exercises of vested awards are recorded as an increase in equity.

#### **Employee benefits**

The liability in respect to defined benefit pension plans is the defined benefit obligation calculated regularly by an independent actuary using the projected unit credit method. The defined benefit obligation is measured at the present value of the estimated future cash flows. The charge for such pension plans, representing the net periodic pension cost less employee contributions, is included in the wages. Plan assets are recorded at their fair values. Significant gains or losses arising from experience adjustments, changes in actuarial assumptions, and amendments to pension plans are charged or credited to income over the service lives of the related employees.

#### **Research and development**

Research and development costs consist primarily of compensation and other expenses related to research and development personnel; costs associated with preclinical testing and clinical trials of Arpida's product candidates, including the costs of manufacturing the product candidates; expenses for research and services under collaboration agreements as well as outsourced research and development at research institutions.

Research and development expenses are fully charged to the income statement as incurred. Arpida considers that regulatory and other uncertainties inherent in the development of its key new products preclude it from capitalising development costs under IFRS. Research and development projects, which have achieved technical feasibility, usually signified by US Food & Drug Administration or comparable regulatory body approval, would be capitalised because it is probable that the costs will give rise to future economic benefits. Laboratory buildings and equipment included in plant and equipment are depreciated over their estimated useful lives.

#### **Deferred income taxes**

Deferred taxes are provided for, using the liability method, for all temporary differences between the tax bases of assets and liabilities and their carrying values for financial reporting

purposes. Deferred tax assets relating to the carry forward of unused tax losses and deductible temporary differences are recognised to the extent that future taxable profit is expected to be available. The realisation of the deferred tax asset is assessed on an annual basis. The recognition of such a deferred tax asset is based on this assessment. To determine deferred tax, currently enacted tax rates are used net of the beneficial effect of specific agreements to which Arpida is a party.

#### **Earnings/(Loss) per share**

Basic earning/(loss) per share is calculated by dividing the net profit/(loss) attributable to the shareholders by the weighted average shares outstanding during the period.

Diluted earning/(loss) per share is calculated by dividing the net profit/(loss) attributable to the shareholders by the weighted average shares outstanding during the period adjusted for the conversion of all dilutive potential shares.

#### **Dividends payable**

The Company may declare dividends upon the recommendation of the Board of Directors and the approval of shareholders at their annual general meeting. Under Swiss corporate law, the Company's right to pay dividends may be limited in certain circumstances. At this point, the Company has not paid any dividends since its inception and does not anticipate paying dividends in the foreseeable future.

#### **Changes in accounting policies**

In 2003, the International Accounting Standards Board (IASB) published a revised version of IAS 32 "Financial Instruments: Disclosure and Presentation", a revised version of IAS 39

"Financial Instruments: Recognition and Measurement" and "Improvements to International Accounting Standards", which makes changes to 14 existing standards. In 2004 the IASB published IFRS 2 "Share-based Payment", IFRS 3 "Business Combinations", IFRS 4 "Insurance Contracts", IFRS 5 "Non-current Assets Held for Sale and Discontinued Operations", revised versions of IAS 36 "Impairment of Assets" and IAS 38 "Intangible Assets" and further amendments to IAS 39. Arpida adopted these effective 1 January 2005.

Except for IFRS 2 and IFRS 3, the adoption of these standards had no or an immaterial impact on Arpida's consolidated financial statements.

*IFRS 2 (share-based compensation):* IFRS 2 requires the fair value of any equity instruments granted to employees to be recognised as an expense as long as such instruments are granted after 7 November 2002 and had not yet vested at 1 January 2005. In order to assess such expenses, the Company calculates the fair value of the granted options using a binomial option value assessment model. The resulting expenses are recognised on a straight-line basis over the vesting period. As a result, total operating expenses for the years 2004 and 2005 increase by CHF 990,367 and CHF 915,060 respectively. The net losses for the above periods increase by the same amounts.

In the consolidated financial statements as per 31 December 2004, no equity related expense has been recognised. As required by IFRS 2, the Company has restated its prior-year audited historical consolidated financial statements to reflect the cost of grants awarded since 7 November 2002.

CHF	2004 reported	IFRS 2	2004 restated
<b>Restated statement of operations for the period 1 January to 31 December 2004</b>			
<b>Income from services</b>	<b>58,360</b>	<b>-</b>	<b>58,360</b>
Research and development	(17,463,772)	(126,683)	(17,590,455)
Management and general expenses	(4,135,763)	(863,684)	(4,999,447)
<b>Total operating expenses</b>	<b>(21,599,535)</b>	<b>(990,367)</b>	<b>(22,589,902)</b>
<b>Operating loss</b>	<b>(21,541,175)</b>	<b>(990,367)</b>	<b>(22,531,542)</b>
Financial result, net	(623,241)	-	(623,241)
Foreign exchange gains	2,707	-	2,707
<b>Net loss before tax</b>	<b>(22,161,709)</b>	<b>(990,367)</b>	<b>(23,152,076)</b>
Income tax expense/benefit	-	-	-
<b>Net loss for the period</b>	<b>(22,161,709)</b>	<b>(990,367)</b>	<b>(23,152,076)</b>
<b>Basic and diluted loss per share</b>	<b>(2.84)</b>	<b>(0.12)</b>	<b>(2.96)</b>
<b>Restated equity at 31 December 2004</b>			
Share capital	2,194,392	-	2,194,392
Share premium	143,652,980	-	143,652,980
Other reserves (Share-based compensation)	-	990,367	990,367
Cumulative translation difference	(70,289)	-	(70,289)
Accumulated loss	(70,180,655)	(990,367)	(71,171,022)
<b>Total equity</b>	<b>75,596,428</b>	<b>-</b>	<b>75,596,428</b>

*IFRS 3 (business combination):* Under IFRS 3, with effect from 1 January 2005, goodwill is considered to have an indefinite life and is not amortised but is subject to annual impairment testing. This new accounting policy was already applied in 2004 for the preliminary estimate of the goodwill in conjunction with the acquisition of Arpida A/S (formerly known as Combio A/S) in October 2004. There is no other goodwill.

