



**For immediate release:**

## **Entelos Announces 2006 Preliminary Results**

**Foster City, CA, April 18, 2007** – Entelos, Inc. (LSE: ENTL), a leading life sciences company building predictive computer models of human physiology and “virtual patients” for drug discovery and development, today announces its preliminary results for the twelve months ended 31 December 2006.

### **2006 Highlights**

- Successful admission to AIM in April 2006, raising a total of \$16.6 million in net proceeds through a placing of 13,810,173 shares of common stock
- Recognized revenues of \$21.6 million for the full year 2006, a substantial portion of this revenue resulted from completion of a large multi-year contract, compared to \$2.8 million for the full year 2005
- Reduced net loss to \$754,000 compared to \$13.8 million for the full year 2005
- Six new collaborations formed in multiple disease areas:
  - Renewed and expanded ongoing collaboration with long term customer Johnson & Johnson Pharmaceutical Research and Development, L.L.C. to include multiple therapeutic areas over the next five years
  - Signed two-year collaboration with Roche focused on metabolic diseases
  - Established *in silico* research facility with the American Diabetes Association to test novel therapies in type 1 diabetes using a “virtual diabetic mouse”
  - Formed collaboration with Novartis in multiple disease areas
  - Announced completion of skin sensitization PhysioLab platform with Unilever
  - Announced completion of the cardiovascular PhysioLab platform and research being conducted with three pharmaceutical companies

### **Post-Period Highlights**

In separate announcements following the year end, Entelos announced that it has:

- Extended its research agreement with Organon in rheumatoid arthritis
- Continued its research contract with Pfizer in cardiovascular disease, Entelos’ original collaborator in building the cardiovascular PhysioLab platform
- Appointed two new non-executive directors in February and April 2007, respectively:
  - Greg Schiffman, currently Chief Financial Officer of Seattle-based Dendreon Corporation. Mr. Schiffman brings a strong financial background from the life sciences industry and he will chair the Audit Committee
  - Per Peterson, M.D., Ph.D., retired Chair of Research and Development and a former member of the Executive Committee of Johnson & Johnson. Dr. Peterson brings a wealth of senior-executive level experience from the pharmaceutical industry
- Acquired a series of compounds from Ortho-McNeil, an affiliate of Johnson & Johnson Pharmaceutical Research and Development, L.L.C.

James Karis, Chief Executive Officer said: "I am delighted that we have made such strong progress in our first year as a public company. We have continued to expand our blue chip customer base and our portfolio of physiolab platforms which are addressing a growing number of disease areas. Just today we are announcing that we have acquired a series of compounds which we hope to develop in-house. I am also delighted to welcome our two new board members who I am confident will add considerable experience to our company and will help us to continue to add value to our shareholders in 2007 and beyond".

### **Enquiries**

#### **Entelos, Inc.**

James Karis, CEO

Alan Blazej, CFO

Jill Fujisaki, Investor Relations

Tel: +44 207 404 5959

(on 18 April)

Tel: +1 650 572 5430

#### **Brunswick Group**

Justine McIlroy / Alex Tweed / Jon Coles

Tel: +44 207 404 5959

## CHAIRMAN AND CHIEF EXECUTIVE'S STATEMENT

It gives us great pleasure to present our results for the year ended 31 December 2006. First and foremost, on 12 April 2006, Entelos successfully completed its initial public offering on the AIM Market of the London Stock Exchange ("AIM"), raising \$16.6 million dollars after expenses and increasing the visibility of the company. Since then, Entelos has made significant progress in expanding its customer base, building new products, and focusing on the most promising new opportunities with which to leverage its base predictive technologies.

Celebrating its 10th anniversary in August 2006, the Company has achieved significant milestones in the following areas:

### Financial and Operating Highlights

- Achieved successful admission to AIM in April 2006, raising a total of \$16.6 million in net proceeds through a placing of 13,810,173 shares of common stock
- Recognized revenues of \$21.6 million in 2006 compared to \$2.8 million in 2005
- US accounting rules require revenue from some long term contracts to be recognized at the end of the contract rather than as the work is performed. During 2006 we recognized revenue on a large multi-year contract. This is the primary reason for the large increase in revenue year over year
- Reduced our net loss to \$754,000 in 2006 compared to \$13.8 million in 2005
- Paid down \$4 million of high-interest debt and strengthened our balance sheet
- As at 31 December 2006, had \$9.9 million in cash, investments and accounts receivable

### Collaborative Partners

Entelos partners with global pharmaceutical and biotechnology companies and provides services to accelerate drug discovery, development, and commercialization. We made significant progress in 2006 in expanding our customer base as well as securing new business with existing customers.

- In March, we announced that long-time pharmaceutical customer Johnson & Johnson Pharmaceutical Research and Development (J&JPRD) renewed and expanded its relationship with Entelos to include multiple therapeutic areas over the next five years
- In May, we announced a two-year collaboration with Roche in metabolic diseases to help optimize future clinical trials across several research programs
- In early June, the American Diabetes Association (ADA) and Entelos established an *in silico* research facility in type 1 diabetes, providing academic researchers the ability to tap into Entelos' powerful biosimulation platforms using a "virtual diabetic mouse" to test novel therapies for this complex, underserved disease area
- In August, we announced a collaboration with Novartis in multiple disease areas
- In December, we announced completion of the Skin Sensitization PhysioLab® platform, built in collaboration with Unilever, and designed to assess the risk of chemicals that may induce skin allergy (sensitization) in humans
- Post-period, the company also announced:
  - Extending its research agreement with Organon in rheumatoid arthritis for two years; and
  - Continuing its research contract with Pfizer in cardiovascular disease.

