

**PAION AG, Aachen**

## **Consolidated Financial Statements**

as of 31 December 2007 in accordance with Sec. 315a HGB and IFRS and

## **Group Management Report**

for the Fiscal Year 2007

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# Group Management Report for Fiscal Year 2007

## Economic Background

### I. Overall Economic Development

The global economy grew strongly once again in 2007. According to the Ifo Institute for Economic Research, global GDP rose by 5% following a 5.4% increase in 2006. However, the economic climate clouded significantly towards the end of the year as a result of the turbulence on the financial markets, which triggered the US real estate and financial crisis, record oil prices, and the euro's strength against the US dollar.

The US economy was unstable in 2007. Following weak expansion in the first quarter, overall economic production received a strong boost in the summer months. Nevertheless, the real estate and financial crisis in the fourth quarter of 2007 resulted in a significant slowdown and there are even fears that the US could slide into recession. In 2007, emerging markets, especially China and India, continued their course of above-average real GDP growth which began in prior years. The upturn in the eurozone continued in 2007, albeit at a slightly slower pace. Overall economic growth of some 2.6% is forecasted for 2007. The German economy proved to be robust in 2007 and continued the positive development it had experienced in the two prior years. The driving forces of this growth were once again export demand, which rose yet again despite the appreciation of the euro against the US dollar, and domestic demand. German GDP is expected to rise by about 2.5% in 2007 overall.

While equity markets were also able to post notable growth in 2007, insecurities regarding the effects of the real estate and financial crisis became noticeable in the second half of the year. Following the considerable dip on the European and US equity markets at the end of February 2007 in response to the crash on the Chinese equity markets, a tangible recovery was quick to follow. The DAX hit a record high of 8,106 points on 16 July 2007 and the Dow Jones Index cracked the 14,000 mark for the first time one day later. However, the soaring indices were subdued again by the US real estate and financial crisis. The Dow Jones was able to recover these losses in the fourth quarter but succumbed at the end of the year once again to the ongoing insecurity on the financial markets. Nevertheless, the Dow Jones Index posted growth of 6% for the full year. The DAX recovered from the decline it experienced in the third quarter and closed the year 22% higher than the prior year. The TecDax did even better, notching up growth of 30%.

## 2. Development of the Pharmaceutical and Biotechnology Industry

2007 was once again shaped by the risks and insecurities connected to clinical development. PAION was just one of a number of companies that experienced sustainable setbacks in their development programs, which, in some cases, even led to the development of individual drug candidates being discontinued.

The high risks connected to pharmaceutical development and the expiry of patent protection on a number of products in the years to come continued to drive company mergers in 2007. The number of mergers in 2007 remained at a similarly high level to 2006. Pharmaceutical companies not only merged among themselves; they also merged with or acquired biotechnology companies. In many cases, these acquisitions were preceded by long-standing cooperation between the parties.

The setbacks in the development programmes had a sustained effect on the share prices of the affected companies, especially the smaller ones. Overall, the listed pharmaceutical and biotechnology companies were able to maintain the growth course that they embarked on in the prior year but they were unable to match the growth rates achieved in the general indices. Deutsche Börse AG's Prime Pharma & Healthcare Performance Index increased by around 10% year on year, and the AMEX Biotechnology Index was up 4%. The NASDAQ Biotechnology Index, which only posted growth of 1% in 2006, grew by 5% in 2007.

## **Business Performance**

Fiscal year 2007 was shaped by the negative outcome of the clinical Phase III study (DIAS-2) with PAION's most advanced developed substance, Desmoteplase, and the discontinuation of the cooperation with Forest Laboratories, Inc. (Forest). PAION's efforts to quickly clarify the results of the DIAS-2 study and, on the basis of those results, to secure the continuation of the development programme with Desmoteplase were successfully concluded with the signing of a new licence agreement with PAION's cooperation partner, H. Lundbeck A/S (Lundbeck) in December 2007.

### **I. Overview of Research and Development Activities**

PAION's research and development activities are currently focused on three substances: Desmoteplase, Enecadin and Solulin.

#### **a. Desmoteplase**

Desmoteplase is an intravenous therapeutic that may primarily serve for causal treatment of acute ischemic stroke. Desmoteplase belongs to a group of blood clot-dissolving substances known as plasminogen activators.

#### **Clinical Development**

Between spring 2005 and February 2007, PAION and its former cooperation partner, Forest, conducted a Phase III study with Desmoteplase on a total of 186 patients. This study examined the clinical improvement for patients who had suffered an acute ischemic stroke and received Desmoteplase in comparison to a placebo group. Patients received either a 90mcg/kg or a 125mcg/kg dose of Desmoteplase. Treatment took place within three to nine hours following the onset of stroke symptoms. The study only included patients with potentially salvageable tissue (penumbra) of at least 20%, compared to the infarct core. The penumbra was detected either via magnetic resonance imaging (MRI) or perfusion computed tomography (PCT). The primary efficacy endpoint of the study was defined as the percentage difference between the clinically measurable improvement in the condition of patients 90 days after treatment in the patient groups that were given either the test substance or the placebo. The first results of the study were published at the end of May 2007. Neither dose investigated showed a statistically significant difference in clinical improvement compared to the placebo group. The primary efficacy endpoint of the study was thus not achieved. However, Desmoteplase met the safety profile expectations for both doses. It was particularly surprising that an unusually large number of patients in the placebo group (46.0%) showed a strong clinical improvement. On average, the patients treated in the DIAS 2 study only displayed relatively minor stroke symptoms and thus had a greater chance of improvement. This was considered to be a first indication towards explaining the unexpected results, however, this on its own did not sufficiently explain the results of the study.

For this reason, PAION and its cooperation partners began analysing the results of the study at the beginning of June 2007 placing primary emphasis on explaining the unusually high response to the placebo. PAION published the results of this analysis in October 2007. The main reason for the unusually high response to the placebo was the fact that in contrast to previous Phase II studies more than half of the DIAS 2 patients did not display any visible blockage of

major brain arteries at the start of treatment, despite positively having a penumbra. This became apparent after subsequent analysis of the images made of the blood vessels in the brain (angiographs). These patients would therefore have benefited less from the effects of the blood clot-dissolving substance Desmoteplase. In the past, stroke experts assumed the presence of a penumbra to be a key indication of both visible (in the larger brain arteries) and non-visible occlusions (in smaller arteries) and, independent of proof of the presence of a (partial) occlusion in the larger brain arteries, to represent an indication for reperfusion therapy. When analysing patient subgroups in which visible occlusion could be proved, a lower response rate was observed in the placebo group and a more positive effect registered in those patients who received Desmoteplase than those who received the placebo; however, due to the lower number of patients in the subgroup this did not reach statistical significance. Furthermore, the combined evaluation of the data from the Phase II and Phase III studies (DIAS/DEDAS/DIAS 2) showed Desmoteplase to have a statistically significant effect when patients without visible occlusion in major brain arteries were excluded. Furthermore, the follow-up analysis indicated that patients with no visible artery occlusion but with a large penumbra may also benefit from treatment with Desmoteplase.

The results obtained provide solid reasons for the further development of Desmoteplase, which is now ensured based on the continuation of the cooperation with Lundbeck.

#### **Cooperation Agreements**

Due to the negative results of the DIAS 2 study, PAION's cooperation partner Forest has decided to return the development and marketing rights for North America acquired in 2004 to PAION and announced this in August 2007 before completion of the analysis. Discontinuation of the cooperation with Forest did not result in any repayment obligations for PAION for the milestone payments received in the past by Forest and development expense refunds paid by Forest.

By contrast, Lundbeck, on the basis of the knowledge gained from the analysis of the DIAS 2 study results, decided to continue the cooperation with PAION and even to extend this cooperation to include North America (the contractual territory that had originally been outlicensed to Forest), and to bear all future development expenses. With the new license agreement, which was signed on 21 December 2007, Lundbeck now has the exclusive global rights for the development and marketing of Desmoteplase. This agreement was contingent on the successful completion of the patent review that was still ongoing on the date it was signed. On 29 January 2008, Lundbeck announced that the patent review had been completed and that the new licence agreement had taken effect without condition as of that day.

Under this agreement, Lundbeck has agreed to undertake the following:

- Payment of a non-refundable amount of EUR 8m in advance, on the date the agreement takes effect;
- Assumption of all future costs, especially for clinical development, production development, and approval;
- Milestone payments of up to EUR 63m, of which EUR 38m comprises milestone payments falling due prior to commencement of marketing activities and EUR 25m falling due upon commencement of marketing activities and the achievement of specific revenue targets; and
- Payments of licence fees (dependent on revenues) which, following the deduction of the licence fees PAION has to pay to the original licensor, Bayer Schering Pharma AG amount to a double-digit percentage.

PAION has reserved the option to co-market Desmoteplase in Germany, Austria and Switzerland. If PAION decides to exercise this option it will receive a direct share in earnings rather than licence fees based on revenues.

Under the new agreement, Lundbeck will be responsible for the further development of Desmoteplase and will be supported by PAION. Lundbeck plans to initiate the next clinical Phase III study in the second half of 2008.

## **b. Enecadin**

Enecadin is a neuroprotectant which may increase the survival time of damaged nerve cells and thus treat neuronal damage during acute ischemic stroke. In 2004, PAION procured exclusive licences for Enecadin from the Japanese manufacturer Nippon Shinyaku Co., Ltd for all markets outside of Japan. The Company has co-exclusive rights with Nippon Shinyaku for Japan.

### **Clinical Development**

PAION has been conducting the Phase IIa clinical study called TEST (Tolerability of Enecadin in acute ischemic Stroke Trial) since the first quarter of 2006. TEST is designed as a multicentric, double-blind, randomised, placebo-controlled, dose-finding study. Its aim is to examine the safety and tolerability of the drug as well as obtain first indications of its efficacy in patients with acute ischemic stroke in a timeframe of up to nine hours after the onset of symptoms. Patient enrolment for the first dose group of this study was completed in the second quarter of 2007. The subsequent safety review of the study held by the independent Data Monitoring Committee (DMC) did not give rise to any reservations regarding the safety of the drug. Since its in-licensing, the development of Enecadin was aimed at a combination with blood clot-dissolving substances such as Desmoteplase. PAION opted mid-2007 to discontinue recruitment for the TEST study until a decision had been made regarding the strategic realignment of the development pipeline.

### c. Solulin

Solulin is a thrombin modulator which may act as an “intelligent anticoagulant” with anti-inflammatory potential which could be useful for the treatment of thrombo-embolic diseases. The substance is an improved recombinant variant of the human protein thrombomodulin.

#### **Clinical Development**

In mid-2007, PAION initiated a Phase I clinical study in which Solulin will be tested on humans for the first time. The study is designed to evaluate Solulin’s safety, tolerability and pharmacokinetics and to obtain information on pharmacodynamic properties of the drug upon intravenous injection. It is being conducted as a single-centre, randomised, single-blind, placebo-controlled Phase I study. The first part of this study, the administration of increasing single doses to explore tolerability of the substance, has already been completed. Solulin was tolerated well. Multiple-dose schedules are now being tested. The results are expected in the first half of 2008.

PAION is currently evaluating various thromboembolic diseases as potential indications for a future Phase II study.

## 2. Net Assets, Financial Position, and Results of Operations

### a. Results of Operations

The results of operations were heavily affected by various extraordinary effects in fiscal year 2007. The extraordinary effects resulted in income of EUR 4,643k. The EUR 10,512k net loss for fiscal year 2007 would have amounted to EUR 15,155k without these effects.

The extraordinary effects mainly resulted from discontinuation of the cooperation arrangement by Forest. The termination of the cooperation agreement by Forest did not result in any repayment obligations with regard to the milestone payments and cost refunds received. The repayment obligations towards Forest which would have arisen in the event that regulatory approval for Desmoteplase had been granted in Europe and/or Japan, and were recognised as provisions in past financial statements, were reversed in the current fiscal year (EUR 10,890k). The refund claims against Lundbeck related directly to these repayment obligations (EUR -8,222) were also derecognised due to the fact that the reference figure no longer existed. The reversal of repayment obligations and derecognition of refund claims resulted in non-recurring income of EUR 2,668k, which was offset against research and development expenses. In addition, the accrued portion (EUR 1,669k) of the signing fee received by Forest in fiscal year 2004 was released and recognised under revenues.