#### **New accounting pronouncements**

In 2005, the International Accounting Standards Board (IASB) amended IFRS 6 "Exploration for and Evaluation of Mineral Resources", IAS 39 "Financial Instruments: Recognition and Measurement" regarding the Fair Value Option, the Cash Flow Hedging of Forecast Intragroup Transaction and the Transition and Initial Recognition of Financial Assets and Financial Liabilities, IAS 39 and IFRS 4 "Insurance Contracts" regarding Financial Guarantee Contracts, IAS 21 "The Effects of Changes in Foreign Exchange Rates" regarding Net Investment in a Foreign Operation and IAS 19 "Employee benefits"

requiring additional disclosures and allowing the recognition of all actuarial gains and losses as they occur, outside profit or loss in a statement of total recognised gains and losses. In 2005, the IASB, also published IFRS 7 "Financial Instruments: Disclosures", will be replacing IAS 30 "Disclosure in the financial statements of banks and similar financial institutions" and IAS 32 "Financial Instruments: Disclosure and Presentation". Arpida is currently assessing the impact and, if applicable, will adopt the standard in 2006.

#### **Financial risk management**

Financial risk management is governed by policies and guidelines approved by senior management. These policies cover foreign exchange risk, interest rate risk and liquidity risk. Currently, Arpida is not exposed to market risk and credit risk.

*Foreign exchange risk:* Arpida sources supplies as well as research and development, consulting and other services in several countries and operates a foreign subsidiary perform-

ing research and development activities and is exposed to foreign currency movements affecting its net loss and financial position, as expressed in Swiss francs. Arpida monitors its currency exposures.

*Interest rate risk:* Interest rate risk arises from movements in interest rates, which could have adverse effects on Arpida's net loss or financial position. Changes in interest rates cause variations in interest income and expenses on interest-bearing assets and liabilities. In addition, they can affect

the market value of certain financial assets, liabilities and instruments. Arpida does not have significant exposure to interest rate risks.

*Liquidity risk:* To date, Arpida has financed its cash requirements primarily from share issuances and debt financings. Therefore, Arpida is potentially exposed to liquidity risks. Cash and cash equivalents are held with first-rate financial institutions.

### 3. Changes in the Scope of Consolidation

In 2005, there were no changes to the group scope.

On 14 October 2004, the Company acquired 100% of the outstanding shares of Combio A/S, a biotechnological Company domiciled in Copenhagen, Denmark, by issuing Company's preferred C shares with a total fair value of CHF 30,399,989 to the shareholders of Combio A/S. Combio A/S was renamed Arpida A/S on 1 March 2005. The acquisition enhances Arpida's in-house drug discovery capabilities and further strengthens its platform through the integration of additional resources and technologies.

The acquired business contributed operating expenses of CHF 1,770,930 and a net loss of CHF 1,696,667 to the

Group for the period from 14 October 2004 to 31 December 2004. If the acquisition had occurred on 1 January 2004, group operating expenses for 2004 would have been CHF 27,752,685 and the group net loss would have been CHF 28,243,734.

The fair value of the Company's preferred C shares issued to the shareholders of Combio A/S is equal to the value of the Company's preferred C shares issued on 23 September 2004. The assets and liabilities arising from the acquisition are as follows:

	Fair value 14 October 2004	Acquiree's carrying amount 14 October 2004
CHF		
Cash and cash equivalents	21,579,727	21,579,727
Property and equipment	2,092,761	1,099,501
Research projects (included in intangible assets)	64,530	–
Technology (included in intangible assets)	309,580	154,663
Inventories	982,916	–
Prepayments	214,257	214,257
Accounts payables and accrued liabilities	(822,904)	(822,904)
<b>Net assets acquired</b>	<b>24,420,867</b>	<b>22,225,244</b>

The purchase price allocation between other intangible assets and therefore to goodwill was finalised in 2005.

Details of net assets acquired and goodwill are as follows:

CHF	
Fair value of shares issued	30,399,989
Fair value of net assets acquired	(24,420,867)
<b>Goodwill</b>	<b>5,979,122</b>

The goodwill is mainly attributable to the assembled workforce of the acquired business and the synergies expected from combining the drug discovery capabilities.

CHF	
Purchase consideration settled in cash	–
Cash and cash equivalents in subsidiary acquired	21,579,727
<b>Cash inflow on acquisition</b>	<b>21,579,727</b>

Direct costs relating to the capital increase for the acquisition of CHF 165,707 were deducted from equity.

#### 4. Information by Geographical Area

The group has only one business segment, namely the discovery and development of new, safer and more efficacious antimicrobial drugs for the treatment of infectious diseases.

The geographical analysis of assets is as follows:

CHF	<b>2005</b>	<b>2004</b>
Switzerland	111,668,382	49,096,469
Outside Switzerland	23,984,794	29,310,792
<b>Total assets</b>	<b>135,653,176</b>	<b>78,407,261</b>

The geographical analysis of capital expenditure is as follows:

CHF	<b>2005</b>	<b>2004</b>
Switzerland	1,093,534	323,376
Outside Switzerland	684,052	50,688
<b>Total capital expenditure</b>	<b>1,777,586</b>	<b>374,064</b>

The geographical analysis of operating expenses is as follows:

CHF	2005	2004
Switzerland	(23,866,243)	(16,075,046)
Outside Switzerland	(5,333,377)	(1,515,409)
<b>Total research and development</b>	<b>(29,199,620)</b>	<b>(17,590,455)</b>
Switzerland	(6,781,527)	(4,743,926)
Outside Switzerland	(489,393)	(255,521)
<b>Total management and general expenses</b>	<b>(7,270,920)</b>	<b>(4,999,447)</b>
<b>Total operating expenses</b>	<b>(36,470,540)</b>	<b>(22,589,902)</b>

## 5. Staff Costs

CHF	2005	2004
Wages and salaries	8,732,003	7,194,619
Share-based compensation	915,060	990,367
Social security costs	502,459	499,049
Post employment benefits	683,894	381,646
Other staff-related costs	768,811	111,108
<b>Total staff-related costs</b>	<b>11,602,227</b>	<b>9,176,789</b>