## PhysioLab® Models

The centerpiece of our predictive technology is our proprietary PhysioLab biosimulation platforms. During 2006, we made important progress on developing and expanding our capabilities by completing three new disease models:

- Type 1 Diabetes: In collaboration with the American Diabetes Association, we completed the type 1 Diabetes PhysioLab platform to enhance understanding of the disease, to translate animal test results into a human context, and to more rapidly test and find novel therapies that will be effective in patients.
- Skin Sensitization: In collaboration with Unilever, we completed the Skin Sensitization PhysioLab platform, designed to assess the risk of chemicals that may induce skin allergy (sensitization) in humans. Entelos is now actively offering the use of this technology to other companies as part of a broader effort within the European Union to “replace, reduce and refine animal use (the Three R’s)” in safety and efficacy evaluations within the pharmaceutical, chemicals, cosmetics, agrochemicals and food manufacturing industries.
- Atherosclerosis/Cardiovascular: In December, we announced conducting research with three pharmaceutical customers with this model of cholesterol regulation and atherogenesis that embodies the most significant precursors leading to heart attacks and stroke. Post-period, the company announced that Pfizer, the original collaborator in building this platform, extended its agreement to conduct further research in cardiovascular disease.

## Post-Period Announcements

- We announced that due to two of our customers reprioritized clinical programs, expected follow-on research will be delayed into later periods and we have since realigned our costs.
- We appointed two new non-executive directors in February and April 2007, respectively:
  - Greg Schiffman, currently Chief Financial Officer of Seattle-based Dendreon Corporation. Mr. Schiffman brings a strong financial background from the life sciences industry and he will chair the Audit Committee.
  - Per Peterson, M.D., Ph.D., retired Chair of Research and Development and a former member of the Executive Committee of Johnson & Johnson. Dr. Peterson brings a wealth of senior executive level experience from the pharmaceutical industry.
- Dr. Jonathan MacQuitty, a director of the company since March 2000 and President and Director of Abingworth’s US subsidiary, Abingworth Management Inc., will not be standing for re-election to the Board at the Annual General Meeting to be held on 23 May 2007. We thank Dr. MacQuitty for his many contributions to the Board during his tenure as a director.
- Finally, we acquired a series of selective progesterone-receptor modulators from Ortho-McNeil, an affiliate of Johnson & Johnson Pharmaceutical Research and Development, L.L.C. The lead compound has been tested in humans, and Entelos intends to explore the possibility of using these compounds to treat a variety of women’s health-related diseases such as endometriosis, uterine fibroids, and breast, uterine, or ovarian cancers.

## Strategy & Outlook

We are looking forward to finding new ways to use our predictive technology and disease expertise and creating a broader and deeper capability to help our customer base address their critical needs, which include:

- Evaluating and acquiring promising therapeutics for their pipelines
- Discovering and developing new therapeutics in a more cost-effective manner
- Salvaging therapeutic programs and initiatives through reprofiling and repositioning; that is, finding new uses and indications for existing drug programs.

Our strategy thus focuses on the following key points:

- Continue to build more models and generate revenue from services and technology licensing

- Expand customers to include markets outside of pharmaceutical R&D
- Acquire rights to promising late stage therapeutics for value added development
- Pursue targeted acquisitions of complementary technologies and services to:
  - Provide more valuable solutions to customers
  - Expand our geographic presence
  - Diversify our customer base.

Going forward, we would like to highlight several important milestones for 2007:

- We expect to be in line with our previous trading statement dated 12 March 2007 for full-year 2007 revenues
- We plan to grow both organically and by acquisition
- We plan to initiate and complete development of a new PhysioLab platform in oncology
- We expect to begin development of in-licensed therapeutics, beginning with our acquired series of selective progesterone-receptor modulators
- Finally, while consolidations and reductions in research and development budgets in the pharmaceutical industry will continue to challenge us, other trends such as the FDA's support for greater use of predictive technologies, the European Union's 3R's initiative, and the convergence of devices, diagnostics, and therapeutics in the life sciences offer us new opportunities to apply our technology and disease expertise. We intend to take advantage of these opportunities.

We are excited with this new era of Entelos' growth and look forward to even greater successes in the future.

**Jon Saxe**  
**Chairman of the Board**

**James M. Karis**  
**President and Chief Executive Officer**

18 April 2007

## MANAGEMENT REVIEW

### Financial Information

The financial record of the Company is set out in the section entitled "Financials". The following data has been extracted from that section except for cash receipts.

	<b>Year Ended 31 December 2006</b>	<b>Year Ended 31 December 2005</b>
	<b>\$'000</b>	<b>\$'000</b>
Revenues	21,564	2,767
Cost of revenues	(7,862)	(6,891)
General and administrative	(4,266)	(1,965)
Research and development	(6,673)	(5,270)
Sales and marketing costs	(2,260)	(1,965)
Goodwill and intangible impairment charges	(1,370)	-
Net loss	<u>(867)</u>	<u>(13,324)</u>
Cash receipts from customers	10,127	12,831
Waived contractual rights to \$4,200,000 of receipts from a customer	4,200	-
Total	<u>14,327</u>	<u>12,831</u>

### Revenues

The Company's revenue is principally derived from long term contracts with large pharmaceutical companies. US GAAP revenue recognition rules require revenue from some long term contracts to be recognized at the end of the contract rather than on a prorated basis as the work is performed. As a result, revenue may not be recorded in the same period in which the work is performed. During 2006 we met certain obligations that allowed us to recognize revenue on a large multi-year contract which is the primary reason for the large increase in revenue year over year.

### Cost of revenues

Cost of revenues is primarily comprised of personnel costs and related overhead for the employees working on customer projects. The increase in cost of revenues in 2006 from 2005 is a result of an increase in the number of scientists working directly on customer projects. The average number employees or full time equivalents (FTE's) working on customer projects was 36.9 during 2006 versus 29.1 during 2005. FTE's and cash receipts are the key indicators of the Company's operating progress year over year.