Due to the negative DIAS-2 results in the second quarter of 2007, restructuring expenses totalling EUR 327k were recognised and adjustments made to the present value of the long-term repayment obligations to Forest and the long-term refund claims against Lundbeck in the amount of EUR 633k.

	2007 EUR k	2006 EUR k
Revenues	4,847	10,459
Cost of revenues	-2,979	-7,252
<b>Gross profit</b>	<b>1,868</b>	<b>3,207</b>
Research and development	-9,814	-16,487
General and administration	-4,407	-4,563
Selling	-560	-1,088
Other income (expenses)	289	149
<b>Operating expenses</b>	<b>-14,492</b>	<b>-21,989</b>
<b>Operating loss</b>	<b>-12,624</b>	<b>-18,782</b>
<b>Financial result</b>	<b>2,112</b>	<b>1,396</b>
<b>Loss for the year</b>	<b>-10,512</b>	<b>-17,386</b>

The **revenues** generated in fiscal year 2007 comprise deferred income of EUR 1,669k from a signing fee which was released early due to the termination of the cooperation with Forest. As in prior periods, the remaining revenues are attributable to the refund of development expenses by Forest and Lundbeck. The decline in revenues is primarily due to the fact that the portion of costs that can be charged on has fallen. This, in turn, is due to the fact that the costs of the DIAS-2 study have been largely invoiced and that Lundbeck has borne a portion of the costs of production development directly ever since Lundbeck became party to the agreement with the manufacturer (CMO) of Desmoteplase in the second quarter of 2007.

The **cost of revenues** of EUR 2,979k incurred in fiscal year 2007 related to the development expenses incurred in this period, which were refunded by Forest and Lundbeck. In the prior year, this item also related exclusively to development expenses charged on to Forest and Lundbeck.

**Research and development expenses** in fiscal year 2007 fell year on year and amounted to EUR 9,814k. The EUR 6,673k decline is mainly attributable to the fact that the reversal of the long-term repayment obligations to Forest and the derecognition of the long-term refund claims against Lundbeck resulted in income of EUR 2,668k which was offset against research and development expenses. Without this income, research and development expenses in the reporting period would have merely dropped EUR 4,005k to EUR 12,482k in comparison to the prior year. The EUR 4,005k decline reflects the noticeably lower development expenses related to the production of Desmoteplase. By contrast, development expenses for Enecadin and Solulin have risen in comparison to the prior-year period.

Compared to the prior year, **general and administrative expenses** decreased slightly, amounting to EUR 4,407k (prior year: EUR 4,563k).

In fiscal year 2007, **selling expenses** fell to EUR 560k, down EUR 528k on the prior year. The decline is attributable to much lower internal and external costs.

In fiscal year 2007, the **financial result** was impacted by non-recurring income of EUR 633k. This effect recognised in the second quarter of 2007 is attributable to the change in the approval date following the DIAS 2 study which was used to calculate the present value of the long-term refund claims against Lundbeck and the long-term repayment obligations to Forest. Without this non-recurring income, the financial result would only have increased by EUR 83k year on year, mainly due to the higher interest rates.

## b. Net Assets and Financial Position

Compared to the 2006 balance sheet date, the balance sheet structure as of 31 December 2007 underwent a permanent change. Largely as a result of the reversal of the long-term repayment obligations to Forest, the derecognition of the long-term refund claims against Lundbeck and the reduction in cash and cash equivalents, the balance sheet total as of 31 December 2007 dropped EUR 24,508k to EUR 45,542k in comparison to 31 December 2006. As of 31 December 2007, the equity ratio rose to 78.3% against 64.9% on a year earlier. Accounting for the subordinated loan as economic equity increases the equity ratio by 14.6 percentage points to 92.9%.

	31 Dec. 2007	31 Dec. 2006	Change
	EUR k	EUR k	EUR k
Non-current assets	1,365	9,699	-8,334
Current assets	44,177	60,351	-16,174
<b>Assets</b>	<b>45,542</b>	<b>70,050</b>	<b>-24,508</b>
Equity	35,664	45,471	-9,807
Non-current liabilities	6,746	19,212	-12,466
Current liabilities	3,132	5,367	-2,235
<b>Equity and liabilities</b>	<b>45,542</b>	<b>70,050</b>	<b>-24,508</b>

The decline in **non-current assets** is almost exclusively due to the derecognition of the long-term refund claims against Lundbeck.

**Current assets** dropped by EUR 16,174k to EUR 44,177k compared with 31 December 2006, chiefly as a result of the reduction in cash and cash equivalents (EUR 14,288k) and the decline in trade receivables (EUR 1,514k). The change in cash and cash equivalents stems from the following areas:

	2007	2006
	EUR k	EUR k
Cash flow from ordinary activities	-13,448	-14,742
Cash flow from investing activities	-204	-452
Cash flow from financing activities	-636	14,012
<b>Change in cash and cash equivalents</b>	<b>-14,288</b>	<b>-1,182</b>

The negative cash flow from operating activities of EUR 13,448k is mainly attributable to the EUR 14,850k loss for the year adjusted for extraordinary effects not affecting cash, as well as to

the non-cash expenses from option plans (EUR -705k) and amortisation and depreciation (EUR -522k).

The negative cash flow from financing activities in fiscal year 2007 is attributable to interest payments on the subordinated loan received from HSBC Trinkaus & Burkhardt KGaA in April 2006. The positive cash flow from financing activities in the prior year was chiefly due to cash received from the capital increase (EUR 9,440k), from the subordinated loan received (EUR 6,720k net of the debt discount of EUR 280k), payments in relation to the capital increase (EUR -448k), and from payment of the last tranche in connection with the discontinuation of PAION Deutschland GmbH's pre-IPO stock option plan (EUR 1,192k).

Compared to 31 December 2006, **non-current liabilities** as of 31 December 2007 decreased considerably by EUR 12,466k to EUR 6,746 following the reversal of the long-term repayment obligations to Forest and the release of the deferred signing fee received by Forest in 2004.

In comparison to 31 December 2006, **current liabilities** were down EUR 2,235k to EUR 3,132k as of 31 December 2007, mainly due to the reduction in trade payables by EUR 2,214k.

## Headcount

Due to the negative results of the DIAS 2 study, PAION passed a plan of action in mid-2007 aimed at reducing internal and external costs. As a part of this plan, PAION reduced its headcount by 25%. The personnel cutback, which affected almost all areas of the company, was carried out on the condition that the development unit was retained. Contractual notice periods were adhered to and appropriate compensation paid to the terminated personnel. In addition, terminated employees were also offered outplacement advisory services aimed at facilitating the quick transition to new employment. According to information made available to management, the majority of terminated personnel quickly found a new full-time position.

As of 31 December 2007, PAION had 53 employees (prior year: 81). The future headcount will depend upon the strategic realignment of the development pipeline.

## Changes to the Supervisory Board

The annual general meeting of PAION AG appointed Dr. Jörg Spiekerkötter, Kleinmachow, Germany, to the supervisory board on 20 June 2007. Dr. Spiekerkötter replaced Dr. Franz A. Wirtz, who reached the age limit set by PAION AG for supervisory board members in 2007 and thus resigned from the supervisory board. The other members of the supervisory board are Dr. Walter Wenninger (chairman), Leverkusen, Germany, and Prof. Dr. Erich Schlick, Otterstadt, Germany. At its constituent meeting on 20 June 2007, the supervisory board appointed Prof. Dr. Erich Schlick as deputy chairman.

Dr. Spiekerkötter has many years of experience in the pharmaceutical industry where he held management positions in finance, legal affairs and human resources. He has been CFO of Conergy AG, Hamburg, Germany, since November 2007. Dr. Spiekerkötter is not a member of any other supervisory board.

## Compensation Report

### I. Management Board

The remuneration paid to management board members comprises fixed annual compensation, a variable bonus and a long-term performance-based compensation component in the form of stock options and stock appreciation rights. The variable bonus depends on the achievement of financial and strategic corporate targets and personal goals which are defined by the supervisory board in conjunction with the management board at the beginning of each fiscal year. The level of target achievement and the related amount of the variable compensation is assessed and determined by the supervisory board at the end of each year. Bonuses are limited to a maximum amount and are paid depending on personal goal achievement. Performance targets are not subsequently adjusted. The members of the management board received stock options from the stock option plan approved at the annual general meeting on 30 December 2004. The number of shares to be allocated to the management board was fixed by the supervisory board immediately after the IPO. The two to four-year vesting period before stock options can be exercised acts as a long-term incentive to increase the Company's value. The exercise price for the stock options is EUR 8.00 per stock option, the issue price of shares at the IPO. The stock option agreements with the members of the management board limit the quantities of stock options that can be granted. No restrictions have been imposed as to the change in value of the stock options, which is directly linked to the development of the PAION share, apart from minimum increases in value. The supervisory board granted the management board members a total of 100,000 stock appreciation rights under the employee participation plan 2006. The stock appreciation rights have a two-year vesting period after which time the holder is entitled to receive a sum of money based on the PAION AG share price. In addition to an annual minimum appreciation, the employee participation plan 2006 also limits the value of the amount payable. The maximum amount paid out will be 100% of the exercise price, which for the stock appreciation rights granted in fiscal year 2006, is EUR 7.89. In fiscal year 2007, no stock options or stock appreciation rights were exercised by the management board.

Based on the agreements with the members of management, the compensation structure for fiscal year 2007 is as follows:

		Dr. Wolfgang Söhngen	Alexander Vos	Dr. Mariola Söhngen	Bernhard Hofer
<b>Total remuneration 2007:</b>					
Fixed salary	EUR	223,333	213,333	203,333	163,339
Variable bonuses	EUR	53,333	48,000	63,000	42,667
Other compensation	EUR	26,724	15,659	21,128	14,154
<b>Overview of outstanding stock options and stock appreciation rights as of 31 Dec. 2007:</b>					
Stock options	No.	138,964	138,964	109,186	109,186
Stock options - fair value*	EUR	494,017	494,017	388,156	388,156
Stock Appreciation Rights (SAR)	No.	25,000	25,000	25,000	25,000
SAR - fair value**	EUR	5,000	5,000	5,000	5,000
* fair value on the date of issue, determined on the basis of the Black/Scholes option pricing model					
** fair value as of the balance sheet date, determined on the basis of the Black/Schole option pricing model					

The “other compensation” item contains insurance premiums assumed by PAION as well as non-monetary benefits from the provision of company cars.

Total management board remuneration amounted to EUR 1,088k in fiscal year 2007 (prior year: EUR 1,083k).

A two-year non-compete agreement has been concluded with Mr. and Ms. Söhngen. For the duration of the prohibition of competition, Mr. and Ms. Söhngen will be entitled to payment of 75% of their average fixed compensation for the last 12 months before leaving the Company. Any sums which Mr. and Ms. Söhngen earn, or maliciously fail to earn, through their work elsewhere will be deducted from this compensation to the extent that the aggregate of such income and the compensation exceeds 100% of the last fixed compensation paid.

In the event of a change of control and the termination of employment within a certain period after the change of control, the management board members are each entitled to contractual severance payments in the amount of their capitalised and discounted aggregate fixed compensation calculated for the remainder of their employment term, but no less than 150% of their annual fixed basic compensation. However, a claim to a severance payment in connection with a change of control only exists when the change of control also entails a significant change in business strategy, a significant change in responsibilities or a relocation of the place of work by at least 300 kilometres. Sums earned by working elsewhere during the remainder of the contract term covered by the severance payment will be deducted from severance payment claims.

With the exception of changes of control as described above, the employment contracts of management board members do not contain any specific severance payment provisions for

cases of early termination of employment relationships. Furthermore, the employment contracts of management board members do not provide for interim payment upon expiry.

The terms of the stock option plan 2005 stipulate that, in the event of a change of control, the vesting period for all stock options issued to management board members and employees will expire two years after the issue date. The employee participation plan 2006 states that in the event of a change of control, the vesting period for the stock appreciation rights issued expires on the date of the change of control, unless the supervisory board decides otherwise before that date.