## 6. Financial Result

CHF	2005	2004
Charges related to bank accounts	(9,408)	(12,695)
Interest expenses on subordinated convertible loan (Note 15)	-	(86,263)
Expenses related to planned capital increases	-	(712,860)
<b>Total financial expenses</b>	<b>(9,408)</b>	<b>(811,818)</b>
Interest income from bank deposits	973,328	188,577
Foreign exchange gains, net	464,960	2,707
<b>Total financial income</b>	<b>1,438,288</b>	<b>191,284</b>
<b>Net financial result</b>	<b>1,428,880</b>	<b>(620,534)</b>

## 7. Income Taxes

Arpida had net operating loss carry-forwards for tax purposes, which are available to offset future taxable income. The loss carry-forwards with their expiry dates are as follows:

CHF	2005	2004
Within one year	1,859,926	1,844,855
Later than one year and not later than 5 years	16,780,589	13,401,256
More than 5 years	34,763,067	23,219,849
<b>Total</b>	<b>53,403,582</b>	<b>38,465,960</b>

Deferred income tax assets and liabilities are offset when there is a legally enforceable right to set off current tax assets against current tax liabilities and when the deferred income taxes relate to the same fiscal authority.

Temporary differences at 31 December comprise:

CHF	2005	2004
Capitalised R & D costs in tax books	61,130,507	44,193,683
Intangible assets	252,660	32,387
Plant and equipment	1,465,504	826,444
Prepaid pension	(114,613)	(3,335)
Inventories	–	490,566
<b>Total temporary differences</b>	<b>62,734,058</b>	<b>45,539,745</b>

In accordance with IAS 12 Arpida did not capitalise a deferred tax asset relating to tax loss carry-forwards and temporary differences since the criteria for recognition are not met. The expected tax rate would be 25% for the Swiss operations and 30% for the operations outside Switzerland.

## 8. Earnings per Share

Basic and diluted losses per share are calculated by dividing the net loss attributable to shareholders by the weighted average number of shares outstanding during the year.

CHF, except share and per share data	2005	2004
Net loss attributable to shareholders	(35,041,660)	(23,152,076)
Weighted average number of shares outstanding	14,562,069	7,813,003
Basic and diluted loss per share	(2.41)	(2.96)

For the years ended 31 December 2005, and 2004 loss per basic and diluted shares are based on weighted average of shares outstanding and exclude diluted shares relating to employee stock options and subordinated convertible loans, as they would be anti-dilutive.

## 9. Plant and Equipment

CHF	Laboratory equipment	Furnitures and fixtures	Office equipment	Other	Total 2005	Total 2004
<b>Historical cost</b>						
<b>1 January</b>	<b>4,220,545</b>	<b>201,483</b>	<b>750,659</b>	<b>156,525</b>	<b>5,329,212</b>	<b>2,916,425</b>
Consolidation changes	-	-	-	-	-	2,092,761
Additions	1,154,209	295,502	284,775	43,100	1,777,586	323,376
Disposals	-	-	-	-	-	-
Translation differences	14,515	623	330	-	15,468	(3,350)
<b>31 December</b>	<b>5,389,269</b>	<b>497,608</b>	<b>1,035,764</b>	<b>199,625</b>	<b>7,122,266</b>	<b>5,329,212</b>
<b>Accumulated depreciation</b>						
<b>1 January</b>	<b>(1,959,974)</b>	<b>(88,577)</b>	<b>(557,947)</b>	<b>(128,440)</b>	<b>(2,734,938)</b>	<b>(2,077,988)</b>
Consolidation changes	-	-	-	-	-	-
Additions	(930,184)	(132,175)	(196,633)	(20,145)	(1,279,137)	(655,934)
Disposals	-	-	-	-	-	-
Translation differences	(3,932)	(206)	(128)	-	(4,266)	(1,016)
<b>31 December</b>	<b>(2,894,090)</b>	<b>(220,958)</b>	<b>(754,708)</b>	<b>(148,585)</b>	<b>(4,018,341)</b>	<b>(2,734,938)</b>
<b>Net book value at</b>						
<b>31 December</b>	<b>2,495,179</b>	<b>276,650</b>	<b>281,056</b>	<b>51,040</b>	<b>3,103,925</b>	<b>2,594,274</b>

## 10. Intangible Assets

CHF	Goodwill	Research projects	Technology	Total 2005	Total 2004
<b>Historical costs</b>					
1 January	5,968,265	64,412	309,018	<b>6,341,695</b>	-
Consolidation changes	-	-	-	-	<b>6,353,232</b>
Additions	-	-	-	-	-
Disposals	-	(64,387)	-	<b>(64,387)</b>	-
Translation differences	32,113	(25)	1,663	<b>33,751</b>	<b>(11,537)</b>
<b>31 December</b>	<b>6,000,378</b>	-	<b>310,681</b>	<b>6,311,059</b>	<b>6,341,695</b>
<b>Accumulated amortisation</b>					
1 January	-	-	(33,048)	<b>(33,048)</b>	-
Consolidation changes	-	-	-	-	-
Additions	-	-	(154,448)	<b>(154,448)</b>	<b>(32,757)</b>
Disposals	-	-	-	-	-
Translation differences	-	-	(1,070)	<b>(1,070)</b>	<b>(291)</b>
<b>31 December</b>	-	-	<b>(188,566)</b>	<b>(188,566)</b>	<b>(33,048)</b>
<b>Net book value at 31 December</b>	<b>6,000,378</b>	-	<b>122,115</b>	<b>6,122,493</b>	<b>6,308,647</b>

Goodwill is tested for possible impairment annually. For this purpose, Arpida Group was determined to be the cash-generating unit. The recoverable amount is based on fair value, which is determined with reference to the publicly quoted share price of Arpida Ltd, less costs to sell.

## 11. Inventories

CHF	2005	2004
Auxiliary material	-	154,560
Work in progress	-	336,006
<b>Total</b>	<b>-</b>	<b>490,566</b>

Both, the auxiliary material and the semi-finished products were acquired as part of the business combination with Arpida A/S and were consumed subsequently.