### General and administrative

The increase in general and administrative is primarily due to the increase in costs associated with the Company's status as an AIM-listed company public entity effective April 2006 (professional fees, board fees, insurance costs, etc.) as well as additional personnel required to maintain appropriate governance procedures.

### Research and development

Research and development expenses include personnel costs and related overhead for the employees working on internal projects as well as outside service costs and patent fees. Internal projects are focused on creating business assets and other intellectual property that can support the expansion of the Company's business activities. The increase in research and development costs year over year is primarily due to an increase in personnel and the number of internal development projects.

**Sales and marketing**

The increase in sales and marketing costs in 2006 from 2005 is primarily due to an increase in the number of independent sales personnel utilized.

**Goodwill and intangible impairment charges**

During fiscal 2006, in performing our annual impairment test of goodwill and intangible assets in accordance with Statement of Financial Accounting Standards No. 142 "Goodwill and Other Intangible Assets" ("SFAS No. 142), we determined that the carrying value of goodwill and net intangible assets associated with our acquisition of Discovery Innovations, Inc. exceeded their estimated fair values. Consequently, we recorded non-cash intangible impairment charges of \$1,370,570.

**Cash receipts**

Cash receipts from customers are payments actually received pursuant to customer service contracts. Additionally, the Company waived the contractual right to \$4,200,000 of receipts from a customer as payment for a family of therapeutic compounds.

# FINANCIAL STATEMENTS

## ENTELOS, INC. UNAUDITED BALANCE SHEET

	31 December	
	2006	2005
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 4,702,426	\$ 283,005
Short-term investments	3,267,351	5,103,851
Accounts receivable, net of allowance of \$0 and \$50,000 at 31 December 2006 and 2005, respectively	1,969,539	2,501,703
Notes receivable from related parties	—	522,785
Prepaid expenses and other current assets	238,425	703,375
Total current assets	<u>10,177,741</u>	<u>9,114,719</u>
Property and equipment, net	2,159,102	1,209,741
Intangible assets, net	—	447,111
Notes receivable from related parties	694,443	204,167
Other assets	375,000	444,754
Total assets	<u>\$ 13,406,286</u>	<u>\$ 11,420,492</u>
<b>LIABILITIES, REDEEMABLE CONVERTIBLE PREFERRED STOCK AND STOCKHOLDERS' DEFICIT</b>		
Current liabilities:		
Accounts payable	\$ 379,159	\$ 599,985
Accrued liabilities	527,303	714,942
Accrued compensation	2,133,794	1,649,150
Deferred revenue	13,770,388	25,359,375
Notes payable, current	112,446	1,605,686
Total current liabilities	<u>16,923,090</u>	<u>29,929,138</u>
Notes payable, less current portion	—	2,444,367
Total liabilities	<u>16,923,090</u>	<u>32,373,505</u>
Redeemable convertible preferred stock: no par value; 29,000,000 shares authorized; 0, and 24,572,519 shares issued and outstanding at 31 December 2006 and 2005, respectively.	—	51,432,509
Stockholders' deficit		
Common stock, par value \$0.001, authorized 150,000,000 shares, issued and outstanding 53,265,434 and 9,224,598 shares at 31 December 2006 and 2005, respectively	53,266	9,225
Additional paid-in capital	70,625,226	1,263,961
Deferred stock-based compensation	(310,717)	(562,597)
Accumulated deficit	<u>(73,884,579)</u>	<u>(73,096,111)</u>
Total stockholders' deficit	<u>(3,516,804)</u>	<u>(72,385,522)</u>
Total liabilities, redeemable convertible preferred stock and stockholders' deficit	<u>\$ 13,406,286</u>	<u>\$ 11,420,492</u>

**ENTELOS, INC.**  
**UNAUDITED STATEMENTS OF OPERATIONS**

Years Ended 31 December

	<u>2006</u>	<u>2005</u>	<u>2004</u>
Revenues	\$ 21,564,488	\$ 2,766,999	\$ 2,098,684
Operating costs and expenses:			
Cost of revenue	7,861,754	6,891,302	4,527,161
General and administrative	4,265,901	1,965,404	1,761,621
Research and development	6,673,558	5,269,771	4,890,706
Sales and marketing	2,260,110	1,964,501	2,103,369
Goodwill and intangible impairment charges	1,370,570	—	—
Total operating costs and expenses	<u>22,431,893</u>	<u>16,090,978</u>	<u>13,282,857</u>
Loss from operations	(867,405)	(13,323,979)	(11,184,173)
Interest income	555,772	268,726	87,536
Interest expense	(681,926)	(755,886)	(234,318)
Other income (expense), net	<u>(154,854)</u>	<u>10,745</u>	<u>(82,491)</u>
Loss before cumulative effect of change in accounting principle	(1,148,413)	(13,800,394)	(11,413,446)
Cumulative effect of change in accounting principle	<u>394,549</u>	<u>—</u>	<u>—</u>
Net loss	(753,864)	(13,800,394)	(11,413,446)
Accretion on redeemable preferred stock	<u>(34,604)</u>	<u>(138,888)</u>	<u>(290,724)</u>
Net loss allocable to common stockholders	<u>\$ (788,468)</u>	<u>\$ (13,939,282)</u>	<u>\$ (11,704,170)</u>
Net loss per share - basic and diluted			
Before cumulative effect of change in accounting principle	\$ (0.03)	\$ (1.56)	\$ (1.35)
Cumulative effect of change in accounting principle	<u>0.01</u>	<u>—</u>	<u>—</u>
Net loss per share - basic and diluted	<u>\$ (0.02)</u>	<u>\$ (1.56)</u>	<u>\$ (1.35)</u>
Weighted average common shares outstanding used in calculating net loss per common share:			
Basic and diluted	<u>41,427,310</u>	<u>8,914,997</u>	<u>8,681,026</u>