## 2. Supervisory Board

Supervisory board remuneration comprises basic compensation and per-meeting fees. The members of the supervisory board do not currently receive performance-based remuneration. The chairman of the supervisory board receives twice the basic compensation and per-meeting fee, his deputy receives one-and-a-half time these amounts. The members of the supervisory board received the following remuneration for their activities in fiscal year 2007:

in EUR	Basic salary	Per-meeting fee	Total
Dr. Walter Wenninger	30,000	18,000	48,000
Prof. Dr. Erich Schlick	18,986	10,500	29,486
Dr. Franz A. Wirtz	10,541	9,000	19,541
Dr. Jörg Spiekerkötter	7,973	3,000	10,973

Total supervisory board remuneration amounted to EUR 108k in fiscal year 2007 (prior year: EUR 104k).

## **Disclosures Pursuant to Sec. 315 (4) HGB [“Handelsgesetzbuch”: German Commercial Code] and Explanatory Report**

### **Composition of Subscribed Capital**

As of 31 December 2007, PAION AG had subscribed capital of EUR 16,755,552.00, divided into 16,755,552 no-par value shares, each representing a notional share in the share capital of EUR 1.00. The no-par value shares are made out to the bearer and are fully paid in. The shareholders have no right to receive a share certificate for their shares under Art. 6 (2) of the articles of incorporation unless certification is required by the regulations of the stock exchange on which the shares are listed. All shares carry the same rights and duties. Each share carries the right to one vote at the annual general meeting and also forms the basis of the holder’s share in profit. More information on the individual rights and duties of the shareholders can be found in the German Stock Corporation Act [“Aktengesetz”: AktG], in particular Secs. 12, 53a et seq., Sec. 118 et seq. and Sec. 186.

### **Restrictions Relating to Voting Rights or the Transfer of Shares**

Under German law and the articles of incorporation of PAION AG, there are no restrictions on the voting rights or transferability of the shares. The management board of PAION AG is also not aware of any restrictions at shareholder level as to the voting rights or transfer of the shares.

### **Shareholdings Which Exceed 10% of Voting Rights**

According to the German Securities Trading Act [“Wertpapierhandelsgesetz”: WpHG], every shareholder who achieves, exceeds or falls short of specific voting rights in the Company through the purchase or sale of shares or by other means, must inform the Company and the German Federal Financial Supervisory Authority [“Bundesanstalt für Finanzdienstleistungsaufsicht”: BaFin] of this. The lowest threshold for this reporting obligation is 3%. Direct or indirect shareholdings in the Company’s share capital that equal or exceed 10% have not been reported to the Company and the management board of PAION AG is not aware of any such shareholdings.

### **Shares With Special Rights Conferring Control**

The bearers of PAION AG shares have not been granted any special rights by the Company, in particular with regard to powers of control.

### **Type of Control of Voting Rights When Employees are Shareholders and do not Directly Exercise Their Control Rights**

The share options issued to employees and members of the management board can be exercised once the defined vesting period has expired and the other conditions have been met by the beneficiaries. Shares acquired in this way give the beneficiaries the same rights as other shareholders and are not subject to control rights.

### **Legal Provisions and Provisions of the Articles of Incorporation on the Appointment and Removal of Members of the Management Board and Amendments to the Articles of Incorporation**

Members of the management board are appointed and removed in accordance with Secs. 84 and 85 AktG and the supplementary provisions of the supervisory board's rules of procedure which stipulate an age limit of 65 years for management board members. Pursuant to Sec. 84 AktG, members of the management board can be elected for a maximum of five years by the supervisory board. Repeat appointments or extensions of the term of office for up to a maximum of five years at a time are permissible. Pursuant to Art. 8 (1) of the articles of incorporation, the management board must comprise at least two persons. The supervisory board determines the number of members of the management board. Furthermore, pursuant to Sec. 84 (2) AktG and Art. 8 (2) of the articles of incorporation, the supervisory board may appoint a member of the management board to serve as chairman of the management board.

Amendments to the articles of incorporation are made in accordance with Secs. 179 and 133 AktG in conjunction with Art. 27 of PAION AG's articles of incorporation. The shareholder resolution required for an amendment of the articles of incorporation can, under PAION AG's articles of incorporation, be adopted by a simple majority of the share capital represented upon adoption of the resolution, provided this is permitted by law.

### **Authority of the Management Board to Issue or Buy Back Shares**

The management board is authorised to increase the share capital on or prior to 10 May 2011, with the consent of the supervisory board, on one or more occasions, by up to an aggregate of EUR 7,850,000.00 through the issuance of up to 7,850,000 new no-par value bearer shares in return for cash contributions or contributions in kind (Authorised Capital I). In capital increases in return for contributions in kind, the management board is also authorised to exclude the right to subscribe with the supervisory board's consent. In cash capital increases, shareholders must be granted a subscription right. The new shares may also be underwritten by one or more banks subject to the requirement that they are offered to shareholders. The management board is authorised, with the approval of the supervisory board, to exclude fractional amounts from the shareholders' subscription rights. The management board is also authorised to exclude the shareholders' subscription rights, with the consent of the supervisory board, if the issue price of the new shares is not significantly less than the market price and the shares issued in return for cash contributions when no subscription rights are granted to shareholders, in accordance with Sec. 186 (3) Sentence 4 AktG, do not exceed 10% of the share capital as of 10 May 2006. The management board is authorised to exclude the shareholders' subscription rights, with the consent of the supervisory board, to the extent necessary to grant subscription rights to holders of convertible bonds, participation rights or options as defined by Sec. 221 AktG. Furthermore, the management board is authorised to issue on or before 10 May 2011, on one or more occasions, bearer and/or registered convertible and/or warrant bonds of up to an aggregate of EUR 63,000,000.00 with a maximum term of 20 years and grant the holders or creditors of bonds conversion rights or options to new shares in PAION AG with a share in share capital of up to an aggregate of EUR 6,300,000.00 (Conditional Capital I). In addition, the management board is authorised to acquire treasury shares representing up to a total of 10% of the share capital on 20 June 2007, on one or more occasions until 20 December 2008, with the consent of the

supervisory board. The authorisations granted by the shareholder meeting have not yet been exercised.

### **Material Arrangements Dependent on a Change in Control in the Wake of a Take-Over Bid**

The new licence agreement with Lundbeck stipulates that Lundbeck, in certain circumstances, has the authorisation to limit PAION's information rights to a minimum in the event of a change of control at PAION, and, if required, to terminate all options exercised by PAION with regard to co-marketing. If Lundbeck exercises its termination right, PAION retains its claim to a share in the joint marketing result.

### **Compensation Agreements Entered Into by the Company With Members of the Management Board and Employees in the Event of a Takeover Bid**

For more information on existing compensation agreements, please refer to our comments in the section 'Compensation Report'.

## **Risks and Opportunities Report**

### **I. Risk Management**

As a bio-pharmaceutical company, PAION is exposed to the segment and market risks that are typically associated with the development of pharmaceutical products. In accordance with the German Law on Control and Transparency in Business [“Gesetz zur Kontrolle und Transparenz im Unternehmensbereich”: KonTraG], PAION has implemented a comprehensive and effect risk management system which is integrated into operating processes and is flexibly adapted to the changing environment. The task of the risk management system is to promote the conscious and responsible handling of risk, to identify future developments with inherent risks and opportunities early, and to monitor, analyse, assess, and manage such risks. By involving all management levels and project management in the process of the development of strategy and business, a shared awareness of the critical success factors and related risks is created.

PAION's risk management system comprises an internal control system, an early warning system for the detection of risk, and a control system. These three sub-systems interact directly with each other and also take on tasks from each of the other sub-systems.

The financial accounting and cost accounting software Navision and an enterprise planning tool customised for PAION form the basis for financial control. Monthly internal reporting is performed on a cost centre and cost unit basis, allowing deviations from the budget to be identified at an early stage. Short and long-term corporate planning (cost centre planning, cost unit and project planning, budget income statement, budget balance sheet and budget cash flow statement) is conducted using an Excel-based planning tool. Using this planning tool, management and the controlling department are in a position to simulate various scenarios to identify, assess, and determine the impact of opportunities and risks on the future development of the Company, particularly with regard to the key factor of liquidity.

The implemented internal control system includes rules for the management of business activities as well as arrangements for the monitoring of compliance with these rules. The primary

tasks of the internal control system include determining which types of business transactions require approval, limiting the issuance of signing and banking authority, standardising workflows using procedural instructions, monitoring compliance with process steps using checklists, and establishing measures for the protection of data and IT systems.

PAION has implemented a matrix organisation which combines both project organisation and department organisation. Within this organisational structure, detailed reporting and information structures have been set up to ensure the early identification and communication of risks. The individual projects are managed and monitored by project teams. The project teams provide reports on an ongoing basis – also in writing – on the current progress of a project and potential risks to the individual department heads and to management.

## **2. Significant Risks to Future Development**

### **a. Drug Development Risks**

All of PAION's substances are currently at different stages of development. Before they can be approved and marketed, their safety and efficacy must be proven in appropriate and carefully monitored clinical studies. The results of preclinical and clinical studies cannot be forecasted. There is always the danger that the results achieved in prior studies may not be achieved in later studies. If this turns out to be the case, further clinical development can be delayed considerably or development of a specific drug candidate may be discontinued altogether.

The completion of clinical studies depends, among other things, on the ability to enrol a sufficient number of patients to participate in them. Difficulties in enrolling patients in clinical studies may increase costs and negatively affect the timing of these clinical studies.

There is also the risk that the data provided by the individual clinical studies are deemed to be insufficient for commencement of the next development phase or as a basis for an application for approval by the regulatory authorities and, as such, additional data may have to be generated or further studies conducted. The assessments of the regulatory authorities in different countries may also vary. A data package which is deemed sufficient in one country may be considered to be insufficient by a regulatory authority in another country. In addition, it is possible that the regulatory authorities will demand additional studies, which would entail additional costs for the Company and would significantly delay its receipt of regulatory approval.

Once a certain level of development has been reached, PAION aims to minimise these risks by seeking development cooperation with established pharmaceutical and biotechnology companies which then bear some or all of the respective financing risk. Furthermore, PAION also cooperates closely with the regulatory authorities with a view to ensuring that all requirements are met and utilises the knowledge of external experts in this regard.

## **b. Risks in Relation to the Manufacture of Pharmaceutical Substances**

PAION does not currently own or operate any production facilities. Accordingly, it relies on third parties for the supply of its pharmaceutical substances and the manufacture of clinical and commercial quantities of them. PAION might not be in a position to maintain or renew the existing agreements with third parties on acceptable terms or at all.

Some of PAION's substances are produced in biological production processes. These processes are highly complex and require extensive validation. In the past, the substances have been produced in sufficient quantities for clinical development, but it is not entirely certain that the larger batches needed for commercial purposes can be produced. Should this be the case, costs could increase and market potential might not be fully exploited.

## **c. Risks in Relation to the Marketing of Drugs**

In the foreseeable future, PAION expects to continue to be dependent on cooperation agreements with experienced partners to complete the development of its current and future drug candidates and to market them successfully. Should PAION fail to enter into cooperation agreements on terms favourable to it, fail to enter into cooperation agreements at all, or fail to maintain existing cooperation agreements, its ability to develop and market its existing and future drug candidates may be reduced, which may increase development and marketing expenses.

## **d. Risks in Relation to Patents and Other Intellectual Property**

PAION's business operations are to a large extent dependent on its ability to achieve an extensive patent protection and other intellectual property protection for the individual substances and to protect these from third parties without violating their rights. There can be no assurance that patents with respect to our current or future applications will be granted or that any patents issued or licensed to us will be valid and of sufficient scope to provide us with sufficient legal protection or any commercial advantage.

## **e. Competitive Risks**

PAION's business environment is shaped by strong competition, intensive research activities and rapid technical change. PAION's success is highly dependent on its ability to develop existing and new drug candidates on a cost-effective basis and to market them successfully. In doing so, it faces and will continue to face stiff competition from a variety of competitors, ranging from small biotech companies to large international pharmaceutical groups.