## 12. Cash and Cash Equivalents

CHF	2005	2004
Cash at bank and in hand	8,763,492	1,981,999
Short-term bank deposits	113,656,917	66,217,188
<b>Total Cash and cash equivalents</b>	<b>122,420,409</b>	<b>68,199,187</b>

## 13. Share Capital

On 31 December 2003, the issued share capital amounted to CHF 1,022,170 consisting of 516,250 common shares with a nominal value of CHF 0.20 each and 4,594,600 preferred A, B and C shares with a nominal value of CHF 0.20 each.

On 7 May 2004, the Company increased its share capital by CHF 629,470 (3,147,350 preferred C shares with a nominal value of CHF 0.20 each). Part of this capital increase involved the conversion of the subordinated convertible loans into the preferred C shares. As of 23 September 2004, the Company increased its share capital by CHF 157,476 (787,379 preferred C shares with a nominal value of CHF 0.20 each). As of 14 October 2004, the Company increased its share capital by CHF 373,006 (1,865,030 preferred C shares with a nominal value of CHF 0.20 each) in order to acquire Arpida A/S and by CHF 12,270 (61,350 common shares with a nominal value of 0.20 each) in connection with the exercise of warrants associated with the subordinated convertible loans.

On 3 May 2005, the Company converted all preferred A, B and C shares one for one into common shares and issued 5,400,000 common shares in the Initial Public Offering at the SWX Swiss Exchange excluding the pre-emptive right ("Bezugsrecht") of the shareholders. The first day of trading was 4 May 2005, and the total number of registered common shares issued amounts to 16,371,959 with a nominal value of CHF 0.20 each, bringing the nominal share capital to CHF 3,274,391.80.

On 31 December 2005, the Company has a conditional share capital for the potential issuance of 1,935,000 registered shares (common shares) of CHF 0.20 each (CHF 387,000) under the stock option plan for employees, Board members and persons in comparable positions. On 31 December 2004, the conditional share capital was 1,389,750 registered shares (common shares) of CHF 0.20 each (CHF 277,950).

## 14. Accrued and Other Current Liabilities

CHF	2005	2004
Accrued vacation	935,590	812,770
Accrued salaries and social security	330,876	278,472
Accrued finance costs	77,465	441,567
Other	1,866,147	477,385
<b>Total</b>	<b>3,210,078</b>	<b>2,010,194</b>

## 15. Subordinated Convertible Loans

On 18 August 2003, the Company signed subordinated convertible loan agreements (8% interest) with 17 lenders (thereof 15 shareholders of the Company) at a nominal value of total CHF 6,017,058. The subordinated convertible loans were to be disbursed in two equal tranches. The first tranche, which amounted to CHF 3,008,529 or 50% of the total value, was disbursed within 10 days of the date of the subordinated convertible loan agreements. The second tranche would have been disbursed at the full and sole discretion of the Company but was never drawn down. The loans would have matured 18 months from 18 August 2003, unless converted into the Company's shares (preferred B shares in case no preferred C shares would have been issued) at the conversion price of at least CHF 14.40 per share.

On 7 May 2004, the subordinated convertible loans were converted into equity as part of the C financing round. There are no further obligations outstanding in connection with the subordinated loan agreements.

The fair values of the liability component and the equity conversion component were determined on 18 August 2003.

CHF	
Proceeds received from convertible loans	3,008,529
Equity conversion component	(87,855)
<b>Liability component on initial recognition at 18 August 2003</b>	<b>2,920,674</b>
Interest expense	109,349
<b>Total liability component at 31 December 2003</b>	<b>3,030,023</b>
Interest expense	86,263
<b>Total liability component converted at 7 May 2004</b>	<b>3,116,286</b>

Upon conversion of the subordinated convertible loans, warrants were issued which were exercisable at any time during their duration. They were given the right to subscribe to common shares of the Company without any preferential right. The exercise price was equal to the nominal value of the common shares (CHF 0.20). The calculation for the total

The fair value of the liability component, included in the current liabilities, was calculated using a market interest rate for an equivalent non-subordinated convertible loan. The residual amount, representing the value of the equity conversion component, is included in the equity in other reserves (refer to statement of equity).

In subsequent periods the liability component continued to be presented on the amortised cost basis, until extinguished on conversion or maturity of the loans.

The carrying amount of the liability component of the subordinated convertible loan at 7 May 2004, and at 31 December 2003, approximated its fair value. Interest expense on the loans are calculated on the effective yield basis by applying the effective interest rate (10.0%) for an equivalent non-subordinated convertible loan to the liability component of the subordinated convertible loans.

The subordinated convertible loans are recognised in the balance sheet as follows:

number of warrants to be issued for this subordinated convertible loans including interest accrued was computed according to the rules defined in the subordinated convertible loan agreements. All warrants were exercised on 14 October 2004.

## 16. Employee Benefits

Arpida maintains retirement plans covering all of its employees including its executive officers. The plan for the Danish Arpida A/S is considered to be a defined contribution plan and therefore no actuarial calculations as required under IAS 19 have been taken into consideration. Charges of CHF 373,038 and CHF 110,551 were recognized in 2005 and 2004 respectively for the Danish plan.

The Swiss plans are considered as defined benefit plans in accordance with IAS 19. These plans are structured according to the principles of the Swiss Occupational Benefits Law (BVG) and are substantially identical to the BVG programme

except that the Company plan also covers salaries above the salary limit of the BVG. The Company and its employees pay retirement contributions, which are defined as a percentage of the employees' covered salaries, to a collective pension fund operated by an insurance Company. Interest is credited to the employees' accounts at the minimum rate provided in the plan, payment of which is guaranteed by the insurance contract. Additionally the plans provide benefits on the death or long-term disability of its employees.

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

CHF	2005	2004
Present value of funded obligations	4,758,356	4,090,919
Fair value of plan assets	(4,599,378)	(3,820,663)
	<b>158,978</b>	<b>270,256</b>
Unrecognised actuarial gains (losses)	(273,591)	(273,591)
<b>Prepaid pension</b>	<b>(114,613)</b>	<b>(3,335)</b>

The amounts recognised in the income statement for the Swiss plans are as follows:

CHF	2005	2004
Current service cost	503,800	434,379
Interest cost	163,637	149,631
Expected return on plan assets	(133,723)	(127,078)
Participation contribution	(222,859)	(185,837)
<b>Net periodic pension cost</b>	<b>310,855</b>	<b>271,095</b>

Of the total charge CHF 242,466 (2004: CHF 206,032) and CHF 68,389 (2004: CHF 65,063) were included in research and development and management and general expenses, respectively. The actual return on plan assets was CHF 133,723 (2004: CHF 71,481).