**ENTELOS, INC.**  
**UNAUDITED STATEMENTS OF STOCKHOLDERS' DEFICIT**

	Common Shares		Additional Paid-In Capital	Deferred Stock- Based Compensation	Accumulated Deficit	Total Stockholders' Deficit
	Shares	Amount				
<b>Balances, 31 December 2003</b>	8,635,219	\$ 8,635	\$ 459,409	\$ -	\$ (47,452,659)	\$ (46,984,615)
Net loss	-	-	-	-	(11,413,446)	(11,413,446)
Issuance of common stock on exercise of options	129,825	130	21,876	-	-	22,006
Deferred stock based compensation	-	-	92,073	(92,073)	-	-
Amortization of deferred stock-based compensation	-	-	-	13,053	-	13,053
Accretion on redeemable preferred stock	-	-	-	-	(290,724)	(290,724)
<b>Balances, 31 December 2004</b>	<u>8,765,044</u>	<u>8,765</u>	<u>573,358</u>	<u>(79,020)</u>	<u>(59,156,829)</u>	<u>(58,653,726)</u>
Net loss	-	-	-	-	(13,800,394)	(13,800,394)
Issuance of common stock on exercise of options	459,554	460	105,445	-	-	105,905
Deferred stock based compensation	-	-	585,158	(585,158)	-	-
Amortization of deferred stock-based compensation	-	-	-	101,581	-	101,581
Accretion on redeemable preferred stock	-	-	-	-	(138,888)	(138,888)
<b>Balances, 31 December 2005</b>	<u>9,224,598</u>	<u>9,225</u>	<u>1,263,961</u>	<u>(562,597)</u>	<u>(73,096,111)</u>	<u>(72,385,522)</u>
Net loss	-	-	-	-	(753,864)	(753,864)
Conversion of redeemable convertible preferred stock to common stock	28,921,934	28,922	50,911,799	-	-	50,940,721
Conversion of warrants from warrants for preferred stock to warrants for common stock	-	-	287,597	-	-	287,597
Issuance of common stock on exercise of options	652,964	653	149,473	-	-	150,126
Issuance of common stock upon initial public offering, net of issuance costs	13,810,173	13,810	16,622,981	-	-	16,636,791
Issuance of common stock for acquisition	655,765	656	956,761	-	-	957,417
Amortization of deferred stock-based compensation	-	-	-	146,406	-	146,406
Reversal of deferred compensation due to cancellations	-	-	(105,474)	105,474	-	-
Stock based compensation expense	-	-	538,128	-	-	538,128
Accretion on redeemable preferred stock	-	-	-	-	(34,604)	(34,604)
<b>Balances, 31 December 2006</b>	<u>53,265,434</u>	<u>\$ 53,266</u>	<u>\$ 70,625,226</u>	<u>\$ (310,717)</u>	<u>\$ (73,884,579)</u>	<u>\$ (3,516,804)</u>

**ENTELOS, INC.**  
**UNAUDITED STATEMENTS OF CASH FLOWS**

	31 December		
	2006	2005	2004
Cash flows from operating activities:			
Net loss	\$ (753,864)	\$ (13,800,394)	\$ (11,413,446)
Adjustments to reconcile net loss to net cash used in operating activities:			
Depreciation and amortization	826,779	708,308	856,433
Change in fair value of warrants	(238,796)	—	—
Stock-based compensation	684,534	101,581	13,053
Amortization of discount on notes payable	162,850	136,196	22,954
Goodwill and asset impairment charges	1,370,570	—	—
Changes in assets and liabilities:			
Accounts receivable	532,164	3,497,583	2,091,772
Prepaid expenses, notes receivable and other current assets	464,950	(797,606)	23,844
Other assets	102,263	(324,754)	—
Accounts payable	(220,826)	(548,865)	(171,985)
Accrued liabilities	49,676	123,611	201,030
Accrued compensation	484,644	118,938	152,661
Deferred revenue	(11,588,987)	6,567,167	6,194,708
Net cash used in operating activities	<u>(8,124,043)</u>	<u>(4,218,235)</u>	<u>(2,028,976)</u>
Cash flows from investing activities:			
Purchase of short-term investments	(22,272,700)	(6,718,758)	(469,977)
Sales of short-term investments	24,109,200	3,666,341	1,419,525
Purchases of property and equipment	(1,742,182)	(833,286)	(542,042)
Net cash provided by (used in) investing activities	<u>94,318</u>	<u>(3,885,703)</u>	<u>407,506</u>
Cash flows from financing activities:			
Proceeds from issuance of redeemable convertible preferred stock, net of issuance costs	—	4,962,901	—
Proceeds from issuance of common stock on exercise of options	150,126	105,905	22,006
Proceeds from initial public offering of common stock, net	16,636,791	—	—
Change in book overdraft	(237,314)	237,314	—
Proceeds from issuance of notes payable	—	3,000,000	2,600,014
Repayment of notes payable	(4,100,457)	(1,820,562)	(564,159)
Net cash provided by financing activities	<u>12,449,146</u>	<u>6,485,558</u>	<u>2,057,861</u>
Net increase (decrease) in cash and cash equivalents	4,419,421	(1,618,380)	436,391
Cash and cash equivalents at beginning of year	<u>283,005</u>	<u>1,901,385</u>	<u>1,464,994</u>
Cash and cash equivalents at end of year	<u>\$ 4,702,426</u>	<u>\$ 283,005</u>	<u>\$ 1,901,385</u>
<b>Supplemental disclosures of cash flow information:</b>			
Interest paid	<u>\$ 519,135</u>	<u>\$ 439,836</u>	<u>\$ 234,318</u>
<b>Supplemental disclosure of noncash investing and financing activities:</b>			
Issuance of warrants in connection with notes payable	<u>—</u>	<u>—</u>	<u>\$ 322,000</u>
Issuance of redeemable preferred stock upon an acquisition	<u>—</u>	<u>\$ 500,000</u>	<u>—</u>
Issuance of common shares upon acquisition	<u>\$ 957,417</u>	<u>—</u>	<u>—</u>
Deferred stock-based compensation	<u>—</u>	<u>\$ 585,158</u>	<u>\$ 92,073</u>
Accretion on redeemable convertible preferred stock	<u>\$ 34,604</u>	<u>\$ 138,888</u>	<u>\$ 290,724</u>
Reclassification of preferred stock warrant upon adoption of of FSP 150-5	<u>\$ 526,392</u>	<u>—</u>	<u>—</u>