## **f. Risks in Relation to Additional Financing Requirements**

PAION believes that the currently available cash and cash equivalents and future payments expected from the cooperation with Lundbeck and possible future cooperation agreements will be sufficient to finance its mid-term financing needs. However, it may need additional funding within this timeframe in order to licence new drugs, acquire or invest in businesses, drug candidates or technologies, and to fund preclinical studies and clinical studies, for example. Funding requirements may also arise due to delays in clinical development and the related delays in milestone payments from cooperation partners. Milestone payments could even be cancelled

altogether if the agreed-upon targets are not reached. PAION's future ability to secure additional funding will depend on the success of its development activities, the situation on the capital markets and other factors. If PAION is unable to raise financing on favourable terms or unable to raise financing at all, it could be forced to reduce its operating expenses by delaying, reducing or discontinuing the clinical development of one or more of its drug candidates.

#### **g. Risks in Relation to Personnel**

PAION's management and the scientific and technical staff it has in key positions play a key role in its success, many of whom have substantial experience with our Company and would be difficult to replace. In addition, competition for qualified personnel is intense in PAION's industry and PAION might be unable to attract and retain highly qualified employees.

### **3. Market Opportunities**

PAION is aiming to become a leading player in the development and marketing of innovative drugs for the treatment of stroke and other thrombotic conditions for which there is substantial unmet medical demand. With its most advanced drug candidate Desmoteplase, PAION has already demonstrated in two clinical Phase II studies that the previous timeframe for treating patients with ischemic stroke may possibly be extended by six hours to nine hours, and other parameters indicate superior effectiveness of Desmoteplase compared with currently approved drugs. It was not possible to confirm these successful results in the DIAS-2 study but the knowledge gained from the analysis of the DIAS-2 results provide a strong rationale for the further development of Desmoteplase. The conclusion of the extended cooperation agreement with Lundbeck secures the continuation of the development programme with Desmoteplase and underlines the potential of Desmoteplase for the treatment of acute ischemic stroke. If Desmoteplase and the other two substances are successfully developed, PAION would have substantial earnings potential in the future.

## Events After the Balance Sheet Date

On 29 January 2008, PAION was informed by its cooperation partner Lundbeck that the licence agreement entered into on 21 December 2007 took full effect without condition following the patent review which had since been concluded.

Furthermore, no other significant events occurred in the period between the balance sheet date (31 December 2007) and the date of completion of this report.

## Forecast

Given that continuation of the development programme with Desmoteplase has now been secured through the conclusion of the new cooperation agreement with Lundbeck, PAION now aims to drive forward the strategic realignment of the development pipeline. PAION intends to reduce the risks connected to the development of substances through cooperation arrangements as well as through expansion of the development pipeline and consideration of additional fields of therapy besides that of stroke. In this regard, PAION has already evaluated numerous substances and companies in the past. PAION will pursue this process more intensively in 2008.

The further development of Desmoteplase is now being lead-managed by Lundbeck. Lundbeck plans to present data to the regulatory authorities in order to gain acceptance on the new Phase III study with Desmoteplase. Lundbeck expects this study to be initiated in the second half of 2008.

The further development of Enecadin will be decided as part of the strategic realignment of the development pipeline.

PAION expects to be able to publish the results of the Phase I study with Solulin in the first half of 2008 and at the same time aims to prepare a Phase II study with Solulin.

Based on the cash and cash equivalents of EUR 43m as of 31 December 2007 and considering the upfront payment of EUR 8m received by Lundbeck at the beginning of 2008, PAION started fiscal year 2008 with solid cash and cash equivalents of approximately EUR 50m. Now that Lundbeck will bear all development expenses for Desmoteplase, PAION's research and development expenses will be lower than in the prior year. The actual amount of expenses and result will, however, depend heavily on the new corporate strategy.

## Consolidated Balance Sheet as of 31 December 2007

ASSETS	Note	31 Dec. 2007 EUR	31 Dec. 2006 EUR
<b>Non-current assets</b>			
Intangible assets	1.	462,349.84	524,246.44
Equipment	2.	902,786.33	1,163,871.92
Long-term refund claims resulting from the assumption of development expenses	3.	0.00	8,010,826.74
		<b>1,365,136.17</b>	<b>9,698,945.10</b>
<b>Current assets</b>			
Trade receivables	4.	776,806.33	2,290,567.20
Prepaid expenses and other assets	5.	498,934.20	871,707.98
Cash and cash equivalents	6.	42,901,123.18	57,188,779.78
		<b>44,176,863.71</b>	<b>60,351,054.96</b>
<b>Total assets</b>		<b>45,541,999.88</b>	<b>70,050,000.06</b>

EQUITY AND LIABILITIES	Note	31 Dec. 2007 EUR	31 Dec. 2006 EUR
<b>Equity</b>	7.		
Share capital		16,755,552.00	16,755,552.00
Capital reserve		85,737,273.03	85,032,116.76
Loss carryforward		-56,316,554.35	-38,930,499.47
Loss for the period		-10,512,054.28	-17,386,054.88
		<b>35,664,216.40</b>	<b>45,471,114.41</b>
<b>Non-current liabilities</b>			
Provisions	8.	0.00	10,616,825.08
Financial liabilities	9.	6,657,137.24	6,741,483.43
Finance lease liabilities	10.	61,761.00	133,320.00
Deferred income	11.	27,121.27	1,720,630.08
		<b>6,746,019.51</b>	<b>19,212,258.59</b>
<b>Current liabilities</b>			
Trade payables	12.	2,294,817.61	4,508,927.03
Provisions	8.	421,417.51	442,446.78
Current portion of finance lease liabilities	10.	71,559.00	74,163.00
Other current liabilities	13.	319,536.65	316,657.05
Current portion of deferred income	11.	24,433.20	24,433.20
		<b>3,131,763.97</b>	<b>5,366,627.06</b>
<b>Total equity and liabilities</b>		<b>45,541,999.88</b>	<b>70,050,000.06</b>

## Consolidated Income Statement for the Fiscal Year 2007

	Note	2007 EUR	2006 EUR
Revenues	14.	4,846,472.51	10,458,951.94
Cost of revenues		-2,978,513.01	-7,251,732.37
<b>Gross profit</b>		<b>1,867,959.50</b>	<b>3,207,219.57</b>
Research and development expenses		-9,814,009.42	-16,486,558.17
General and administrative expenses		-4,407,369.00	-4,563,448.72
Selling and marketing expenses		-559,570.00	-1,088,225.45
Other income (expenses), net	15.	289,334.51	149,199.08
<b>Operating expenses</b>		<b>-14,491,613.91</b>	<b>-21,989,033.26</b>
<b>Operating result</b>		<b>-12,623,654.41</b>	<b>-18,781,813.69</b>
Financial income	16.	4,549,187.50	2,042,188.53
Financial expenses	17.	-2,437,587.37	-646,429.72
<b>Financial result</b>		<b>2,111,600.13</b>	<b>1,395,758.81</b>
<b>Loss for the period before taxes</b>		<b>-10,512,054.28</b>	<b>-17,386,054.88</b>
Income taxes	18.	0.00	0.00
<b>Loss for the period</b>		<b>-10,512,054.28</b>	<b>-17,386,054.88</b>
Earnings per share (basic)	19.	-0.63	-1.06
Earnings per share (diluted)	19.	-0.63	-1.06

## Consolidated Cash Flow Statement for the Fiscal Year 2007

	2007	2006
	EUR	EUR
<b>Cash flows from operating activities:</b>		
Net result for the period	-10,512,054.28	-17,386,054.88
<b>Reconciliation of net result for the period to cash flows from operating activities:</b>		
Amortization/depreciation	522,441.84	364,245.40
Profit/loss from the disposal of non-current assets	4,360.86	8,419.74
Interest expenses and interest income	-2,111,600.13	-1,395,758.81
Release of investment grants	-24,433.20	-24,433.20
Release of deferred income	-1,669,075.61	0.00
Expenses from stock option plans	705,156.27	1,115,100.16
<b>Change in assets and liabilities which are not attributable to investing or financing activities:</b>		
Long-term refund claims resulting from the assumption of development expenses	6,065,907.88	-4,525,846.10
Trade receivables	1,513,760.87	-877,370.28
Prepaid expenses and other assets	511,387.54	402,141.68
Trade payables	-2,214,109.42	100,535.19
Provisions	-8,061,802.86	6,132,270.15
Other current liabilities	2,879.60	-259,874.57
Interest received	-15,267,180.64	-16,346,625.52
Interest received	1,819,485.55	1,604,929.79
<b>Net cash used in/from operating activities</b>	<b>-13,447,695.09</b>	<b>-14,741,695.73</b>
<b>Cash flows from investing activities:</b>		
Cash paid for investments in intangible assets and equipment	-205,459.11	-452,773.91
Cash received from the sale of intangible assets and equipment	1,638.60	517.24
<b>Net cash used in/from investing activities</b>	<b>-203,820.51</b>	<b>-452,256.67</b>
<b>Cash flows from financing activities:</b>		
Capital increase	0.00	1,000,000.00
Contributions to the capital reserve	0.00	8,440,000.00
Payments in connection with the raising of capital	0.00	-448,273.31
Borrowing	0.00	6,720,000.00
Capital repayment due to the settlement of options	0.00	-1,192,493.32
Interest paid	-555,310.00	-423,499.04
Payments of finance lease liabilities	-80,831.00	-83,542.00
<b>Net cash used in/from financing activities</b>	<b>-636,141.00</b>	<b>14,012,192.33</b>
Change in cash and cash equivalents	-14,287,656.60	-1,181,760.07
Cash and cash equivalents at beginning of the period	57,188,779.78	58,370,539.85
<b>Cash and cash equivalents at end of the period</b>	<b>42,901,123.18</b>	<b>57,188,779.78</b>
<b>Composition of cash and cash equivalents at the end of the period:</b>		
<b>Cash and cash equivalents</b>	<b>42,901,123.18</b>	<b>57,188,779.78</b>

## Consolidated Statement of Changes in Equity for the Fiscal Year 2007

	Share capital EUR	Capital reserve EUR	Loss carryforward EUR	Equity EUR
<b>31 December 2005</b>	<b>15,755,552.00</b>	<b>75,925,289.91</b>	<b>-38,930,499.47</b>	<b>52,750,342.44</b>
Issue of shares	1,000,000.00	0.00	0.00	1,000,000.00
Contribution to the capital reserve	0.00	8,440,000.00	0.00	8,440,000.00
Cost of raising capital	0.00	-448,273.31	0.00	-448,273.31
Additional contribution to the capital reserve due to the issue of options	0.00	1,115,100.16	0.00	1,115,100.16
Loss for the period	0.00	0.00	-17,386,054.88	-17,386,054.88
<b>31 December 2006</b>	<b>16,755,552.00</b>	<b>85,032,116.76</b>	<b>-56,316,554.35</b>	<b>45,471,114.41</b>
Additional contribution to the capital reserve due to the issue of options	0.00	705,156.27	0.00	705,156.27
Loss for the period	0.00	0.00	-10,512,054.28	-10,512,054.28
<b>31 December 2007</b>	<b>16,755,552.00</b>	<b>85,737,273.03</b>	<b>-66,828,608.63</b>	<b>35,664,216.40</b>

# Notes to the Consolidated Financial Statements for Fiscal Year 2007

## General

The consolidated financial statements comprise PAION AG as parent company registered at Martinstrasse 10-12, 52062 Aachen, Germany, and the wholly-owned subsidiary PAION Deutschland GmbH, Aachen, Germany, which is fully consolidated.

PAION AG acts as a holding company and renders various services for PAION Deutschland GmbH. PAION Deutschland GmbH, a bio-pharmaceutical company founded in 2000, aims to become a leading player in the development and marketing of innovative drugs for the treatment of stroke and other thrombotic diseases for which there is substantial unmet medical need.

PAION AG stock has been listed on Prime Standard of the regulated market of the Frankfurt Stock Exchange since February 2005, and is subject to extensive reporting obligations.

The consolidated financial statements as of 31 December 2007 and the group management report for fiscal year 2007 are due to be approved for publication at the supervisory board meeting on 3 March 2008.