Movement in the net asset/(liability) recognised in the balance sheet for the Swiss plans:

CHF	2005	2004
At beginning of year	3,335	(97,724)
Net periodic pension cost	(310,855)	(271,095)
Contributions paid	422,133	372,154
<b>At end of year</b>	<b>114,613</b>	<b>3,335</b>

The principal actuarial assumptions used for the Swiss plans were as follows:

	2005	2004
Discount rate	3.5%	4,0%
Expected return on plan assets	3.5%	4,0%
Future salary increases	1.5%	1.5%
Future pension increases	0.5%	0.5%

## 17. Stock Option Plans

The Board of Directors administers the Stock option plans. The granting to employees and members of the Board of Directors is, according to the stock option plan regulation, under the discretion of the Plan Administrator, who is elected by the Board of Directors of the Company.

No compensation expense has been recognised for options granted under plan A and Plan B except to the extent that the social security cost related to the issuance of options has been expensed.

### Plan A

Options under this equity-settled stock option plan were granted for the first time on 1 July 2001. According to this plan 20% of the options vest after two full years of employment and an additional 10% vest after the third year of employment. Finally, all remaining options would have vested on 1 July 2003, provided the option holder was at that time still employed by the Company. In case of death or disability (but not retirement), all options vest immediately. All options would have expired by 31 March 2004. In 2002, the plan was amended whereby all options became vested. Furthermore, the first exercise date is now 1 October 2004 (first day after a lock-up period of two years), and the options now expire by 1 October 2006.

### Plan B

In 2002, an additional stock option plan was issued. Options under this equity settled plan were granted for the first time on 1 October 2002. 20% of the options vest after two full years of employment, an additional 30% vests after the third year of employment and the remaining 50% vest after 4 years of employment. During the applicable post-service exercise period, no additional options vest. In case of death or

disability (but not retirement), all options vest immediately. The first exercise date is 1 October 2004 (first day after a lock-up period of two years), and the options expire by 1 October 2007.

### Plan C

In 2004, an additional stock option plan was issued. Options under this equity settled plan were granted for the first time on 1 May 2004. The options can be exercised between 1 May 2006, and 30 April 2007, after a lock-up period of two years. Economically, the options vest over three years as the Company has a repurchase right of the shares: Within the first year after the grant date, the Company is entitled to repurchase all the shares. Within the second year after the grant date, the Company is entitled to repurchase two third of the shares. Within the third year after the grant date, the Company is entitled to repurchase one third of the shares. The entitlement to repurchase shares ceases after three years.

### Plan D

In 2005, an additional stock option plan was issued. Options under this equity settled plan were granted for the first time on 31 December 2005. The options vest over four years. The lock-up period is four years. The first exercise date is 1 January 2010 (first day after a lock-up period of four years), and the options expire by 31 December 2016. In case of cessation of service, the vested options remain exercisable the later of (i) six months after termination or (ii) six months after the end of the lock-up period. In case of death, the vested options are exercisable within one year.

On 12 August 2004, the Company's shares were split 1 to 50. All references to options have been restated to reflect this change.

Options outstanding under the plans as of 31 December 2005 are as follows:

Year of grant	Senior Executive Officers	Non executive Board members	Other	Number of options outstanding	Weighted average exercise price (CHF)	Weighted average years remaining contractual life
2001	217,400	5,500	280,200	<b>503,100</b>	5.00	0.75
2002	172,600	5,700	75,470	<b>253,770</b>	5.00	1.75
2004	514,400	42,988	55,067	<b>612,455</b>	6.90	1.33
2005	158,512	10,313	12,000	<b>180,825</b>	10.00	11.00
<b>Total</b>	<b>1,062,912</b>	<b>64,501</b>	<b>422,737</b>	<b>1,550,150</b>	<b>6.33</b>	<b>2.34</b>

A summary of the options granted, exercised, cancelled and outstanding for the above plan is as follows:

	2005		2004	
	Number of options	Weighted average exercise price (in CHF)	Number of options	Weighted average exercise price (in CHF)
<b>Outstanding at 1 January</b>	<b>1,389,750</b>	<b>5.85</b>	<b>768,450</b>	<b>5.00</b>
Granted	180,825	10.00	621,300	6.90
Exercised	–	–	–	–
Forfeited	(20,425)	5.82	–	–
Expired	–	–	–	–
<b>Outstanding at 31 December</b>	<b>1,550,150</b>	<b>6.33</b>	<b>1,389,750</b>	<b>5.85</b>
Of which exercisable	739,820	5.00	720,485	5.00

The fair value of the 2004 grant using a binomial option value assessment model was CHF 2,353,365. The resulting expenses are recognised on a straight-line basis over the vesting period. The 2004 grant resulted in expenses of CHF 915,060 (CHF 116,439 related to research and develop-

ment, CHF 798,621 related to management and general expenses) for 2005 and CHF 990,367 (CHF 126,683 related to research and development, CHF 863,684 related to management and general expenses) for 2004. The significant inputs into the model for the 2004 grant were as follows:

Valuation date	1 May 2004
Expiration date	30 April 2007
Share price	CHF 10.04
Exercise price	CHF 6.90
Volatility	40.0%
Expected dividend yield	0.0%
Risk-free interest rate	1.4%

## 18. Related Parties

### Senior executive and Board compensation

The total compensation for the 5 senior executives (2004: 4 senior executives) and the 9 members of the Board of Directors (2004: 9 members) was as follows:

Compensation	Board of Directors		Senior executives	
	2005	2004	2005	2004
Short-term employee benefits	229,381	167,938	1,841,438	1,451,996
Post-employment benefits	–	–	124,230	103,372
Share-based compensations	71,443	79,210	774,183	834,929
<b>Total</b>	<b>300,824</b>	<b>247,148</b>	<b>2,739,851</b>	<b>2,390,297</b>

Two members of the Board of Directors are also senior executives. Their compensation and their options are included in the senior executive figures. Short-term employee benefits comprise salaries, bonus payments, social security and expense allowance. IFRS 2 rules were used for accounting for share-based compensation.