**ENTELOS, INC.**  
**NOTES TO FINANCIAL STATEMENTS (UNAUDITED)**

**NOTE 1 - The Company and Summary of Significant Accounting Policies**

**The Company**

Entelos, Inc (the "Company") was incorporated in the state of California on 31 July 1996. On 4 April 2006, the Company reincorporated from the State of California into the State of Delaware. On 12 April 2006, the Company completed an initial public offering on the Alternative Investment Market of the London Stock Exchange ("AIM") for the sale of 13,810,173 common shares which raised \$16.6 million of net proceeds.

Entelos is a US-based life sciences company involved in the development and application of next generation predictive technologies designed to reduce the risk, time, and cost of drug discovery and development. The Company's portfolio of proprietary computer models, known as PhysioLab® systems, have helped its pharmaceutical customers validate novel drug targets, develop compounds, optimize clinical trials, evaluate in-licensing candidates, and better position existing products in competitive markets. Entelos currently provides scientific expertise in chronic disease areas such as cardiovascular, asthma, obesity, diabetes and rheumatoid arthritis, and complex physiological processes such as hematopoiesis (anemia), cholesterol metabolism, and skin sensitization.

**Basis of Presentation**

The accompanying unaudited financial statements have been prepared in accordance with U.S. generally accepted accounting principles for preliminary financial information. Accordingly, they do not include all of the information required by accounting principles generally accepted in the United States of America for complete financial statements, nor indicative of results for future periods.

**Risks and uncertainties**

The Company is subject to all of the risks inherent in a company which operates in the intensely competitive service industry, providing a service which is relatively new and constantly evolving. These risks include, but are not limited to: the Company's ability to convince prospective strategic partners and customers that its technology is an attractive component of pharmaceutical research and development; the willingness and ability of customers to adopt new technologies; its customers' perception that the Company's technologies can help accelerate efforts and reduce costs in drug development; and the Company's ability to sell and support sufficient numbers of customer projects.

**Use of estimates**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates and such differences could affect the results of operations reported in future periods.

## **Revenue Recognition**

The Company is using its patented PhysioLab<sup>®</sup> technology to derive revenue from research and development collaboration contracts. Collaboration agreements involve development of and research using dynamic computer models of human diseases, and typically require payments from customers for technology access fees, research and development funding, milestone payments (which can be either success-based or delivery-based), or a combination of these elements.

When software is not incidental to the arrangement and the services in the arrangement do not involve significant production, modification, or customization of the software, the Company recognizes revenue in accordance with Statement of Position No. 97-2, "Software Revenue Recognition" ("SOP 97-2"), as amended. Revenue from multiple-element arrangements is allocated to each individual element based on vendor specific objective evidence. Amounts billed but not yet recognized as revenue, and other payments received prior to recognition of revenue, are recorded as deferred revenue.

When the arrangement requires significant production, modification or customization of software, the entire arrangement is accounted in accordance with SOP 81-1 "Accounting for Performance of Construction-Type and Certain Production-Type Contracts", as required by SOP 97-2. For arrangements for which the costs to complete a project can not be reasonably and reliably estimated, the completed contract method of accounting is used. Under the completed contract method, revenue is recognized only when a contract is completed or substantially complete.

For arrangements consisting solely of services, we recognize revenue in accordance with Securities and Exchange Commission Staff Accounting Bulletin No. 104 ("SAB 104") when persuasive evidence of an arrangement exists, the price is fixed or determinable and collection of the resulting receivables is reasonably assured. Arrangements with multiple elements are accounted for in accordance with EITF 00-21, "Revenue Arrangements with Multiple Deliverables." Revenues are recognized when persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, the price is fixed and determinable and collectibility is reasonably assured.

Certain agreements may define specific milestones and the payments associated with each milestone. Such payments are recognized as revenue upon achievement of the milestone events, after which there are no future performance obligations to this payment. Any payments received in advance of the completion of the milestone are recorded as deferred revenue.

Reimbursements received from customers for out-of-pocket expenses are classified as revenue, with the associated costs included in cost of revenue.

## **Impairment of long-lived assets**

The Company evaluates the carrying amount of its long-live assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. The Company assesses

recoverability using undiscounted cash flow attributed to that asset. If an asset is impaired, it is written down to its estimated fair market value.

### **Goodwill and purchased intangible assets**

Identifiable finite lived intangible assets are generally comprised of service agreements and related relationships and trademarks and are amortized on a straight line basis over the estimated useful lives of the assets. Such lives range from 12 months to 48 months. The Company evaluates the recovery of finite lived intangible assets whenever events or changes in circumstances indicate that their current value may not be recoverable through the estimated and undiscounted future cash flows resulting from the use of the assets. If determined that the carrying value is not recoverable, impairment is measured by using the projected discounted cash flow method.

The excess of the cost of acquisition over the net amount assigned to the assets acquired and liabilities assumed is recorded as goodwill. Goodwill is not amortized but instead tested for impairment annually and whenever events or circumstances may occur that might require the need for more frequent tests.

For goodwill and intangible assets, the impairment test consists of a comparison of the fair value of the asset to its carrying amount. If the carrying amount of the asset exceeds its fair value, an impairment loss is recognized in an amount equal to that excess. In valuing its goodwill and intangible assets, the Company uses the income method. Under the income approach, the fair value of a reporting unit is calculated based on the present value of estimated discounted future cash flows. The present value of estimated discounted future cash flows uses the Company's estimates of revenues driven by assumed market growth rates and estimated costs as well as appropriate discount rates.