## Basis of Accounting

The consolidated financial statements have been prepared in accordance with Sec. 315a HGB [“Handelsgesetzbuch”: German Commercial Code] and International Financial Reporting Standards (IFRSs), as adopted by the EU, and the interpretations of the International Financial Reporting Interpretations Committee (IFRIC). All IFRSs issued by the International Accounting Standards Board (IASB), London, UK, which were effective as of the balance sheet date of 31 December 2007 and applied by PAION, were adopted by the European Commission for application in the EU. In accordance with IAS 1, assets and liabilities have been recognised and measured pursuant to the standards which were effective as of 31 December 2007.

The new and revised standards and interpretations listed below were applied for the first time in the fiscal year. Adoption of these standards and interpretations did not have any effect on the Group's net assets, financial position and results of operations, but lead to additional disclosures.

- Amendment to IAS 1, “**Presentation of Financial Statements**”: The amendment sets out the disclosure requirements in relation to objectives, policies and processes for managing capital.
- IFRS 7, “**Financial Instruments: Disclosures**”: This new standard sets out the disclosure requirements for financial instruments and enables users to evaluate the significance of financial instruments for the Group's financial position and performance and the nature and extent of risks arising from financial instruments.
- IFRIC 8 “**Scope of IFRS 2 Share-Based Payment**”: The interpretation requires IFRS 2 to be applied to all transactions in which an entity cannot identify some or all of the goods or services received. This applies in particular if the consideration for the issued equity instruments by the entity appears to be less than the fair value. Since PAION merely issued equity instruments to members of the management board and employees in the context of employee stock option programs, the application of this interpretation did not have any effect on the Group's net assets, financial position and results of operations.
- IFRIC 9 “**Reassessment of Embedded Derivatives**”: In accordance with IFRIC 9, an entity must assess whether any embedded derivatives are created through a contract as a component of a hybrid instrument when it first becomes a party to the contract. Subsequent reassessment is prohibited unless there is a change in the terms of the contract that significantly modifies the cash flows. Since PAION does not have any embedded derivatives required to be separated from the host contract, this interpretation did not have any effect on the Group's net assets, financial position and results of operations.
- IFRIC 10 “**Interim Reporting and Impairment**”: This interpretation states that an entity shall not reverse an impairment loss recognised in a previous interim period in respect of goodwill or an investment in either an equity instrument or a financial asset carried at cost in a subsequent period. Since PAION made no such adjustments to impairment losses recognised, this interpretation did not have any effect on the Group's net assets, financial position and results of operations.

The following standards and interpretations which have already been issued will be applied as soon as they become effective, provided they are adopted by the European Commission:

- Amendments to IAS 23, “**Borrowing Costs**”: In March 2007, the IASB published the revised IAS 23, which required borrowing costs attributable to a qualified asset to be capitalised. The revised standard becomes operative for reporting periods beginning on or after 1 January 2009.
- Amendments to IFRS 2, “**Share-Based Payment**”: In January 2008, the IASB published the revised IFRS 2. The amendments mainly serve to clarify the terms “vesting conditions” and “cancellations”. The revised standard becomes operative for reporting periods beginning on or after 1 January 2009.
- Amendments to IFRS 3, “**Business Combinations**”, and IAS 27, “Consolidated and Separate Financial Statements”: In January 2008, the IASB published the revised IFRS 3 and IAS 27. The amendments primarily relate to the balance sheet disclosure of minority interests and business combinations where less than 100% of the interests were acquired. The revised standard becomes operative for reporting periods beginning on or after 1 June 2009.
- IFRS 8, “**Operating Segments**”: In November 2006, the IASB published IFRS 8. This standard supersedes IAS 14, “Segment Reporting”, and brings the IASB’s standards into line with the US GAAP provisions of SFAS 131. In general, financial information must be reported on the basis of the internal reporting format used in assessing the operating segments (management approach). IFRS 8 becomes operative for reporting periods beginning on or after 1 January 2009.
- IFRIC 11: In November 2006, the IFRIC published IFRIC 11, “**IFRS 2 – Group and Treasury Share Transactions**”. IFRIC 11 answers the question as to how IFRS 2, “**Share-Based Payment**”, applies to share-based payment arrangements involving an entity granting rights to its own equity instruments or equity instruments of another group entity. IFRIC 11 is effective for reporting periods beginning on or after 1 March 2007.
- IFRIC 12: In November 2006, the IFRIC published IFRIC 12, “**Service Concession Arrangements**”. IFRIC 12 clarifies application of existing IFRSs by public service concession operators with regard to the obligations and related rights in the service concession arrangements. IFRIC 12 is effective for reporting periods beginning on or after 1 January 2008.
- IFRIC 13: In June 2007, the IFRIC published IFRIC 13, “**Customer Loyalty Programs**”. The interpretation determines how customer loyalty programs operated by manufacturers and service providers are recognised. IFRIC 13 is effective for reporting periods beginning on or after 1 July 2008.
- IFRIC 14: In July 2007, IFRIC published IFRIC 14, IAS 19 “**The Limit on a Defined Benefit Asset, Minimum Funding Requirements and Their Interaction**”. Using general guidelines, IFRIC 14 regulates the measurement of a pension fund’s surplus which can be recognised as an asset pursuant to IAS 19, “Employee Benefits”, in accordance with the provisions of asset ceilings.

Application of these new or revised standards and interpretations will in some cases lead to additional disclosures in the next set of consolidated financial statements. Application of these standards and interpretations is not expected to have material effects on PAION's net assets, financial position and results of operations.

The consolidated financial statements were prepared in euros.

The income statement was prepared using the function of expense method. Research and development expenses are disclosed separately in the income statement due to their significance.

Under IAS 1, "**Presentation of Financial Statements**", non-current and current assets and non-current and current liabilities must be presented as separate classifications on the face of the balance sheet. Assets, liabilities and provisions due within one year are classified as current.

The consolidated financial statements do not contain any segment information as no reportable business or geographical segments could be identified. We currently assume that the new provisions of IFRS 8 will not result in segment reporting.

The preparation of consolidated financial statements in accordance with IFRSs requires management to make estimates and assumptions which have an effect on the amount of recognised assets and liabilities, income and expenses and contingent liabilities. Actual amounts may differ from these estimates.

The consolidation and accounting policies used in the prior year have been retained, making allowances for the new or changed standards and interpretations. Adoption of the new or revised standards and interpretations only lead to additional disclosure requirements, which were treated accordingly. There were no effects on the Group's net assets, financial position and results of operations.

## Consolidation Principles

The consolidated financial statements comprise PAION AG and its subsidiary PAION Deutschland GmbH. The financial statements of the two entities included in the consolidated financial statements are drawn up on the basis of uniform accounting policies. Receivables and liabilities, income and expenses, and profits from group transactions are eliminated.

## Accounting Policies

### Intangible Assets

Purchased intangible assets are measured at cost. They are amortised over their useful lives using the straight-line method and assessed for impairment if there is an indication that the intangible assets may be impaired. The useful life of software is determined to be three years, while research and marketing rights for compounds are amortised over the term of the respective patent.

### Equipment

Equipment is measured at cost less accumulated depreciation. Depreciation is calculated by applying the straight-line method over the estimated useful life of the assets, which normally ranges between three and twenty years. The Company tests assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by comparing the carrying amount of an asset to the higher of its fair value less costs to sell and its value in use. If such assets are considered to be impaired, the impairment loss recognised is the amount by which the carrying amount of the assets exceeds the higher of fair value less costs to sell or value in use. If the grounds for impairment no longer exist, the assets are written up.

Leased equipment which satisfies certain criteria under IAS 17, “**Leases**”, is recognised as an asset, while the present value of lease payments is recognised as a liability. Depreciation on leased assets is charged on a straight line basis over the term of the lease.

### Long-Term Refund Claims Resulting From the Assumption of Development Expenses

In the prior year, long-term refund claims from the assumption of development expenses from Lundbeck were recognised at present value, applying an interest rate of 3.8%. Due to the direct connection with the repayment obligation to Forest disclosed as a provision, these claims were recognised in accordance with IAS 37.53, “**Provisions, Contingent Liabilities and Contingent Assets**”.

### Receivables and Other Assets

Trade receivables and other assets are disclosed at amortised cost. Receivables denominated in foreign currency are translated at the closing rate. Exchange gains and losses are recognised in profit or loss.

### Cash and Cash Equivalents

Cash and cash equivalents comprise cash on hand, bank balances and short-term deposits with an original maturity of three months or less. They are measured at amortised cost.

**Equity**

The costs directly associated with issuing equity are not expensed but directly deducted from equity.

**Provisions**

Provisions are recognised when a present obligation (legal or constructive) exists as a result of a past event and when it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation and a reliable estimate can be made of the amount of the obligation. Provisions with a maturity of more than one year are recognised at present value.

**Financial Liabilities**

Financial liabilities are measured at amortised cost using the effective interest method.

**Trade Payables/Other Liabilities**

Trade payables and other liabilities are carried at the amount repayable. Liabilities denominated in foreign currency are translated at the closing rate. Exchange gains and losses are recognised in profit or loss.

**Deferred Income**

Investment grants in connection with the acquisition of assets are recognised as deferred income in the balance sheet. The deferred investment grants are released in line with the depreciation/amortisation of the underlying assets. The amounts released are deducted from research and development expenses.

Non-repayable signing fees received in connection with outlicencing agreements are disclosed as deferred income and recognised in profit or loss as the respective milestones are achieved.

**Revenues**

Revenues for the fiscal year are recognised when realised. Revenues are recognised when the owed service has been rendered, and the risks of ownership have been transferred and the amount of expected consideration can be measured reliably. Payments related to the sale or outlicencing of compounds or technological know-how are recognised in profit or loss when the services to be rendered on the basis of contractual regulations have been met in full.

**Cost of Revenues**

Development expenses charged on are recognised as cost of revenues.

**Research and Development Expenses**

Research expenses are expensed as incurred. Development expenses are recognised as an asset in accordance with IAS 38, "Intangible Assets", depending on the possible outcome of the development activities and whether or not all of the criteria for recognition are met. These criteria are not currently met, such that development expenses are expensed as incurred.

### **Interest Income/Expenses**

Interest income and expenses are recognised in the period in which they are generated or incurred. Any necessary deferrals are calculated using the effective interest method.

### **Income Taxes/Deferred Taxes**

Deferred taxes are recognised according to IAS 12, “**Income Taxes**”. Deferred taxes are recognised by applying enacted statutory tax rates applicable to future years to temporary differences between the IFRS carrying amounts and the tax bases of existing assets and liabilities. In addition, deferred tax assets are recognised on tax loss carryforwards. The effect of a change in the enacted tax rates on deferred taxes is recorded in the period in which the change in enacted. No deferred tax assets are recognised, if it is probable that some or all of the deferred tax assets may not be recoverable.

### **Share-Based Payment Transactions**

Stock options are measured at fair value on the date on which they are granted. The fair value of the obligation is recognised as a personnel expense and as a simultaneous increase in equity over the vesting period. Obligations from stock appreciation rights are recognised as a provision and measured at fair value on the balance sheet date. Expenses are recognised as personnel expenses over the vesting period. The fair value is determined on the basis of internationally accepted valuation methods both for stock options and stock appreciation rights.

### **Accounting for Expenses Incurred in Connection With the Development of Desmoteplase**

The development of Desmoteplase and its financing was regulated under the licence agreements concluded between PAION, Forest Laboratories Ireland Limited, Clonshaugh, Ireland (hereinafter also referred to as “Forest”) and H. Lundbeck A/S, Valby-Kopenhagen, Denmark (hereinafter also referred to as “Lundbeck”). After the negative results of the Phase III clinical study (DIAS-2) carried out with Forest in the first half-year of 2007 was announced, Forest terminated the licence agreement with PAION in August 2007 and returned all rights from this licence agreement to PAION. Due to the termination, Forest is no longer obliged to finance the future development of Desmoteplase. It merely has to bear the follow-up costs relating to the DIAS-2 study for a six-month period after the termination.

In December 2007, PAION and Lundbeck concluded a new licence agreement for the development and marketing of Desmoteplase, which was contingent upon the successful completion of a patent review in progress at the time of conclusion. On 29 January 2008, Lundbeck announced that the patent review was completed and that the new licence agreement was in effect without condition as of that day. Under the new agreement, Lundbeck will take over the development and financing of Desmoteplase in future. For details of this new agreement, please see our comments in the group management report.