Options granted	2005	2004
Senior executives	158,512	514,400
Board of Directors	10,313	42,988
<b>Total</b>	<b>168,825</b>	<b>557,388</b>

The total number of options held by executives amounts to 1,062,912 (904,400 as per year-end 2004). The total number of options held by members of the Board of Directors amounts to 64,501 (54,188 as per year-end 2004).

See Note 16 and 17 to the consolidated financial statements for disclosure of other related parties transactions and balances.

## 19. Commitments and Contingencies

### Operating lease commitments

The future minimum lease payments under non-cancellable operating leases that are not accounted for in the balance sheet were as of year-end:

CHF	2005
Within one year	6,190
Later than one year and not later than five years	–
Later than five years	–
<b>Total</b>	<b>6,190</b>

### Commitment for the rent of buildings

CHF	2005
Within one year	914,550
Later than one year and not later than 5 years	5,332,945
Later than 5 years	12,647,340
<b>Total</b>	<b>18,894,835</b>

As of 1 January 2003, a rental contract is applicable for the building Dammstrasse 36, 4142 Münchenstein in Switzerland. This contract has been terminated with effect as per 31 December 2006.

In October 2005, the company entered into a rental contract for office and laboratory space in the "TechCenter Reinach" in Reinach, Switzerland, starting 1 December 2006. The rental period is 15 years unless it is terminated earlier or extended. The annual rent includes leasehold improvements. The company has the option to extend the rental term for an additional period of five years unless Arpida terminates the contract.

#### Research and development commitments

Arpida has entered into long-term research agreements with various supply institutions including potential milestone and other contingent payments amounting to CHF 4,707,950 in total. The following two contracts represent the most important collaborations:

According to one of the collaboration contracts, total milestone payments amount to CHF 4,050,000 and will be applied for a first compound developed under the agreement. If a further compound will be developed under this agreement, 75% of above disclosed milestone payments shall be due by Arpida. In case of a third and any other compound 50% of the mentioned milestone payments shall be due. The latter two payments are not included in the amount mentioned. The timing of such milestone payments cannot reliably be estimated due to the uncertainty involved in such projects.

According to another collaboration contract Arpida entered into, a milestone payment of USD 500,000 (CHF 657,950) is due immediately after the identification of a lead compound by the joint research committee.

#### Sales and purchase agreement

The Company obtained in 2001 from Hoffmann-La Roche exclusive ownership rights to iclaprim, including its enantiomers, in exchange for a one-time payment and additional future pay-

ments which are fixed as a single digit percentage of net sales. The one-time payment has been expensed as acquired in-process research and development costs in 2001. In 2005 and 2004 no payments were made under this agreement.

#### Other commitments

The company entered into various purchase commitments for services and materials as part of the ordinary business. These commitments are not in excess of current market prices and reflect normal business operations.

## 20. Contingent Assets

The Company is involved in a VAT discussion regarding a possible VAT receivable on incurred expenses for the period 1998–2003. In 2004, the Company received a reimbursement of CHF 511,767. With respect to the remaining VAT amount, which is approximately CHF 160,000, it is unclear whether it will be reimbursed. Therefore, no receivable has been recognised for this as of years-end 2005 and 2004.

## 21. Legal Proceedings

Arpida is not involved in legal proceedings.

## 22. Events Subsequent to the 31 December 2005 Balance Sheet Date

The Board of Directors approved the 2005 consolidated financial statements of the Company on 24 February 2006.

Report of the Group auditors  
to the General Meeting of  
Arpida Ltd  
Münchenstein

As auditors of the Group, we have audited the consolidated financial statements (balance sheet, statement of operations, statement of cash flows, statement of equity and notes), pages 36 to 57, of the Arpida Group for the years ended 31 December 2005 and 2004.

These consolidated financial statements are the responsibility of the Board of Directors. Our responsibility is to express an opinion on these consolidated financial statements based on our audit. We confirm that we meet the legal requirements concerning professional qualification and independence.

Our audit was conducted in accordance with Swiss Auditing Standards and with the International Standards on Auditing, which require that an audit be planned and performed to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement. We have examined on a test basis evidence supporting the amounts and disclosures in the consolidated financial statements. We have also assessed the accounting principles used, significant estimates made and the overall consolidated

financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements give a true and fair view of the financial position, the results of operations and the cash flows in accordance with the International Financial Reporting Standards (IFRS) and comply with Swiss law.

We recommend that the consolidated financial statements submitted to you be approved.

PricewaterhouseCoopers AG



Th. Brüderlin



R. Rutishauser

Basel, 24 February 2006

## Report of the Group Auditors

## Swiss Statutory Balance Sheets

CHF	31 Dec. 2005	31 Dec. 2004
<b>Assets</b>		
<b>Current assets</b>		
Cash and cash equivalents	8,299,701	1,926,356
Fixed deposit	98,657,897	46,000,000
Other receivables		
– Subsidiaries	104,000	–
– Third parties	680,599	349,110
Prepayments	2,900,803	248,294
<b>Total current assets</b>	<b>110,643,000</b>	<b>48,523,760</b>
<b>Non-current assets</b>		
Plant and equipment	1,014,769	569,404
Subsidiaries	24,900,708	24,900,708
Intangible assets		
– Goodwill	4,399,426	5,499,282
– Research and development costs	58,966,241	40,408,290
<b>Total non-current assets</b>	<b>89,281,144</b>	<b>71,377,684</b>
<b>Total assets</b>	<b>199,924,144</b>	<b>119,901,444</b>
<b>Liabilities and shareholders' equity</b>		
<b>Current liabilities</b>		
Trade accounts payables		
– Subsidiaries	5,620,397	–
– Third parties	1,269,483	573,347
Accrued expenses and other current liabilities	1,501,259	1,152,927
<b>Total current liabilities</b>	<b>8,391,139</b>	<b>1,726,274</b>
<b>Non-current liabilities</b>		
Provisions	1,245,800	406,832
<b>Total non-current liabilities</b>	<b>1,245,800</b>	<b>406,832</b>
<b>Shareholders' equity</b>		
Share capital	3,274,392	2,194,392
Legal reserves		
Agio	232,439,921	144,260,959
Accumulated loss	(45,427,108)	(28,687,013)
– Loss carried forward	(28,687,013)	(20,472,581)
– Net loss for the period	(16,740,095)	(8,214,432)
<b>Total shareholders' equity</b>	<b>190,287,205</b>	<b>117,768,338</b>
<b>Total liabilities and shareholders' equity</b>	<b>199,924,144</b>	<b>119,901,444</b>