Goodwill impairment is determined using a two-step process. The first step of the goodwill impairment test is used to identify potential impairment by comparing the fair value of the Company's reporting unit with the net book value (or carrying amount), including goodwill. If the fair value of the reporting unit exceeds the carrying amount, goodwill of the reporting unit is considered not impaired and the second step of the impairment test is unnecessary. If the carrying amount of the reporting unit exceeds the fair value, the second step of the goodwill impairment test is performed to measure the amount of impairment loss, if any.

The second step of the goodwill impairment test compares the implied fair value of the reporting unit's goodwill with the carrying value of that goodwill. If the carrying amount of the reporting unit's goodwill exceeds the implied fair value of the reporting unit goodwill, an impairment loss is recognized in an amount equal to that excess. The implied fair value of goodwill is determined in the same manner as the amount of goodwill recognized in a business combination, accordingly the fair value of the reporting unit is allocated to all of the assets and liabilities of that unit as if the reporting unit had been acquired in a business combination and the fair value of the reporting unit was the purchase price paid to acquire the reporting unit.

During fiscal 2006, in performing our annual impairment test of goodwill and intangible assets in accordance with Statement of Financial Accounting Standards No. 142 "Goodwill and Other Intangible Assets" ("SFAS No. 142), we

determined that the carrying value of goodwill and net intangible assets associated with our acquisition of Discovery Innovations, Inc. exceeded their estimated fair values. The revenues as projected for the first year of operations were lower than expected. Consequently, we recorded non-cash intangible impairment charges of \$1,370,570 (see Note 6).

### **Recent pronouncements**

On 16 December 2004, the Financial Accounting Standards Board (FASB) issued FASB Statement No. 123 (revised 2004), SFAS 123(R) "Share-Based Payment", which is a revision of FASB Statement No. 123, "Accounting for Stock-Based Compensation". SFAS 123(R) supersedes APB Opinion No. 25, "Accounting for Stock Issued to Employees", and amends FASB Statement No. 95, "Statement of Cash Flows". Generally, the approach in SFAS 123(R) is similar to the approach described in Statement 123. However, SFAS 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the statement of operations based on their estimated fair values. SFAS 123(R) also requires the benefits of tax deductions in excess of recognized compensation cost to be reported as a financing cash flow, rather than as an operating cash flow as required under current accounting standards. Pro forma disclosure in our notes to our consolidated financial statements will no longer be an alternative. The Company adopted SFAS 123(R) effective 1 January 2006 using the prospective transition method.

In June 2006, the FASB issued FASB Interpretation 48 (FIN 48), "Accounting for Uncertainty in Income Taxes – an interpretation of FASB No. 109". This interpretation prescribes a recognition threshold and measurement attribute for the financial statements recognition and measurement of a tax position taken or expected to be taken in a tax return. The interpretation also provides guidance on derecognition, classification and other matters. FIN 48 is effective for the fiscal year 2007 and the Company will adopt accordingly. The Company is assessing the impact of the adoption of FIN 48 and currently does not believe that the adoption will have a material effect on its results of operations, cash flow or financial position.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, "Fair Value Measurements". This statement defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. The statement is effective in the fiscal first quarter of 2008 and the Company will adopt the statement at that time. The Company believes that the adoption of SFAS No. 157 will not have a material effect on its results of operations, cash flows or financial position.

### **NOTE 2 – INITIAL PUBLIC OFFERING**

On 12 April 2006, the Company completed its initial public offering of 13,810,173 shares of its common stock, at \$1.44 per share. Net cash proceeds of the initial public offering were approximately \$16.6 million, after deducting underwriter discounts, commissions and other offering expenses. In conjunction with the closing of the initial public offering, all of the Company's outstanding shares of Series A, Series B, Series C, and Series D convertible preferred stock outstanding at the time of the offering were automatically converted into 28,921,934 shares of common stock.

### NOTE 3 – NET LOSS PER SHARE

Basic net loss per share attributed to common shares is computed by dividing the net loss attributable to common shares for the year by the weighted average number of common shares outstanding during the year as reduced by the weighted average unvested common shares subject to repurchase by the Company. Net loss available to common stockholders is calculated using the two class method as the net loss less preferred stock dividends for the period and amounts allocated to preferred stock to reflect the rights of the preferred stock to receive dividends in preference to common stock. Diluted net loss per share is computed using the weighted average number of common and potential common shares outstanding. Potential common shares include long-term incentive awards, common stock subject to repurchase rights, and an incremental number of shares of common stock issuable upon the exercise of stock options and warrants. Potential common shares are excluded from the computation if their effect is anti-dilutive.

	Years Ended 31 December		
	2006	2005	2004
Weighted average number of shares outstanding during the year	41,464,695	8,919,465	8,703,135
Weighted average unvested common shares subject to repurchase	<u>(37,385)</u>	<u>(4,468)</u>	<u>(22,109)</u>
Denominator for basic and diluted net loss per common share	<u>41,427,310</u>	<u>8,914,997</u>	<u>8,681,026</u>

The potential shares, which are excluded from the determination of diluted net loss per share as their effect is anti-dilutive, are as follows:

	Years Ended 31 December		
	2006	2005	2004
Redeemable convertible preferred stock	—	28,380,019	24,361,269
Warrants to purchase common stock	443,332	—	—
Warrants to purchase redeemable convertible preferred stock	—	373,529	373,529
Options to purchase common stock	<u>3,064,861</u>	<u>3,314,355</u>	<u>2,996,896</u>
	<u>3,508,193</u>	<u>32,067,903</u>	<u>27,731,694</u>

### NOTE 4 – RELATED PARTY TRANSACTIONS

At 31 December 2006, the Company held full recourse notes receivable from three employees with total balances of \$694,443. The interest rates on these notes range from 2.78 per cent to 5.26 per cent per annum. The notes mature in 2008 and 2009.