Since the provisions regarding rights and claims of PAION in the agreement with Forest and the original agreement with Lundbeck still significantly influenced the 2007 consolidated financial statements, the way they were accounted for before Forest’s termination is described below. For details of the agreement with Forest and the original agreement with Lundbeck, please see our comments in the consolidated financial statements of the prior year.

The development expenses incurred directly by PAION and to be reimbursed by Forest were recorded as revenue. PAION recognised a provision for the obligation to repay development expenses reimbursed by Forest, which was agreed in the event of regulatory approval, by reducing revenues by 50% of the reimbursed expenses. Accordingly, revenues in any given period effectively included only approximately 50% of the Desmoteplase-related development expenses billed to Forest. 50% of the development expenses billed to Forest was accounted for as cost of revenues.

A provision was also recognised for the potential obligation to repay the development expenses incurred directly by Forest in the amount of the present value of 50% of the expenses incurred directly by Forest. This provision increased the research and development expenses disclosed by PAION accordingly.

The 20% premium on the overall repayment obligation was accounted for by recognising a provision in that amount and an increase in research and development expenses.

The following two cost categories were used in accounting for the claims against Lundbeck resulting from the assumption of development expenses:

1. Development expenses incurred directly by PAION but not charged on to Forest and to be reimbursed by Lundbeck.
2. Development expenses resulting from the repayment obligation to Forest
  - a. Development expenses incurred directly by PAION and charged on to Forest;
  - b. Development expenses incurred directly by Forest.

Forest's termination did not impact the disclosure of the refund claims against Lundbeck from cost category 1, so that it remained the same until the balance sheet date. These refund claims were recognised as revenues while the related development expenses were recognised as cost of revenues. The costs were mainly current production development expenses. These claims against Lundbeck, which are due immediately, were recognised as trade receivables.

The refund claims against Lundbeck resulting from cost category 2a were recorded as revenues, whereas the corresponding development expenses were recognised as cost of revenues. PAION's refund claim against Lundbeck resulting from cost category 2b was recognised in profit or loss by being netted with the corresponding development expenses. The 20% premium payable on cost categories 2a and 2b were also included in the refund claim against Lundbeck.

The amount of the refund claims against Lundbeck resulting from cost categories 2a and 2b depended on the extent to which PAION exercises its future joint marketing options. The accounting treatment was based on the assumption that PAION would exercise all options; hence, the lowest possible refund claim against Lundbeck was recorded.

The refund claims against Lundbeck resulting from cost categories 2a and 2b would not have been due until Desmoteplase received regulatory approval in Europe and/or Japan. As they were due in more than one year, the refund claims were carried in the balance sheet as a non-current asset at their present value. In the consolidated cash flow statement, changes in these long-term refund claims were classified as a cash flow from operating activities because of their operating nature. Hence, they were stated in the same way as the changes in the long-term repayment obligation to Forest, which was also presented in the cash flows from operating activities.

Due to Forest's termination of the licence agreement, PAION's repayment obligation to Forest ceases to apply. The related provision was therefore reversed in the third quarter of 2007. The refund claim against Lundbeck directly related to this repayment obligation was also cancelled due to the lack of a reference value and was derecognised accordingly. With respect to the impact of these two license agreements and especially Forest's termination of the agreement on the consolidated financial statements, please refer to the additional disclosures on the respective balance sheet and income statement items.

## Notes to the Consolidated Balance Sheet

### I. Intangible Assets

Intangible assets break down as follows:

in EUR	Industrial rights and similar rights and assets
Acquisition costs	
1 Jan. 2006	830,555.00
Additions	84,749.82
Disposals	61,642.05
31 Dec. 2006	853,662.77
Additions	92,995.90
Disposals	0.00
31 Dec. 2007	946,658.67
Accumulated amortisation, depreciations and impairment losses	
1 Jan. 2006	316,351.39
Additions	74,703.50
Disposals	61,638.56
31 Dec. 2006	329,416.33
Additions	92,595.00
Impairment losses	62,297.50
Disposals	0.00
31 Dec. 2007	484,308.83
<b>Carrying amounts as of 31 Dec. 2006</b>	<b>524,246.44</b>
<b>Carrying amounts as of 31 Dec. 2007</b>	<b>462,349.84</b>

Additions in fiscal year 2007 mainly relate to the acquisition of a document management system (EUR 62k) for the purpose of archiving the documentation on the clinical development of Desmoteplase and preparing the related documents for the regulatory authorities. Due to the postponement in the development of Desmoteplase and the fact that the future development is spearheaded by Lundbeck, the document management system is currently not being utilised. As of the balance sheet date, the system was therefore written down in full; the write-down was recorded under research and development expenses.

## 2. Equipment

Equipment developed as follows:

in EUR	Plant and machinery	Other plant, factory and office equipment	Payments on account and assets under construction	Total
<b>Acquisition cost</b>				
1 Jan. 2006	802,24.58	1,515,880.83	69,287.79	2,387,893.20
Additions	110,908.27	170,858.16	86,257.66	368,024.09
Disposals	157,007.28	88,161.32	0.00	245,168.60
Reclassification	0.00	94,845.45	-94,845.45	0.00
31 Dec. 2006	756,625.57	1,693,423.12	60,700.00	2,510,748.69
Additions	34,834.00	77,630.59	0.00	112,464.59
Disposals	4,292.36	138,816.75	0.00	143,109.11
Reclassification	0.00	60,700.00	-60,700.00	0.00
31 Dec. 2007	787,167.21	1,692,936.96	0.00	2,480,104.17
<b>Accumulated amortisation, depreciation and impairment losses</b>				
1 Jan. 2006	366,318.68	927,251.30	0.00	1,293,569.98
Additions	128,509.00	161,032.90	0.00	289,541.90
Disposals	156,987.28	79,247.83	0.00	236,235.11
31. Dec. 2006	337,840.40	1,009,036.37	0.00	1,346,876.77
Additions	158,895.09	140,635.06	0.00	299,530.15
Impairment losses	0.00	68,020.17	0.00	68,020.17
Disposals	1,701.00	135,408.25	0.00	137,109.25
31 Dec. 2007	495,034.49	1,082,283.35	0.00	1,577,317.84
<b>Carrying amount as of 31 Dec. 2006</b>	<b>418,785.17</b>	<b>684,386.75</b>	<b>60,700.00</b>	<b>1,163,871.92</b>
<b>Carrying amount as of 31 Dec. 2007</b>	<b>292,132.72</b>	<b>610,653.61</b>	<b>0.00</b>	<b>902,786.33</b>

Due to the staff reductions following the negative results of the DIAS-2 study, the lease for an office floor was terminated as of 31 December 2007. The leasehold improvements made on this floor at the beginning of the year were consequently written down as of the balance sheet date (EUR 68k).

Equipment includes assets of EUR 125k acquired through finance leases (prior year: EUR 198k); the gross value of these assets as of the balance sheet date came to EUR 358k (prior year: EUR 393k) and mainly relates to a bioprocess system for the production of Desmoteplase.

### 3. Long-Term Refund Claims Resulting From the Assumption of Development Expenses

The long-term refund claims from the assumption of development expenses disclosed in the prior year were due by the cooperation partner Lundbeck. These refund claims related directly to PAION's repayment obligations to the cooperation partner Forest. Since Forest terminated the cooperation agreement with PAION at the end of August 2007, all repayment obligations became void, making the related refund claims against Lundbeck obsolete. The derecognition of the refund claims against Lundbeck resulted in expenses of EUR 8,222k in fiscal year 2007, which were disclosed under research and development expenses.

### 4. Trade Receivables

Trade receivables for fiscal year 2007 and the prior year relate to refund claims for development expenses for Desmoteplase arising in connection with the license agreement with Forest and the original agreement with Lundbeck.

Trade receivables are non-interest bearing and are generally due in 30 days. As of 31 December, the age structure of trade receivables break down as follows:

in EUR k	Total	Neither overdue nor written down	Overdue, but not written down		
			< 30 days	30-60 days	61-90 days
2007	777	464	89	60	164
2006	2,291	2,291	0	0	0

### 5. Prepaid Expenses and Other Assets

Prepaid expenses and other assets mainly include VAT refund claims of EUR 146k (prior year: EUR 385k), deferred interest claims of EUR 139k (prior year: EUR 187k), prepaid insurance premiums and rental payments of EUR 131k (prior year: EUR 182k).

## 6. Cash and Cash Equivalents

Cash and cash equivalents are composed as follows:

in EUR k	31 Dec. 2007	31 Dec. 2006
Short-term deposits	39,788	54,146
Banks balances and cash on hand	3,113	3,043
	<b>42,901</b>	<b>57,189</b>

Bank balances earn interest at floating rates based on daily bank deposit rates. Short-term deposits are made for varying periods of up to three months and earn interest at the respective short-term deposit rates.

## 7. Equity

As of 31 December 2007, the share capital amounted to EUR 16,755,552.00 and is divided into 16,755,552 no-par value shares.

By resolution adopted by the annual general meeting on 10 May 2006, the management board was authorised to increase share capital on or prior to 10 May 2011, with the consent of the supervisory board, on one or more occasions, by up to an aggregate of EUR 7,850,000.00 through the issuance of up to 7,850,000 new no-par value bearer shares in return for cash contributions or contributions in kind (Authorized Capital 2004). Authorized Capital I is still fully available for issue.

By another resolution adopted by the annual general meeting on 10 May 2006, the management board was authorised to increase share capital on or before 10 May 2011, on one or more occasions by up to an aggregate amount of EUR 63,000,000.00 through the issuance of convertible or warrant-linked bonds with a maximum term of 20 years and grant the holders or creditors of bonds conversion or option rights to new shares in PAION AG with a proportionate share in share capital of up to an aggregate of EUR 6,300,000.00 (Conditional Capital I). Conditional Capital I has not yet been used up.

In addition, pursuant to a resolution adopted by the annual general meeting on 30 December 2004, the share capital of PAION AG was conditionally increased by an aggregate amount of up to EUR 1,000,000.00 by issuing a total of up to 1,000,000 new ordinary no-par bearer shares (Conditional Capital 2004 II). The conditional capital increase may be executed only to the extent that the holders of options granted by PAION AG in connection with the Stock Option Plan 2005 exercise their options. To service the Stock Option Plan 2005, the annual general meeting on 26 August 2005 resolved to conditionally increase PAION AG's share capital by up to another EUR 110,000.00 through the issuance of a maximum total of 110,000 new no-par value bearer shares (Conditional Capital III).

## 8. Provisions

Provisions developed as follows:

in EUR k	31 Dec. 2006	Utilisation	Release	Addition	31 Dec. 2007
Premiums/management bonuses	374	368	0	353	359
Refund obligation to Forest	10,610	0	10,890	280	0
Other	75	0	13	0	62
	<b>11,059</b>	<b>368</b>	<b>10,903</b>	<b>633</b>	<b>421</b>

The provision recognised in the prior year for the repayment obligation to Forest for development expenses was reversed due to Forest's termination of the cooperation agreement in August 2007, as all of PAION's repayment obligations became obsolete. The derecognition of the provision resulted in income of EUR 10,890k in fiscal year 2007, which was disclosed under research and development expenses.

## 9. Financial Liabilities

Financial liabilities relate to a subordinated loan of EUR 7,000,000 raised in April 2006. The subordinated loan was granted by HSBC Trinkaus & Burkhardt KGaA, Düsseldorf, Germany, and is part of the structured mezzanine financing scheme entitled "H.E.A.T. Mezzanine I-2006". In the interim, HSBC Trinkaus & Burkhardt KGaA transferred the subordinated loan to H.E.A.T. Mezzanine S.A., Luxembourg. The bullet loan has a seven-year term and was paid out less the discount of EUR 280,000. The financial liability has a fixed interest rate of 7.933% p.a. and, as such, is not subject to an interest rate risk. Only a sustained ratings deterioration can result in an increase in the interest rate to 8.433%. The effective interest rate is 9.05% p.a. Interest payments are due on a quarterly basis.