## Swiss Statutory Statements of Operations

CHF	Note	Period from 1 Jan. to 31 Dec. 2005	Period from 1 Jan. to 31 Dec. 2004
<b>Income from services</b>			
– Subsidiaries		104,000	–
– Third parties		–	58,360
<b>Total operating income</b>		<b>104,000</b>	<b>58,360</b>
Research and development		(17,467,356)	(10,033,959)
Staff costs		(7,889,857)	(6,973,603)
Rent and maintenance		(593,100)	(454,443)
Administrative expenses		(2,075,745)	(1,424,149)
Other operating costs		(401,261)	(441,719)
Depreciation plant and equipment		(648,169)	(541,720)
Write-off research and development costs		(3,858,770)	(249,720)
Goodwill amortisation		(1,099,856)	–
Reimbursement subsidiaries		(5,620,397)	–
<b>Total operating expenses</b>		<b>(39,654,511)</b>	<b>(20,119,313)</b>
<b>Capitalisation of research and development costs</b>		<b>22,416,721</b>	<b>12,936,543</b>
Financial expenses		(9,407)	(795,135)
Financial income		1,171,602	116,751
<b>Loss before tax</b>		<b>(15,971,595)</b>	<b>(7,802,794)</b>
Taxes		(768,500)	(411,638)
<b>Net loss for the period</b>		<b>(16,740,095)</b>	<b>(8,214,432)</b>

## Proposed Appropriation of Accumulated Losses

The Board of Directors proposes to compensate the accumulated loss of CHF 45,427,108 with an equal amount of share premium in the general reserves.

CHF	
Loss carried forward as of 1 January 2005	(28,687,013)
Net loss for the period	(16,740,095)
<b>Accumulated loss as of 31 December 2005</b>	<b>(45,427,108)</b>
Compensation with share premium in the general reserves	45,427,108
<b>Loss to be carried forward</b>	<b>–</b>

## Notes to the Swiss Statutory Financial Statements of Arpida Ltd

Notes in accordance with article 663b of the Swiss Code of Obligations

CHF	2005	2004
1. Lease commitments not recorded in the balance sheet	6,190	16,801
2. Fire insurance value of plant and equipment	4,000,000	4,000,000
3. Contingent capital	387,000	277,950
4. Liabilities to pension fund	58,350	–

### 5. Subsidiaries

Name	Location	Nominal capital	Holding	Purpose
Arpida UK Ltd (inactive)	UK	GBP 1,000	100%	Trade
Arpida A/S	DK	DKK 4,311,538	100%	Research

### 6. Major shareholders

According to the information available to Arpida, the following shareholders held over 5% as at 31 December 2005:

Shareholder	Location	Arpida Shares
Health Cap Funds	Sweden	8.5%
HBM Bioventures	Cayman Islands	6.8%
3i Group plc	United Kingdom	6.4%

7. The position *Research and Development costs* (intangible assets) comprises capitalised research and development costs relating to various projects. Research and development projects are capitalized to the extent that research and development projects are considered to represent sustained and valuable prospective commercial opportunities and the financing of the finalisation of the projects appears possible. Exploratory research is expensed as occurred. For research and development projects, where these requirements are not met, any costs capitalised in previous periods as well as cost incurred in the current period are written-off and fully charged to the income statement. However, the remaining book-value of CHF 58,966,241 depends on Management's

assumption that the results of the respective research and development projects are expected to be positive and the projects can be successfully finalised.

These circumstances indicate the existence of a material uncertainty regarding the valuation of the capitalised research and development costs, because it is uncertain whether these projects can be successfully finalised and therefore these capitalised research and development costs can be realised through future revenues. In case the respective research and development projects are not successful, the amount of CHF 58,966,241 is fully or partially impaired and needs to be charged to the income statement.

Report of the statutory auditors  
to the General Meeting of  
Arpida Ltd  
Münchenstein

As statutory auditors, we have audited the accounting records and the financial statements (balance sheet, statement of operations and notes), pages 59 to 61, of Arpida Ltd for the year ended 31 December 2005.

These financial statements are the responsibility of the Board of Directors. Our responsibility is to express an opinion on these financial statements based on our audit. We confirm that we meet the legal requirements concerning professional qualification and independence.

Our audit was conducted in accordance with Swiss Auditing Standards, which require that an audit be planned and performed to obtain reasonable assurance about whether the financial statements are free from material misstatement. We have examined on a test basis evidence supporting the amounts and disclosures in the financial statements. We have also assessed the accounting principles used, significant estimates made and the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the accounting records and financial statements and the proposed appropriation of the accumulated losses comply with Swiss law and the company's articles of incorporation.

We recommend that the financial statements submitted to you be approved.

Without qualifying our opinion we draw attention to Note 7 of the financial statements, whereas a material uncertainty regarding the valuation of the capitalised research and development costs exists. This cannot be finally assessed at this date.



Th. Brüderlin



R. Rutishauser

Basel, 24 February 2006

## Report of the Statutory Auditors

## A

**Activity** The strength of a drug (e.g. an antibacterial agent) to exert its action against its target (e.g. bacterium).

**Antibacterial** Any agent that destroys or prevents the growth of bacteria.

**Antibiotic** A class of natural and synthetic compounds that inhibits the growth of or kills bacteria.

**Anti-infective agent** A compound able to stop the growth of or kill infectious agents (viruses, bacteria, fungi, protozoa, etc.).

**Assay** A test to determine the properties of a chemical compound by means of a biological response.

## B

**Bacterium** A bacterium (plural: bacteria) is a microscopic single-celled organism. Bacteria lack the nucleus and organelles of the more complex cells. They are the target of drugs known as antibiotics.