The Company has entered into various collaboration agreements with Pfizer, Inc. (whose subsidiary, Pfizer Overseas Pharmaceuticals is a shareholder of the Company with effect from February 2005) to provide to Pfizer consulting and research related services on drug development. Under the collaboration agreements, the Company has recognized revenues amounting to \$1,078,125 and \$937,500 for the years ended 31 December 2006 and 2005, respectively. At 31 December 2006 and 2005, the deferred revenue balance with Pfizer, Inc. was and \$787,500 and \$253,125, respectively.

#### **NOTE 5 – CHANGE IN ACCOUNTING POLICY**

On 29 June 2005, the FASB issued Staff Position 150-5, "Issuer's Accounting under FASB Statement No. 150 ("SFAS 150") for Freestanding Warrants and Other Similar Instruments on Shares That Are Redeemable" ("FSP 150-5"). FSP 150-5 affirms that such warrants are subject to the requirements in SFAS 150, regardless of the timing of the redemption feature or the redemption price. Therefore, under SFAS 150, the freestanding warrants that are related to the purchase of the Company's convertible preferred stock are liabilities that should be recorded at fair value.

The Company adopted FSP 150-5 and accounted for the cumulative effect of the change in accounting principle as of 1 January 2006. In the year ended 31 December 2006, the Company recorded \$394,549 of additional income related to cumulative change in accounting principle to reflect the warrants remeasured on 1 January 2006. The Company recorded an expense of \$155,753 that is recorded in other income (expense), net to reflect the change in fair value between 1 January 2006 and 6 April 2006, the date the preferred warrants were converted to common stock warrants.

Effective 1 January 2006, the Company adopted FAS 123R using the prospective-transition method. See Note 9 for further discussion.

#### **NOTE 6 – ACQUISITION**

In May 2005 the Company acquired certain assets, intellectual property and technical designs related to the software services of Discovery Innovations, Inc. The initial purchase price of \$570,440 consisted of \$500,000 of Series C convertible preferred stock and \$70,440 of acquisition related costs. The acquisition was accounted for using the purchase method. Upon closing of the transaction, the Company also became contingently liable for up to and additional 1,000,000 shares of Series C convertible preferred stock (1,349,000 common shares upon conversion) in the event certain revenue goals were met as stated in the purchase agreement. In October 2006 the Company issued an additional 655,765 shares of common stock as revenue was less than expected during the first year of operations. The consideration of \$957,417 was recorded as purchase price and allocated to goodwill. The allocation of the purchase price and additional issuance of shares was as follows:

Fixed assets .....	\$	101,662
Service agreements and related relationships.....		90,000
Trademarks .....		20,000
Goodwill .....		1,316,195
	\$	<u>1,527,857</u>

The acquired goodwill, trademarks and service agreements and related relationships were recorded on the balance sheet as intangibles and other assets. Trademarks and service agreements and related relationships were being amortized on a straight-line basis over their estimated useful life of four years. Goodwill was not subject to amortization. Amortization expense relating to the intangibles totaled \$33,958 and \$21,667, for the years ended 31 December 2006 and 2005, respectively.

As a result of our annual impairment analysis, the intangible asset related to the trademarks and service agreements and goodwill were determined to be impaired. In both cases we reduced the carrying value to zero and recorded a loss of \$1,370,570 due to the impairment on the Statement of Operations.

#### **NOTE 7 – REDEEMABLE CONVERTIBLE PREFERRED STOCK**

In conjunction with the closing of the initial public offering on 12 April 2006, all the Company's outstanding shares of Series A, Series B, Series C and Series D convertible preferred stock outstanding at the time of the offering were converted into 28,921,934 shares of common stock. There was no convertible preferred stock outstanding as of 31 December 2006.

#### **NOTE 8 – COMMON STOCK**

The Company's Articles of Incorporation, as amended, authorize the Company to issue 150,000,000 shares of common stock. As of 31 December 2006, the Company has reserved the following shares of common stock for future issuance:

Stock options outstanding.....	3,064,861
Stock options available for future grant.....	1,983,866
Stock warrants.....	443,332

## NOTE 9 – STOCK OPTION PLANS

### 1997 Stock Option Plan

On 12 June 1997, the Company adopted the 1997 Stock Plan (the “1997 Plan”) under which 7,153,552 shares of the Company’s common stock were reserved for issuance to employees, directors and consultants. Options granted under the 1997 Plan may be incentive stock options or nonqualified stock options. Incentive stock options (“ISO”) may only be granted to employees of the Company. The nonqualified stock options (“NSO”) may be granted to Company employees, directors and consultants. Options to purchase shares of the Company’s common stock are granted at a price equal to the fair value of the stock at the date of grant, as determined by the Board of Directors. The exercise price of an ISO granted to an employee who owns stock more than 10 per cent of the voting power of all classes of stock of the Company shall not be less than 110 per cent of the fair value per share on the date of grant. Generally options terminate ten years after the date of the grant. ISO’s granted to employees who own more than ten per cent- of the total stock of the Company terminate five years from the date of the grant. The options generally vest over a four year period, 25 per cent after one year and the balance ratably thereafter. The 1997 Plan has been replaced with the 2006 Equity Plan (the “2006 Plan”).

### The 2006 Plan

On 28 March 2006, the Company adopted the 2006 Plan under which 2,000,000 shares of the Company’s common stock have been reserved for issuance to employees, directors and consultants. Options granted under the 2006 Plan may be ISO’s, restricted stock awards, and NSO’s to employees, directors and consultants. ISO’s may be granted to current employees only. NSO’s and restricted stock awards may be granted to employees, directors and consultants. ISO’s may be granted with an exercise price of no less than 100% of the market value of the underlying common shares on the date of grant. NSO’s and restricted stock awards may be granted with an exercise price or purchase price of no less than 85 per cent of the market value of the underlying common shares on the date of grant. No option shall be exercisable after its expiration date or have an expiration date that is more than ten years (five years in the case of a 10 per cent shareholder) after the date of grant.