## 10. Finance Lease Liabilities

Liabilities due to lease contracts are recognised when the respective asset is recognised under assets (finance lease). They are recorded at their present value. Lease payments of EUR 138k (prior year: EUR 219k) are due to the lessor over the next few years. The interest included therein comes to EUR 5k (prior year: EUR 12k).

The finance lease liabilities are presented according to their maturity as follows:

in EUR k	Lease payments	Interest portion included	Lease liability
2008	75	4	71
2009	63	1	62
	<b>138</b>	<b>5</b>	<b>133</b>

## II. Deferred Income

In the prior year, deferred income included a non-repayable signing fee which was due upon conclusion of the license agreement with Forest. Originally, it was intended to recognise the signing fee proportionally upon achieving respective milestones. Due to Forest's termination of the cooperation, the deferred signing fee of EUR 1,669k was reversed and recognised as revenues.

As of 31 December 2007, deferred income still included investment grants which PAION received from the Federal Ministry for Education and Research (Bundesministerium für Bildung und Forschung). The deferred investment grants are released in line with the depreciation/amortisation of the underlying assets. The amounts released are deducted from research and development expenses (EUR 24k; prior year: EUR 24k). The portion of the grants which is not due within the next 12 months is disclosed under non-current liabilities (EUR 27k; prior year: EUR 52k).

## 12. Trade Payables

As of 31 December 2007, trade payables amounted to EUR 2,295k (prior year: EUR 4,509k). They are non-interest bearing and are generally due in 30 days.

### 13. Other Current Liabilities

Other current liabilities comprise the following items:

in EUR k	31 Dec. 2007	31 Dec. 2006
Wage tax	121	145
Vacation entitlements	111	166
Other	88	6
	<b>320</b>	<b>317</b>

### Notes to the Consolidated Income Statement

#### 14. Revenues

Revenues in fiscal year 2007 are attributable to the refund of development expenses by the cooperation partners Forest and Lundbeck (EUR 3,177k) and a deferred signing fee which was released due to Forest's termination of the cooperation (EUR 1,669k). Revenues in the prior year solely included the refund of development expenses by Forest and Lundbeck (EUR 10,459k).

#### 15. Other Income (Expenses), Net

This item mainly includes income for services provided in the area of clinical development and pharmacovigilance (EUR 174k) as well as other minor effects that cannot be allocated to other line items.

## 16. Financial Income

Financial income breaks down as follows:

in EUR k	2007	2006
Discounting of provisions	2,585	250
Interest income on the basis of amortized cost (bank balances and short-term deposits)	1,958	1,792
Discounting of non-current refund claims	6	0
	<b>4,549</b>	<b>2,042</b>

## 17. Financial Expenses

Financial expenses comprise the following items:

in EUR k	2007	2006
Discounting of non-current refund claims	1,951	189
Expenses on the basis of amortised cost (subordinate loan)	471	444
Unwinding of discount for provisions	9	0
Finance lease expenses	7	10
Other	0	3
	<b>2,438</b>	<b>646</b>

## 18. Income Taxes/Deferred Taxes

Tax losses have been incurred from the time of PAION Deutschland GmbH's formation in 2000 up to and including 2007. As of 31 December 2007, tax loss carryforwards came to some EUR 70m (prior year: EUR 60m). Under current German tax legislation, these tax losses can be carried forward indefinitely and netted against future income.

The combined income tax rate of 39.77% applied in the past will decrease to 31.41% from 2008 onward due to the German business tax reform. Of this new tax rate comprises corporate income tax of 15%, the solidarity surcharge, which itself constitutes 5.5% of the corporate income tax, and trade tax on income levied at 15.58%.

Applying the combined income tax rate pursuant to the 2008 German business tax reform, deferred tax assets on tax loss carryforwards amounted to EUR 22m as of 31 December 2007 (prior year: EUR 24m, calculated on the basis of the old tax rate). Debit differences between the tax base and the IFRS carrying amount as of 31 December 2007 result in deferred tax assets of EUR 1k (prior year: EUR 320k).

Further losses are expected for the years to come and, as such, it is not yet considered likely that the deferred tax assets will be realised. In accordance with IAS 12.34, “**Income Taxes**”, the deferred tax assets on loss carryforwards and the surplus deferred tax assets on temporary differences were thus not recognised.

The reconciliation of the expected income tax and the current tax expense is shown below applying a tax rate of 39.77 %:

in EUR k	2007	2006
Loss for the period	-10,512	-17,386
Expected tax expense (+)/income (-)	-4,181	-6,914
Non-recognition of deferred taxes on temporary differences	-319	35
Non-recognition of deferred taxes on tax losses of the fiscal year	4,125	6,586
Costs in connection with capital increases	0	-178
Expenses of stock options	280	443
Other	95	28
Current income tax expense	0	0

## 19. Earnings per Share

Earnings per share are calculated in accordance with IAS 33, "Earnings per Share", by dividing the net result of the year by the weighted average number of shares outstanding. The underlying weighted average number of ordinary shares outstanding is calculated as follows:

	2007	2006
Shares outstanding on 1 January	16,755,552	15,755,552
Capital increase in April 2006	0	716,667
Weighted average number of ordinary shares	16,755,552	16,472,219

Basic and diluted earnings per share are calculated on the basis of the following figures:

	2007	2006
Net result of the year in EUR	-10,512,054.28	-17,386,054.88
Weighted average number of ordinary shares for basic earnings per share	16,755,552	16,472,219
Weighted average number of ordinary shares for diluted earnings per share	16,755,552	16,472,219
Earnings per share (in EUR):		
Basic	-0.63	-1.06
Diluted	-0.63	-1.06

The outstanding stock options in the fiscal year and also in the prior year did not dilute the earnings per share.

## Notes to the Consolidated Cash Flow Statement

The consolidated cash flow statement shows how the cash and cash equivalents of PAION have changed during the course of the fiscal year due to inflows and outflows of funds. In accordance with IAS 7, "Cash Flow Statements", a distinction is made between cash flows from operating, investing and financing activities. Cash and cash equivalents disclosed in the consolidated cash flow statement include cash, bank balances and short-term deposits with a maturity of up to three months based on the date of investment.

## Other Notes

### Stock Option Plan 2005

On 30 December 2004, the annual general meeting of PAION AG approved a stock option plan for management board members and employees of PAION. Under the stock option plan, of the total of 1,102,888 stock options, 496,300 stock options can be granted to management board members and 606,588 to employees. One stock option entitles the holder to subscribe to one share from the dedicated “Conditional Capital 2004 II” and “Conditional Capital III”. The stock options have a ten-year term and can only be exercised after a vesting period. The vesting period begins on the issue date and ends, for 50% of the stock options issued, two years after the issue date; for 25% of the stock options issued, the vesting period ends three years, and for the other 25%, four years, after the issue date. Options can only be exercised when the stock price on the exercise date has increased by a cumulative 5% each year since their issue.

Development of the stock options granted:

	Stock Options No.	Weighted average exercise price EUR
Outstanding stock options as of 1 Jan. 2006	891,227	8.00
Granted	11,615	9.55
Expired	-30,926	8.00
Outstanding stock options as of 31 Dec. 2006	871,916	8.02
Granted	94,847	8.00
Expired	-82,506	8.00
Outstanding stock options as of 31 Dec. 2007	884,257	8.02

No stock options were exercised in fiscal year 2007. On 31 December 2007, 424,698 of the outstanding stock options had vested after the expiry of the vesting period. However, the appreciation in value necessary to exercise was not achieved by the balance sheet date. The weighted average remaining term of these stock options was 7.3 years as of the balance sheet date. The exercise prices of the outstanding stock options range from EUR 8.00 to EUR 9.55.

The stock options were accounted for in accordance with IFRS 2, “Share-Based Payment”. The fair value of the stock options on the date of issue was calculated using the Black/Scholes option pricing model and is being recognised in profit or loss as personnel expenses over the vesting period of two to four years. The fair value of the stock options issued in fiscal year 2007 was calculated on the basis of an exercise price of EUR 8.00 per option and a stock price of EUR 8.00 on the issue date. The term of the options until exercise was assumed to be three to five years and a risk-free interest rate of 4.2% was used. The anticipated volatility was assumed to be 47.77%. Dividends were not taken into account. Furthermore, annual employee

turnover was presumed to be 6.5%. On the basis of these parameters and assumptions, the fair values for the stock options issued in 2007 vary between EUR 2.87 and EUR 3.52, depending on the underlying term. In fiscal year 2007, personnel expenses of EUR 705k (prior year: EUR 1,115k) were recognised for the stock options issued, while, at the same time, the capital reserve was increased accordingly.

#### **Employee Participation Plan 2006**

The management board of PAION AG, with the consent of the supervisory board, launched an employee participation plan granting stock appreciation rights. Under this Employee Participation Plan 2006, 252,000 stock appreciation rights from the total 560,000 can be issued to management board members, while the other 308,000 stock appreciation rights can be issued to employees of the PAION Group. A stock appreciation right entitles the holder to receive a sum of money based on the PAION AG share price. The maximum amount payable on a stock appreciation right is limited to 100% of the exercise price. The stock appreciation rights have a ten-year term and can only be exercised after a vesting period of two years. Stock appreciation rights can only be exercised when the stock price on the exercise date has increased by a cumulative 5% each year since their issue.

Development of the stock appreciation rights granted:

	Stock appreciation rights No.	Weighted average exercise price EUR
Stock appreciation rights outstanding on 1 Jan. 2006	0	0
Granted	209,150	7.89
Expired	0	0
Stock appreciation rights outstanding on 31 Dec. 2006	209,150	7.89
Granted	0	0
Expired	-51,400	7.89
Stock appreciation rights outstanding on 31 Dec. 2007	157,750	7.89

Due to the current vesting period, none of the stock appreciation rights granted could be exercised as of 31 December 2007. The weighted average remaining term of these stock appreciation rights was nine years as of the balance sheet date. The exercise price of the outstanding stock appreciation rights is EUR 7.89.

The obligations from these stock appreciation rights are measured at fair value as of the balance sheet date in accordance with the provisions of IFRS 2 “**Share-Based Payment**”. The fair value was calculated using the Black/Scholes option pricing model. An exercise price of EUR 7.89, a stock price of EUR 1.97 as of the balance sheet date, a term of the stock appreciation rights of three years beginning at the grant date, a risk-free interest rate of 4.3%, and an annual employee turnover of 10% were used for the calculation. Dividends were not taken into account. Given the historical volatility of the shares in PAION AG, the anticipated volatility was assumed to be 93.9%. In order to account for the necessary cumulative increase in stock price and the value limits, separate option values were set for these parameters which were combined with the value of the actual exercise options. On the basis of these parameters and assumptions, the fair value of the stock appreciation rights granted was EUR 0.20 as of 31 December 2007. The payment obligations from this employee participation plan led to personnel expenses of EUR 7k (prior year: EUR 6k) in fiscal year 2007. A corresponding provision of EUR 13k (prior year: EUR 6k) was recognised.

#### **Other Financial Obligations/Contingent Liabilities**

PAION has rented office and research premises, as well as motor vehicles and some of its factory and office equipment. The lease agreements for office and research premises provide for an automatic extension of the relevant agreement provided that it is not terminated within a particular time period before the expiry of the agreement.

The future minimum lease obligations under these lease agreements are as follows:

	31 Dec. 2007 EUR k	31 Dec. 2006 EUR k
2008	403	350
2009	311	307
2010	298	297
2011	171	171
<b>Total</b>	<b>1,183</b>	<b>1,125</b>

The rental and lease expenses under these agreements came to EUR 499k in fiscal year 2007 (prior year: EUR 456k).

In addition, PAION is obligated to make payments under various license and purchase agreements pursuant to which PAION acquired the rights to certain patents. Upon the occurrence of certain events, PAION will be required to make milestone payments in an aggregate amount of up to approximately EUR 16m (which is partially payable in USD) to the contracting partners with respect to licenses for Desmoteplase, Enecadin and Solulin. PAION also agreed to pay royalties based on future net sales of Desmoteplase, Solulin and Enecadin.

#### **Employees and Personnel Expenses**

In fiscal year 2007, PAION employed an average of 75 people (prior year: 77). Of these 75 employees, 55 worked in research and development and 20 in administration and sales. Due to the negative results of the DIAS-2 study, PAION adapted its personnel structure mid-2007. As of 31 December 2007, the number of employees fell to 53 (prior year: 81).