**Bacterial resistance** A change (mutation) occurring in a bacterium, that enables it to tolerate an antibiotic.

**Bactericidal** Property of killing bacteria. A term often used to describe certain antibiotics.

**Bacteriostatic** Arresting the growth of bacteria. A term often used to describe the property of antibiotics.

**Broad-spectrum** Often used to describe an antibiotic that is effective against a wide range of microorganisms.

## C

**CDC** U.S. Center for Disease Control and Prevention

**Cell wall synthesis** The bacterial cellular process of building cell wall.

**Clinical development** Process of conducting the necessary studies to demonstrate safety and efficacy of a drug candidate in humans.

**Clinical trial** A test in healthy volunteers or patients that examines the safety and efficacy of a drug candidate.

**Community Antibiotics Market** The market associated with antibiotics that are solely/primarily prescribed by general practitioners for infections that are acquired and treated outside the hospital setting.

## D

**DHFR/Dihydrofolate reductase** An essential enzyme of the folic acid pathway, inhibition of which leads to death or massive growth impairment of living organisms.

## E

**Efficacy** Strength, effectiveness; the ability of a drug to control or cure an illness.

**EMA** European Agency for the Evaluation of Medical products

**Enzyme** A protein capable of catalysing (facilitate and speed up) a set of specific cellular chemical reactions.

## F

**FDA** The US Food and Drug Administration

## G

**GMP** Good Manufacturing Practice

**Gram-negative bacteria** Bacteria may be classified either as Gram-positive or Gram-negative based on the differences in the structure of their bacterial cell envelope. In Gram-negative bacteria a thin cell wall is surrounded by a double impermeable layer which constitutes an outer membrane.

**Gram-positive bacteria** Bacteria may be classified either as Gram-positive or Gram-negative based on the differences in the structure of their bacterial cell envelope (see Gram-negative bacteria). In Gram-positive bacteria the inner membrane is simply protected by a well-structured thick cell wall.

## H

**Hit** A primary active compound, with specific binding behaviour, exceeding a certain threshold value in a given assay.

**Hospital Antibiotics Market** The market associated with antibiotics that are solely/primarily prescribed for infections that must be treated in hospital settings or have been acquired during hospitalisation.

**HTS** High-Throughput Screening. Screening (of a compound collection) to identify hits in an *in vitro* assay.

## I

**IND** Investigational New Drugs – drug candidates under investigation by a regulatory authority such as the FDA.

**In vitro** Biological or biochemical process or testing conducted in a test tube.

**In vivo** Biological or biochemical process or testing conducted in a living organism (often an animal).

**Intravenous** Into a vein

## L

**Lead optimisation** Stage of the drug development process indicating the synthesis and testing of tens/hundreds of variations of a chemical compound or of the series it represents in order to improve its pharmacology, its activity or its potential for side effects.

## M

**Mechanism of action** The way by which a drug exerts its activity on a target.

**Microorganism/Microbe** A microorganism or microbe is an organism that is so small that it is invisible to the naked eye. The term is synonymous by usage to single-celled organisms, such as bacteria and archaea.

**MRSA** Methicillin-Resistant *Staphylococcus aureus* – bacterial strain resistant to methicillin.

**Multi-drug resistant** Resistant to multiple antibiotics

## N

**New Emerging Pathogen** A formerly harmless microbe turning into a disease threat by acquiring new capacities for initiating infections and disease or by altering the human host's natural ability to mount an effective immune response.

**NIAD** National Institute of Allergy and Infectious Diseases (US)

**Nosocomial Infections** Infections acquired in hospital

**Novel drug/novel pharmaceutical/novel antibiotic** A drug/pharmaceutical/antibiotic that is patentable because it is new in chemical structure and either acts on a target which is not exploited by any other known drug or it has properties, which make it sufficiently different from any other drug sharing the same target.

**Novel target** A target which is not exploited by any other known drug.

**Novel mechanism of action** The mechanism of action of a drug that either acts differently from any other drug on a known target or that acts on a novel target.

**Novel class of drugs/pharmaceuticals/antibiotics** Drugs/pharmaceuticals/antibiotics that all employ the same novel mechanism of action.

## P

**Parenteral** Therapy that is not introduced orally through the alimentary tract but delivered by injection such as subcutaneous, intravenous or intramuscular routes

**Pathogen** Organism (bacterium, fungus, virus or similar) that can infect and cause disease.

**Pharmacokinetic study** The analysis of the time courses of absorption, distribution and elimination of drugs in animals and/or humans.

**Phase I** Phase of drug development involving clinical studies in healthy volunteers primarily to determine the behaviour of the drug in the human body and to assess safety and tolerance profile.

**Phase II** Phase of drug development involving clinical studies in patients to test therapeutic activity and observe safety and tolerance usually comparing a range of dosing regimens.

**Phase III** Phase of drug development involving large scale clinical studies in patients to confirm therapeutic activity and acceptable safety and tolerance of the selected dosing regimen.

**Placebo** Substance with no action administered as a control to a group in the same quantity and concentration as the drug being tested.

**Potency** The power of a medicinal agent to elicit the desired response.

**Pre-clinical** Phase of activities where a new drug candidate is tested in animal models and where other activities are performed to prepare for testing in humans.

**Protein** A molecule produced by cells that can have structural or catalytic roles.

## S

**SAR** Structure-Activity Relationship

**Staph** *Staphylococcus aureus*, often referred to simply as "staph", are bacteria healthy people can carry on the skin or the nose. *Staphylococcus* bacteria commonly cause skin infections. In addition to skin infections, *staphylococcus* bacteria can cause infections in the blood, in the bones and in the lungs (pneumonia).

**Strep** *Streptococcus pneumoniae*, often referred to simply as "strep", is the leading cause of bacterial pneumonia, meningitis and otitis media.

**Superbug** Bacteria that are resistant to a wide range of commonly used antibiotics.

## T

**Target (bacterial)** A specific biological molecule (protein, enzyme or other) essential for bacterial survival and/or proliferation and/or host invasion that is addressed by a drug.

## Contact and Important Dates

### Contact

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5 April  
General Shareholders' Meeting, Basel

15 August  
Half-year results 2006

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Arpida Ltd

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