The following table summarizes option activity under both stock option plans:

	<b>Shares Available For Future Grant</b>	<b>Options Outstanding</b>	<b>Weighted Average Exercise Price</b>
Balances at 31 December 2003 .....	41,198	2,549,872	0.24
Additional shares reserved .....	700,000	-	
Options granted .....	(688,000)	688,000	0.25
Options exercised .....	-	(129,825)	0.17
Options canceled .....	111,151	(111,151)	0.25
Balances at 31 December 2004 .....	164,349	2,996,896	0.24
Additional shares reserved .....	1,000,000	-	
Options granted .....	(986,750)	986,750	0.25
Options exercised .....	-	(459,554)	0.23
Options canceled .....	209,737	(209,737)	0.25
Balances at 31 December 2005 .....	387,336	3,314,355	0.25
Additional shares reserved .....	2,000,000	-	
Options granted .....	(630,917)	630,917	1.25
Options exercised .....	-	(652,964)	0.27
Options canceled .....	227,447	(227,447)	0.38
Balances at 31 December 2006 .....	1,983,866	3,064,861	\$ 0.44

The weighted average grant date fair value of stock options granted during 2006 was \$0.74, the intrinsic value of options exercised during 2006 was \$489,295 and the total fair value of shares granted and vested during 2006 was \$34,407.

Option grants outstanding as of 31 December 2006 and related weighted average price and contractual life information are as follows:

<b>Exercise price in US\$</b>	<b>Number Outstanding</b>	<b>Weighted average contractual life (in years)</b>	<b>Weighted average exercise price</b>	<b>Number vested</b>	<b>Weighted average exercise price</b>
\$0.16 - \$0.20	83,500	2.24	\$ 0.17	83,500	\$ 0.17
\$0.25 - \$0.30	2,410,436	6.91	\$ 0.25	1,691,931	\$ 0.25
\$1.09 - \$1.10	390,925	9.38	\$ 1.09	47,309	\$ 1.10
\$1.58 - \$1.61	180,000	9.65	\$ 1.60	-	\$ -
	3,064,861	7.26	\$ 0.44	1,822,740	\$ 0.27

#### Long-Term Incentive Stock Plan

On 5 April 2006, the Remuneration Committee of the Board of Directors granted performance stock awards pursuant to the Long Term Incentive Plan (the "2006 LTIP"). Under the LTIP common stock will be awarded to Executive Directors and senior managers conditional upon the achievement of specific measurable performance criteria determined by the Remuneration Committee. In particular, the Company's total shareholder return ("TSR")

will be measured against the TSR of companies comprised in an appropriate comparator group set by the Remuneration Committee.

The number of shares granted under the 2006 LTIP is 2,878,535. During the year ended 31 December 2006, compensation expense and additional paid-in capital of approximately \$467,505 was recorded in relation to the LTIP. Compensation expense during the year ended 31 December 2006 was based on the fair value of the award at date of grant. As of 31 December 2006 there was approximately \$1,557,821 of total unrecognized compensation expense related to the LTIP. Shares awarded under the LTIP vest at the end of the three year period subject to the Company achieving specified performance targets measured as of the end of the three year period. Management believes the award will be granted and is recognizing expense on a straight-line basis over the life of the award.

### Stock Based Compensation

Through 31 December 2005, the Company accounted for stock-based employee compensation arrangements in accordance with the provisions of Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," ("APB No. 25") and complied with the disclosure provisions of Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" ("SFAS No. 123"). Under APB No. 25, compensation cost is recognized based on the difference, if any, on the date of grant between the fair value of the Company's stock and the exercise price. SFAS No. 123 defines a "fair value" based method of accounting for an employee stock option or similar equity investment.

Effective 1 January 2006, the Company adopted FAS 123R using the prospective-transition method. Under this transition method, stock compensation cost recognized beginning 1 January 2006 includes compensation cost for all share-based payments granted on or subsequent to 1 January 2006 based on the grant-date fair value estimated in accordance with the provisions of FAS 123R and compensation expense on the remaining unvested awards under the intrinsic-value method of APB No. 25 for options granted prior to the SFAS 123R effective date.

The Company uses the Black-Scholes-Merton option-pricing model with the following assumptions to estimate the share-based compensation expense for the year ended 31 December 2006: weighted-average risk-free interest rate of 4.81 per cent based on the U.S. Treasury yield for a period consistent with the expected term of the option in effect at the time of grant; no expected dividend payments; expected life of 4.47 years; weighted-average volatility factor of 57 per cent based on peer group analysis. Total compensation expense under SFAS 123R for the year ended 31 December 2006 was \$538,128; \$70,623 was related to the 1997 and 2006 stock option plans and \$467,505 was recorded in relation to the LTIP.

The Company has not been public for a significant period of time to use its own volatility. Therefore, the Company used the average volatility of similar entities. Four out of the five companies used as guideline companies are U.S. publicly traded companies that have disclosed their volatility assumptions for the year ending 31 December 2006.

The Company used historical exercise data from the Company's inception for the basis of estimating the expected term.

During 2005 and 2004 options were granted to employees at exercise prices that were less than the fair market value of the common shares on the date of grant which resulted in deferred compensation of \$586,000.

Amortization of deferred stock compensation is recognized on a straight-line basis over the vesting period, reduced by cancellations of unvested options. Amortization of deferred stock compensation for 2006, 2005 and 2004 was \$146,406, \$101,581 and \$13,053, respectively.

As of 31 December 2006 there was \$629,321 of total unrecognized compensation expense related to non-vested stock options under APB No. 25 and SFAS No. 123R. The weighted average period over which compensation expense is expected to be recognized is 2.25 years.