The following personnel expenses were incurred in fiscal years 2007 and 2006:

	2007 EUR k	2006 EUR k
Salaries	6,402	6,364
Social security	714	761
	<b>7,116</b>	<b>7,125</b>

The above personnel expenses include costs of granting options under the stock option plan and the participation plan of EUR 712k (prior year: EUR 1,121k).

### **Related Parties**

Transactions with related parties must be disclosed pursuant to IAS 24, “**Related Parties**”. The management and supervisory boards as well as shareholders qualify as related parties within the meaning of IAS 24.9. With regard to the remuneration of the members of the management and supervisory boards, reference is made to the statements under “Members of the Management Board,” and “Members of the Supervisory Board” in this section.

Apart from the above, there are no significant related parties.

### **Financial Risk Management Objectives and Policies**

The objective of PAION’s business activities is currently the production development and clinical development of various substances. No revenues have yet been generated from product sales, with high expenses being incurred as forecast. PAION aims to advance the substances through the clinical development and regulatory approval process and secure the short and medium-term funding for these activities. Funding is chiefly secured by means of equity and development cooperations in the course of which the cooperation partners make milestone payments and bear development expenses directly or indirectly. The ability to raise further equity or receive milestone payments from cooperation partners depends largely on the positive progress in the clinical development of each substance. The Group’s capital structure is of minor significance. PAION’s management has therefore set its focus on managing and monitoring the individual development projects, liquidity and future liquidity needs.

Financial liabilities comprise a subordinated loan, finance leases and trade payables. In addition, PAION has various financial assets such as trade receivables as well as bank balances and short-term deposits. Financial assets and liabilities relate directly to PAION’s business activities or financing of current operations.

PAION has not used derivative financial instruments either in the reporting or in the prior fiscal year.

PAION is exposed to the following risks arising from financial instruments:

PAION is not currently exposed to any notable **foreign currency risk**. Development expenses are charged on and financial investments made in euros. The trade payables which are denominated in a foreign currency are of secondary importance.

All of the trade receivables result from development expenses charged on to Forest and Lundbeck. In spite of this concentration, PAION considers the **credit risk** to be low in view of the credit standing of its two cooperation partners. Bank balances and short-term deposits are held at two major German banks and a saving bank. Various credit protection criteria are applied in selecting short-term investments (e.g. rating, capital guarantee, protection by the Deposit Protection Fund). Given the selection criteria applied and the ongoing monitoring of its investments, PAION does not believe that these activities involve a credit risk. The amounts shown in the balance sheet are the maximum credit risk.

Liquidity is monitored and managed using an enterprise planning tool for short, medium and long-term planning which has been customised for PAION. **Liquidity risks** are identified at an early stage by simulating various scenarios and using sensitivity analyses. Current liquidity is recorded and monitored on a daily basis.

The interest accruing on the bank balances and short-term deposits depend on the development of the market rates. PAION is therefore exposed to an interest rate risk in regard to these items. A 50 basis point reduction in the interest rates in fiscal year 2007 would therefore have resulted in a EUR 250k (prior year: EUR 289k) decrease in the consolidated result. The fixed interest subordinated loan is only subject to an interest rate risk in the event of a sustained ratings deterioration. In such case, the interest rate could rise by 50 basis points to 8.433%. This risk could materialise in fiscal year 2008 at the earliest.

### Financial Instruments

The following table shows the carrying amount and fair value of financial instruments disclosed in the consolidated financial statements.

in EUR k		Net carrying amount		Fair value	
		31 Dec. 2007	31 Dec. 2006	31 Dec. 2007	31 Dec. 2006
Financial assets					
Cash and cash equivalents	(1)	42,901	57,189	42,901	57,189
Trade receivables	(1)	777	2,291	777	2,291
Other assets	(1)	353	487	353	487
Financial liabilities					
Fixed interest subordinated loan	(2)	6,657	6,741	6,893	7,022
Liabilities from finance lease	(3)	133	207	133	208
Trade payables	(2)	2,295	4,509	2,295	4,509
Other liabilities	(2)	199	172	199	172
Measurement category according to IAS 39:					
(1) Loans and receivables					
(2) Liabilities recognised at amortised cost					
(3) Measurement according to IAS 17					

Cash and cash equivalents, trade receivables, other assets, trade payables and other liabilities are all short-term. Thus, the carrying amounts as of the balance sheet date correspond with the fair value. The fair value for the fixed interest subordinated loan was measured at the present value using the term structure of interest rates applicable on the balance sheet date for payments in connection with this liability.

### Members of the Management Board

The members of the management board are:

- Dr. Wolfgang Söhngen, CEO, Chairman
- Alexander Vos, COO, Deputy Chairman
- Dr. Mariola Söhngen, CMO
- Bernhard Hofer, CFO

In fiscal year 2007, the total remuneration paid to management board members was EUR 1,088,004. As of 31 December 2007, a total of 496,300 stock options (fair value on the date of issue: EUR 1,764,347) and 100,000 stock appreciation rights (fair value as of 31 December 2007: EUR 20,000) had been issued to management board members. For further information on

the remuneration of the management board, please see our explanations under “Compensation Report” in the group management report.

The Company’s management board members are also the general managers of PAION Deutschland GmbH and work full time for the Company and for PAION Deutschland GmbH.

As of 31 December 2007, Dr. Mariola Söhngen held 645,543 shares and Dr. Wolfgang Söhngen 579,241 shares in PAION AG. The amounts disclosed each contain a portion consisting of 6,197 shares of PAION AG held by Dres. Söhngen Beteiligungs GmbH & Co. KG; in which Dr. Mariola Söhngen and Dr. Wolfgang Söhngen have interests as general partner and limited partner respectively, each with a 50% share.

As of 31 December 2007, none of the other members of the management board held shares in PAION AG.

### **Members of the Supervisory Board**

- Dr. Walter Wenninger, Leverkusen, Germany, chairman, businessman

Other supervisory board or similar positions:

- Axiogenesis AG, Cologne, Germany
- EPIDAUROS Biotechnologie AG, Bernried, Germany
- NOXXON Pharma AG, Berlin, Germany, chairman of the supervisory board
- Santaris Pharma A/S, Horsholm, Denmark

- Prof. Dr. Erich Schlick, Otterstadt, Germany, deputy chairman (since 20 June 2007); partner at Wellington Partners Venture Capital GmbH, Munich, Germany

Other supervisory board or similar positions:

- BMDSys GmbH, Jena, Germany
- Immatix GmbH, Tübingen, Germany
- Sensimed AG, Lausanne, Switzerland, chairman of the supervisory board
- Administrative board member of the Central Institute for Mental Health, Mannheim, Germany

- Dr. Jörg Spiekerkötter, Kleinmachnow, Germany; CFO of Conergy AG, Hamburg, Germany (Member of the supervisory board since 20 June 2007)

- Dr. Franz Wirtz, Stolberg, Germany, deputy chairman, businessman (Resigned on 20 June 2007)

Other supervisory board or similar positions:

- DASGIP AG, Jülich, Germany
- QIAGEN N.V., Venlo, Netherlands.

The members of the supervisory board received remuneration of EUR 108,000 for fiscal year 2007. For further information on the remuneration of the supervisory board, please see our explanations under “Compensation Report” in the group management report.

As of 31 December 2007, none of the members of the supervisory board held shares in PAION AG.

### **Auditors**

At the annual general meeting on 20 June 2007, Ernst & Young AG, Wirtschaftsprüfungsgesellschaft Steuerberatungsgesellschaft, Cologne, Germany, was appointed as auditor for the individual and consolidated financial statements for fiscal year 2007. The auditor received or will invoice the following fees for services rendered to PAION AG and its subsidiary PAION Deutschland GmbH in fiscal year 2007 and the prior year:

in EUR k	2007	2006
Audit	52	56
Tax advisory	2	8
Other services	20	21
	<b>74</b>	<b>85</b>

Other services mainly relate to fees for the review of the quarterly financial statements.

### **Corporate Governance**

The supervisory board and management board of PAION AG declare that they are committed to responsible and transparent management and control focused on long-term added value.

The Company complies, for the most part, with the recommendations set forth in the most recent version of the German Corporate Governance Code dated 14 June 2007. On 16 November 2007, the supervisory board and the management board issued the declaration of compliance with the Corporate Governance Code pursuant to Sec. 161 AktG [“Aktengesetz”: German Stock Corporation Act]. This declaration of compliance is published on PAION AG’s website ([www.paion.de](http://www.paion.de)).

### **Events Occurring After the Balance Sheet Date**

By notice dated 29 January 2008, PAION’s cooperation partner Lundbeck announced that the licence agreement concluded on 21 December 2007 had taken effect as of that date after the patent review had been completed. For further details of this new cooperation agreement, please see our remarks in the group management report.

Aachen, Germany, 29 February 2008

PAION AG

(signed) Dr. Wolfgang Söhngen      (signed) Alexander Vos  
(signed) Bernhard Hofer              (signed) Dr. Mariola Söhngen

Responsibility Statement (Bilanzzeit) in accordance with section 37y no.1 of the Wertpapierhandelsgesetz (WpHG - German Securities Trading Act) in conjunction with sections 297(2) sentence 4 and 315(1) sentence 6 of the Handelsgesetzbuch (HGB - German Commercial Code)

“To the best of our knowledge, and in accordance with the applicable reporting principles, the consolidated financial statements give a true and fair view of the assets, liabilities, financial position and profit or loss of the group, and the group management report includes a fair review of the development and performance of the business and the position of the group, together with a description of the principal opportunities and risks associated with the expected development of the group.”

Aachen, 29 February 2008  
PAION AG

(signed) Dr. Wolfgang Söhngen  
(signed) Bernhard Hofer

(signed) Alexander Vos  
(signed) Dr. Mariola Söhngen

## Audit opinion

We have audited the consolidated financial statements prepared by PAION AG, Aachen, Germany, comprising the balance sheet, income statement, cash flow statement, statement of changes in equity and the notes to the consolidated financial statements, together with the group management report for the fiscal year from January 1, 2007 to December 31, 2007. The preparation of the consolidated financial statements and group management report in accordance with IFRSs [International Financial Reporting Standards] as adopted by the EU, and the additional requirements of German commercial law pursuant to Sec. 315a (1) HGB [“Handelsgesetzbuch”: German Commercial Code] is the responsibility of the Company’s management. Our responsibility is to express an opinion on the consolidated financial statements and on the group management report based on our audit.

We conducted our audit of the consolidated financial statements in accordance with Sec. 317 HGB and German generally accepted standards for the audit of financial statements promulgated by the Institut der Wirtschaftsprüfer [Institute of Public Auditors in Germany] (IDW). Those standards require that we plan and perform the audit such that misstatements materially affecting the presentation of the net assets, financial position and results of operations in the consolidated financial statements in accordance with the applicable financial reporting framework and in the group management report are detected with reasonable assurance. Knowledge of the business activities and the economic and legal environment of the Group and expectations as to possible misstatements are taken into account in the determination of audit procedures. The effectiveness of the accounting-related internal control system and the evidence supporting the disclosures in the consolidated financial statements and the group management report are examined primarily on a test basis within the framework of the audit. The audit includes assessing the annual financial statements of those entities included in consolidation, the determination of entities to be included in consolidation, the accounting and consolidation principles used and significant estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements and the group management report. We believe that our audit provides a reasonable basis for our opinion.

Our audit has not led to any reservations.

In our opinion, based on the findings of our audit, the consolidated financial statements comply with IFRSs as adopted by the EU, the additional requirements of German commercial law pursuant to Sec. 315a (1) HGB and give a true and fair view of the net assets, financial position and results of operations of the Group in accordance with these requirements. The group management report is consistent with the consolidated financial statements and as a whole provides a suitable view of the Group’s position and suitably presents the opportunities and risks relating to future development.

Cologne, Germany, March 3, 2008

Ernst & Young AG  
Wirtschaftsprüfungsgesellschaft  
Steuerberatungsgesellschaft

(signed) Gockel	(signed) Schlöder
Wirtschaftsprüfer	Wirtschaftsprüfer
[German Public Auditor]	[German Public Auditor]

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